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Treasury Committee

Oral evidence: Autumn Budget and spending review 2021 - 01 11 21 am, HC 825

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Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Harriett Baldwin; Anthony Browne; Gareth Davies; Dame Angela Eagle; Emma Hardy; Julie Marson; Siobhain McDonagh; Alison Thewliss.

Questions 1-93

Witnesses

I: Richard Hughes, Chairman, Office for Budget Responsibility, Professor Sir Charlie Bean, Member of the Budget Responsibility Committee, OBR, and Andy King, Member of the Budget Responsibility Committee, OBR.

Examination of witnesses

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

Chair: Good morning and welcome to the Treasury Committee evidence session on the autumn statement, the Budget, and the spending review. We are very pleased to be joined by three members of the Office for Budget Responsibility. I will ask them to introduce themselves briefly in turn to the Committee, starting with Richard, please.

Richard Hughes: Good morning. I am Richard Hughes, chair of the Office for Budget Responsibility.

Professor Bean: I am Charlie Bean, the economy expert on the Budget Responsibility Committee.

Andy King: I am Andy King and I lead on fiscal issues on the Budget Responsibility Committee.

Q1 **Chair:** Thank you for joining us, gentlemen. Richard, the *FT* reported that you closed your economic forecast model more than a month before the Budget, at the request of the Chancellor. Is that correct? What were his arguments for doing that? Did you feel pressured at all to accede to that request, if he made it?

Richard Hughes: We did receive a request from the Chancellor to close our pre-measures forecast earlier than usual. We did not come under any undue pressure to do so, and we arrived by mutual agreement at the decision to close our forecast about 10 days earlier than we usually would. That was because he was conducting the first multi-year spending review that we had done here in the UK since 2015, and because of the fact that he was doing so in the wake of a pandemic that had been disruptive to public services, we thought that the public interest merited giving him more time to conduct those negotiations.

Q2 **Chair:** You were entirely comfortable—that is what I wanted to check. You did not feel pressured at all, and it was an easy decision to take.

Richard Hughes: Because there has been some public interest in this decision, we have published more information in the foreword to our document about our reasoning and about the consequences for our forecast of taking on board the later data—it has a small effect on the fiscal outlook and, basically, minimal effect on the economic outlook.

We will be reviewing our memorandum of understanding, which governs the timetable for future forecasts. If people have views on where to strike the balance between giving the Government information with time to take it on board and make decisions, and us taking on board the latest information to make forecasts, we will welcome those views. In this case, we made an exception because it was a multi-year spending review, but we plan to go back to normal service.

Q3 **Chair:** Thank you, that is very clear. In your presentation after the Budget, Richard, you said that we were in for a "white-knuckle ride" in relation to the Chancellor's fiscal targets. Will you explain what made you say that?

Richard Hughes: That is because the Chancellor set himself some new fiscal rules in this Budget. They are to get debt falling as a share of GDP by the third year of our forecast—that is 2024-25—and to balance the current Budget. The headroom that he has set aside to reach those targets is the second lowest headroom that any Chancellor has had when setting fiscal rules. It is about £17.5 billion against getting debt falling and he will be about £25.1 billion in current surplus in that year.

Those sound like big numbers but, to put them in context, that is one sixth of our three-years-ahead forecast error for debt falling. It is the second lowest headroom that any Chancellor has set themselves against fiscal rules, when they have set them in the past, and it is important to bear in mind that none of those fiscal rules was actually met; also, we are doing this against a background of continued uncertainty, both about the post-pandemic outlook—there are still big risks around the pandemic—and about the key economic developments that could affect the public finances, like interest rates and inflation. Just a 1% rise in interest rates could easily wipe out the Chancellor's headroom.

Q4 **Chair:** Given the history of fiscal targets, as you mentioned—that they have not been met—the kind of headroom that the Chancellor has, which you quantified in terms of error and so on, and future uncertainty, it sounds like a "white-knuckle ride", and huge optimism on the part of the Chancellor to think that those targets might actually be met. Is that fair?

Richard Hughes: Things have to go right for the Chancellor for those targets to be met. Typically, the risks to the public finances are always tilted towards the downside, because Governments tend to bank good news when it comes in, but they tend to not compensate for bad news when it comes in. Also, the rules are set over three years, and you have to bear in mind that the Chancellor has just done a three-year spending review, so he has fixed about 50% of public spending for the next three years, set out as departmental budgets, so it will be much more costly for him to revisit those spending plans after he has essentially guaranteed them to Departments.

The Chancellor has the one bit of flexibility that this is a rolling target—a rolling target over three years, so it is forever retreating three years into the distance. Next year, he will have an extra year to meet it, but that comes with the downside that, in essence, you never actually reach the destination of the rules, because it is always three years into the future.

Q5 **Chair:** I will switch to R&D for a moment. It seemed to me that at that point in the Chancellor's speech, there was a great flurry of different statistics and moving things around, but basically some of the R&D commitment slipped back in time—the £22 billion, for example. He also seemed to classify R&D tax reliefs as public investment. What is your view of that? Should he be counting R&D tax reliefs within the amount of public spending that he is saying is being invested in R&D?

Richard Hughes: In a moment I will ask Andy to come in, but generally one of the things that we encourage people to look at is the totality of Government support provided to a particular sector of the economy or to a particular public purpose. Whether something is scored as a tax relief or as a subsidy, in some ways, from the point of view of the use of public money, does not really matter one way or another; what matters is basically how much the Exchequer is putting towards a particular purpose—

Q6 **Chair:** Although it could be argued that a relief drives spend that might have happened anyway, even if there was no relief, whereas public spending directly on R&D is clearly a net contributor to overall spending.

Richard Hughes: That is true. There is typically more scope for dead-weight when tax reliefs are involved, because you do not know whether what you are doing is rewarding activity that would already have happened through the tax system versus purchasing something additional, which you are more likely to be able to do with direct public subsidy.

Chair: Charlie or Andy, did you want to comment on R&D and those questions?

Andy King: In terms of the R&D tax credits, there are reliefs and there are also directly payable credits for the companies that are not making profits. This is an area of the forecast, or of the public finances, where the cost has been rising quite quickly. It has also been rising more quickly than we thought.

The evidence, internationally and domestically, is that these reliefs are quite effective at incentivising more spending. From our perspective as forecasters, they seem to have been a little too effective. They are also incentivising—or it appears that they are also incentivising—some rebadging of activity to gain access to what are very generous credits. These are things that the Government have tried to push against by reintroducing a cap on how much can be claimed relative to PAYE liabilities, but it is still an area where the costs are rising quite quickly.

It is also an area where a lot of reforms were announced in this Budget that have not been scored yet—that have not been reflected in our forecast—because there are details that still need to be ironed out over this year, so it is something we will return to in the future.

Q7 **Chair:** Are the changes that will come as a consequence of those reforms going to be significant in the context of the amount of investment that we are expecting to go on in the economy?

Andy King: Since the details are not available yet, we have not looked at them in detail, but there are things that go both ways. There is reducing the amount of subsidy for investment that takes place outside the UK, and then there is the planned increase in eligibility for claims related to cloud computing and data.

Q8 **Chair:** Both of which I think the Chancellor did specifically reference in the Budget, but you are saying the detail as such is not yet known.

Andy King: Indeed. They are not reflected in the forecast.

Q9 **Chair:** Is that a normal situation?

Andy King: Yes, when details are still being formalised or if they are being consulted on, there is a line—it is a somewhat grey area, but there is a line—where there is sufficient detail for us to put a monetary value on how much it will cost in a given year, and in this case there are details outstanding.

Q10 **Chair:** On the R&D spend, the £22 billion, which was originally targeted for 2024-25 and then slipped two years—the Chancellor put that back two years—do you think that was a kind of phasing of the money because he wanted to save £2 billion and spend it later for fiscal reasons, or do you think it was a case of not actually being able to get the money out the door and find the projects to actually invest in?

Richard Hughes: It is hard for us to speculate what the Government's motivations were. Given that spending has been ramping up quite quickly, it would not be unreasonable to think that they would struggle to get all of it out the door between now and the end of the spending review period.

Chair: Great! I wish I had a lot more time to talk to you, particularly about the fiscal targets, but we are going to canter through today, because we are a bit tight on time, and I am going to go to Angela.

Q11 **Dame Angela Eagle:** Mr Hughes, the March forecast was very, very wrong. What gives you any kind of confidence that this one is going to be any better?

Richard Hughes: It is important to bear in mind that we, like all of us, have never lived through a pandemic before, so trying to understand both what it is doing to the economy in the near term and then what its long-term implications are is a real challenge for us. We look back at history, and we look back at what other shocks have done to the UK economy; another thing we have done for the first time in putting these forecasts together is talk to public health experts and epidemiologists about the outlook for the virus.

Two things changed our view about the outlook between March and now, which led us to be both more confident about what was going on in the economic outlook in the near term and also led us to revise down our assessment of the scarring assumption in the medium term. On the one hand, there was the success of the vaccines. It is important to bear in mind that we were putting together our last forecast in January-February last year, when we did not have a lot of information or data about the effectiveness of these vaccines. Because we were ahead of the game in rolling them out, when we were doing our forecast in March, we basically had to take a guess—an informed guess—about how effective they were going to be. I think they have surprised public health experts as well as economists in how successful they have been in preventing serious disease and preventing people from dying from the disease. That is obviously great news for public health, but it has also been very good news for the economy—it has meant that it could open up faster. That is why you have seen a bigger surge in economic activity over the first half of this year.

Q12 **Dame Angela Eagle:** On precisely that matter, we have a very high level of infectivity of the disease out there still, and we are going into winter at a much higher level. The Chancellor talked as if it was all over and it would all be hunky-dory going forward, but there are potentially some downsides if there has to be a move to plan B or more restrictions in the period ahead. You have not taken account of any of that in your forecasting, have you?

Richard Hughes: That is not quite right. We do assume that the rise in infections acts as a drag on economic activity going into the autumn and winter, either through greater voluntary social distancing—people being reluctant to go out to shops and restaurants—or through the imposition of tighter public health restrictions. In our experience, rising case numbers lead to lower activity one way or another, because people voluntarily choose to spend less or because they are not allowed to by virtue of public health restrictions.

We do not see the risks from the epidemic as having receded entirely, and there are clearly more serious risks from a vaccine-escaping variant or waning vaccine-conferred immunity, which we flag in the outlook. That is not what we assume in our central case over the medium term, but in the near term, we assume that rising case numbers act as a drag on economic activity.

Q13 **Dame Angela Eagle:** Assuming that your forecasts are dot on, do you think that measures contained in the Budget make interest rate rises more or less likely?

Richard Hughes: Charlie should come in in a moment on that, because we have looked at not just what we see as our central case but the risks around the outlook. Obviously one of the things that we also did not anticipate back in March was the quite strong rise in inflation that we have seen in recent months. Again, that is part and parcel of the resurgence in demand that we saw over the first half of the year bumped up against supply constraints in the second half of the year, which have fed inflationary pressures.

That is something that we see as entailing some kind of interest rate response from the Bank of England, and markets are expecting that as well at some point over the coming months. It is also the case that the fiscal package that the Chancellor announced in his Budget is a net fiscal stimulus to the economy—

Dame Angela Eagle: 0.8%, I think you said.

Richard Hughes: That is about right. He has spent more than he has brought in in tax rises over the medium term, which means that there is a net fiscal injection that you would also expect monetary policy makers to have to take into account when setting monetary policy. We have also looked the possibilities if we are wrong about inflation and we see stronger inflationary pressure over the medium term, and what that might mean for the macroeconomy and for the public finances.

Q14 **Dame Angela Eagle:** Do you think that the Budget package makes interest rate rises more or less likely?

Professor Bean: That was something we explicitly built into our numbers.

Dame Angela Eagle: A rise in interest rates?

Professor Bean: Yes, more particularly bringing forward in time the rate increases that were in the market at the time we finalised the pre-measures forecast. There is a chart in the report showing the yield curve at the time we fixed the pre-measures forecast and the rate curve that we put in. They finish at about the same point, at 0.75% for Bank rate, but the increase in Bank rate comes earlier and the average increase in Bank rate relative to that pre-measures forecast is about 20 basis points over the whole of the forecast period.

Since we closed the forecast, the yield curve has moved beyond that and is about 25 basis points above even that, which reflects general worries in financial markets about the risks of inflation developing—not just in this country; it is a global phenomenon. We do think that that is one of the major sources of upside risk to interest rates if inflation turns out to be stronger than we expect.

Our central forecast has the current inflationary pressures associated with supply bottlenecks, labour shortages in parts of the labour market and so forth, largely sorting themselves out over the next six months to a year, and inflation dropping back, but it may take longer for those bottlenecks to resolve themselves, both globally and domestically.

A key issue will be what happens to the pockets of labour shortage in some parts of the labour market. We have assumed that some of the migrant workers who left during the pandemic will return—

Q15 **Dame Angela Eagle:** That's a rather big assumption.

Professor Bean: Not all of them—we assumed that basically half would return. Some of those workers will have right to remain and so forth. We also assume that some of the people who went into inactivity during the pandemic will return as the labour market gets stronger.

Q16 **Dame Angela Eagle:** My final question is about the other side of the issue, which, in an economy that is very based on consumer spending, is real living standards. The director of the Institute for Fiscal Studies, Paul Johnson, characterised real household disposable income as "awful" and "stagnant"—I think those were the words he used. Looking at the 16 years between 1992 and 2008, there was 36%-plus growth in real income; up to 2024, that figure is projected to be a mighty 2.4%. We have stagnant real incomes that may begin to fall even further if interest rates go up and mortgage costs go up as a result. This is clearly going to have an effect on the trajectory of the economy, isn't it?

Professor Bean: Yes, very much so. The main reason for that stagnation is the very low rate of productivity growth since around the time of the financial crisis.

Q17 **Dame Angela Eagle:** And you are only talking about 1.3%, 1.6%, 1.3% growth rates at the end, which is not startling.

Professor Bean: It is certainly not startling. We do have a modest pick-up in productivity growth but it is not back to anything like the pre-pandemic rates. It should be said that this is one of the big puzzles that people do not understand. It is not purely a UK phenomenon; the slowdown in productivity growth since around the time of the financial crisis is an international phenomenon. It actually looks like that slightly predates the financial crisis, so it is not purely associated with that.

Increasing productivity growth will be central to raising living standards going forward. On top of that, of course, are layered in things like the increase in taxes and the freezing of allowances announced in the March Budget.

Q18 **Dame Angela Eagle:** A million more people in the top rate of tax, because of fiscal drag.

Professor Bean: Precisely, and the health and social care levy, and so forth. We do not have real household disposable income getting above pre-pandemic levels until the back end of 2023; from then, as you correctly say, it grows at a pretty mediocre rate until the end of the forecast period.

Q19 **Chair:** May I very quickly switch to the public finances and inflation, Charlie? If inflation is rising, as is the assumption in your forecast—or part of it, at least—it is generating more tax take as people are being dragged into tax. However, it is equally increasing the servicing cost on the debt—presumably the part that is indexed—and maybe, if interest rates are following to try to keep it under control, it is having an effect through that route. What is the balance of those effects on public finances?

Professor Bean: That is something we explore in a couple of boxes in the report. The first looks at a scenario in which inflation is higher and more persistent than in our central case. In the absence of Bank of England action, inflation would be up at around 8%, which would add around 8% to the price level at the end of the forecast period. However, vigorous Bank of England action—we assume that the MPC raises rates temporarily up to 3.5%—slows the economy and brings inflation back down. The path of inflation after the Bank's response peaks at about 5.5%, coming back down about a year behind where it comes down in our central forecast.

There are two scenarios we look at, one where the inflation impulse is primarily in the product market, and another one it is coming more from the labour market. That matters for the fiscal consequences. Both of the two scenarios have the same sort of short-run effect, which is to lead to a deterioration of the order of about £30 billion, and that is really associated with the rise in the Bank rate and the implications for debt interest. The differences then lie further out. In the product market scenario, it is pretty much neutral, but in the case where more of the pressure is coming from the labour market and there are more wage increases, that has more benefit to the public finances, to the tune of about £20 billion to £25 billion five years out. Andy may want to add something on the fiscal numbers.

Andy King: The only thing I would add is that relative to a normal situation, both scenarios are more benign for the public finances, because income tax thresholds are frozen. In normal circumstances, inflation would put fiscal drag in reverse, and that would hit the public finances. Over the next five years, inflation hits taxpayers themselves in terms of their real take-home pay.

Q20 **Harriett Baldwin:** Bill Clinton's campaign manager, James Carville, famously said that when he was reincarnated he wanted to come back as the bond market, because it was the most powerful force, overwhelming what Governments are able to control. I wondered how much what is implied in the bond market with regard to inflation differs from what you assume in terms of inflation, and what would mean that you felt you were more confident about your forecasts than the collective expectations of the bond markets.

Professor Bean: I am not necessarily more confident in my forecasts than the bond market forecasts—I have to say that. Markets have, over the past few months, been pricing in the risk of higher inflation. That has led to long rates rising as well as short rates, although interestingly, in some jurisdictions short rates have risen more than long rates, which suggests a concern in the markets that central banks may overreact.

From my point of view, I have always been concerned that at this sort of point, where long rates start rising and bond prices therefore falling, you might get quite a strong reaction by investors realising that bonds are not actually as safe an asset as they had thought, and a move out of bonds. That would obviously accentuate the decline in bond prices, very much like the sort of thing we saw in 1994, if you can remember that, with the US.

Harriett Baldwin: That was what I was going to refer to, because I was trading bonds through 1994.

Professor Bean: I have always thought that that might be one of the issues—that there might be a change in market perceptions of the riskiness of different sorts of assets. There may be a bit of that that has happened, but it could go further. It is something we talked a bit about in our fiscal risk report in the summer, in the chapter about the risks to interest rates, and of course, we do not fully understand why safe interest rates have fallen as much as they have done. It would not come as a surprise to me if there was a bigger correction than many people expect, or is even priced in at the moment. It is not necessarily my central view, but I see it as a material risk.

Q21 **Gareth Davies:** I want to ask first about unemployment. You forecast in March that unemployment would reach 7.5%; you have now revised those forecasts for unemployment to peak at 5.2% and settle at around 4.2%. That is a pretty significant revision. Can you unpack for us the factors or measures that have led to such a significant revision to the unemployment forecast?

Richard Hughes: It comes back to the question from Dame Angela, which was why our outlook is more optimistic in general. It is partly, as I started out saying, the success of the vaccine, which has meant that more of our economic lives can go back to pre-pandemic normality than even we had thought back in March, because they have been so successful in allowing economic activity to normalise. One also has to give credit to the Government for the success of their policies in basically preserving the pre-pandemic economy, more or less, in aspic for us to go back to. It has kept people attached to their employers. It has helped to keep viable firms alive through the support that it has provided. What it has meant is that people coming off the furlough scheme have, generally speaking, been able to go back to their previous employers and the previous sectors in which they were employed.

There may be some structural changes in the meantime that we need to adjust to. There are obviously higher rates of shopping online and higher rates of remote working. That may have consequences for the high street. It may have consequences for businesses that are very much centred in city centres, near where people used to work in larger numbers. Obviously, there are some consequences for public transport and air transport, but generally speaking we became more optimistic between March and now about the scope for people to go back to their previous jobs and previous employers. Those businesses are still there. Those jobs are still there.

It is important to say that we have lost some labour force along the way. As Charlie intimated, we have lost some migrants back to their home countries. We have lost some people to inactivity, especially older workers taking early retirement. There will probably also be some frictional unemployment, as there is a need to adjust to some of these behavioural changes, which have been catalysed by the pandemic, and the need for people to find different places to work if the particular job that they had in the particular place that they had it is no longer there, but generally speaking we have been very pleasantly surprised, as I think everybody has, by how low unemployment has stayed throughout the pandemic, and our forecast reflects that we do not expect it to go up very much after that.

Q22 **Gareth Davies:** Thank you very much. Charlie, you have said that household consumption will largely drive the recovery that we will see, but that trade and investment will be a drag on recovery and represent part of the scarring that we will see post pandemic. Can you tell us a bit more about why you feel that trade and investment is going to contribute to scarring?

Professor Bean: Yes, but let me say first that consumption is the engine of growth this year and the early part of next year, but as we go into next year you see business investment picking up the baton, partly on the back of the super-deduction that the Chancellor introduced in March, which we assume will raise the path of investment about 10% above where it would otherwise have been. To address the question about the longer-run impact and the role of capital in this, the cumulated lost investment, if you like, as a result of the pandemic is about 7.3%. That translates into the capital stock being 1.6% below where it would have been on our last pre-pandemic forecast. That translates into an impact on potential output of about 0.6 percentage points.

That is the pure capital element of our scarring judgment. It is a bit smaller than we had back in March, where we had a 0.8 percentage point contribution. We have had some upward revisions to the past data for investment. It was weak, but not as weak as we thought it was given the current ONS numbers, and also in view of the relatively robust rebound this year—the sign that insolvencies have stayed relatively low. They are picking up now, but we did not have a lot of business disruption during the pandemic. Corporate balance sheets are in a better position than we feared. That is good news for the profile of investment going forward, and we have raised our path of investment a bit for this forecast relative to March.

Q23 **Gareth Davies:** On trade, you have been quite clear that you feel that trade is going to be a lag to our economic growth.

Professor Bean: Trade certainly drags a bit. You have reasonably strong consumption, and we have reasonably strong Government as a result of the fiscal package investment recovering. Some of that, naturally, shows up in a worsening trade picture.

Q24 **Gareth Davies:** Let me pick up on what you have said about business investment. Richard, I think you have mentioned previously that you feel the measures that the Government have announced will not have a great lasting impact on business investment. Charlie, you mentioned that you expect business investment to pick up by 10%. My understanding is that they are currently 10% below where they were pre pandemic, so you are expecting a neutral position in the short term. Richard, you have mentioned that you don’t feel the super-deduction and other measures will have a lasting impact on business investment. To paraphrase what you have said, it is more of a shot in the arm. Can you clarify those comments for us?

Richard Hughes: The main effect of the super-deduction is to move business investment around and incentivise businesses to bring forward their investment plans into the period where they actually get the benefit of the super-deduction on their corporation tax. There is a small overall increase in the level of investment over the medium term, but the vast majority of the cost of the tax credit is actually going to bring forward investment into the next few years. I do not say that in a pejorative way, in the sense that, as Charlie indicated, if you are trying to get an economic recovery going, that might be what you want policy to do—to bring forward investment and have a more balanced recovery over the next few years, compared with what you had before. The bulk of what the taxpayer is getting for its super-deduction investment is basically getting the investment to happen now instead of later, rather than increasing the overall level of investment.

Q25 **Gareth Davies:** But once the investment is made, that will lead to knock-on impacts on business activity and operations. You feel that even if that is a shot in the arm, it will not have a lasting impact on business operations and output productivity that will benefit the economy longer term.

Richard Hughes: Not a significant one.

Professor Bean: The only thing is that it has a lasting impact on activity and potential output, because you have installed the extra machines. You bring them forward in time when you make the investment, so that means that the capital stock rises faster at the beginning. Over time, the capital stock stays where it is; and where it would have been, if you had not had the super-deduction, catches up. The path of the capital stock and the path of potential output is higher in the near term than it would otherwise have been, although there is no really long-run effect 10 or 20 years down the road. In that sense, it is a sensible thing to do, because it is hastening the recovery in potential output.

Q26 **Emma Hardy:** Good morning, everybody. No pressure, but so much depends on you getting all your forecasts absolutely right. You recently revised your scarring assumptions from 3% of GDP down to 2%, but you remain more pessimistic than the Bank of England's latest estimate of 1.4% of GDP. How do you see the balance of risks around scarring, and the consequences for fiscal policy, if you are either too pessimistic or too optimistic?

Richard Hughes: It is something that we keep under constant review. We have revised it down in the light of what we have learned about—in particular, as I mentioned—the effectiveness of the vaccines in allowing our lives to return to normality, and also the effectiveness of Government policy in keeping that capacity alive such that it can then be deployed as our lives normalise. We will learn more about the consequences of how the economy functions with the vaccines fully rolled out, but also Government support fully withdrawn, over the coming months. I think we have to bear in mind that the furlough scheme was just closed in September. A lot of support for businesses has only just rolled off. We have not really seen how the UK economy functions without all that fiscal support being provided, and so we will have to keep that scarring judgment under review.

One thing I would say, though, about some of the components of that judgment is this. As I mentioned, on the labour supply component, some of the labour supply relates to the fact that inactivity rates have already risen. We have seen some net emigration from the country—or net migration fall to zero. We make some assumptions about how many people will come back to the UK as travelling conditions normalise and the economy normalises, but we will have to keep that under review to see whether those predictions are borne out.

As Charlie mentioned, we have forgone some investment during the pandemic; there is capital stock that we had previously forecast being there that is just not there. We have lost about £70 billion of investment as a result of businesses not investing during the pandemic. If there is now a bigger resurgence in investment than we expected, perhaps on the back of the super-deduction—we will keep that under review—that might lead us to revisit our assumption in the future. We are essentially data-driven, in terms of what we see. We know what we know now about labour supply and about the levels of investment. We will keep this assumption under review as more information comes to light.

Q27 **Emma Hardy:** To clarify, do you expect that assumption to change? Is that what you are basically saying?

Richard Hughes: We keep it under review in the light of the data. At the moment, it is our best judgment on the long-term consequences of the pandemic on the economy. If in future the data surprises us in one direction or another, we will of course revisit that assumption in future forecasts.

Q28 **Emma Hardy:** To what extent are the supply bottlenecks that we see consistent with your forecasts for scarring?

Richard Hughes: They are consistent with an economy that has more demand than supply at the moment, which suggests that there are some constraints on the potential output of the economy, although it is important to again bear in mind that this is not only a UK phenomenon but a global one—these supply bottlenecks are happening in all advanced economies. A lot of them relate to supply constraints in Asia rather than necessarily those faced by the UK economy. We have particular challenges in areas such as HGV drivers and finding people for key logistical jobs in the economy, and because we are also more dependent on the gas supply for energy, we are particularly exposed to gas prices compared with some other advanced economies that depend more on renewables, nuclear or other sources of energy.

Some of these bottlenecks bite a bit harder in the UK than in other economies, but this is a global phenomenon basically resulting from lots of economies reopening all at once, with lots of actual demand for goods. People who postponed their durable goods purchases during the pandemic all went out and wanted to buy things for their houses, or cars, and the places where these things are produced are struggling to produce some of the major components, such as semiconductors. We will have to keep that under review, along with everything else, but for us, at least in the UK context, it gave us some reason to think that there are constraints on not only the demand side of the economy but the supply side.

Q29 **Emma Hardy:** So you are saying that it is a global problem, but that it is more difficult in the UK because of labour shortages in some areas and our overreliance on fossil fuels?

Richard Hughes *indicated assent.*

Q30 **Emma Hardy:** Your scarring judgment, in your words, "anchors" the output forecast and is of course a major determinant of how much the Chancellor has to spend, but you acknowledge that, "with the passage of time, it will become increasingly difficult to distinguish the effects of the pandemic from other factors, like Brexit or the…'productivity puzzle'". I realise that it is obviously very tricky to work out what has harmed our country and economy more—a global pandemic in which millions of people have died or our decision to continue with Brexit—but how can we hold you accountable for whether you have made the right judgment on scarring when it is so difficult to work out exactly what the main cause of our current difficulties is?

Richard Hughes: That is right. I would say two things about that. First, in trying to decompose different structural changes that we have to take into account when forecasting the economy, it is the case that Brexit and the pandemic happened at different points in time, so we can look for turning points in data at different points in time, which we have taken into account when trying to disentangle these two effects. We have reported them separately, and we think that they have separate impacts on the economy, not least because they affect different sectors of the economy. Brexit mostly affects the tradeable goods sector while the pandemic mostly affects the non-tradeable services sector, so to some extent you can differentiate their effect on different parts of the economy.

Q31 **Emma Hardy:** Sorry, just to interrupt you on that point, in a previous answer you said that we had been hit harder globally because of labour shortages in some areas. Surely HGV drivers being one of them, because of Brexit, has meant that we have had a harder impact.

Richard Hughes: That is true. Brexit has been one factor in making it harder to find HGV drivers, although it is important to bear in mind that most of the fall in the labour force has actually been from early retirement on the part of UK-born workers, rather than those who come from Europe. Brexit clearly makes it more difficult to find labour from the kind of options that we had in the past. However, the fact that these two things happened at separate points in time allows us to interrogate the data somewhat differently.

The other thing to say is that you can also differentiate between the effects that that these two things have had on our trade with the rest of the world versus our trade with Europe. Our trading relationship with the rest of the world has more or less gone back to normal, or gone back to pre-pandemic levels, in the last few months. Trade with Europe is still down significantly, which suggests that there is something going on with our trade with the rest of Europe that is different from what is going on with our trading relationship with the rest of the world.

Q32 **Emma Hardy:** That is really interesting. I will be quick, because I am coming back to you all a bit later on, but I have just one more question. Do you think additional fiscal stimulus in the near term could help to reduce long-term scarring, and is that something you incorporate into your forecast?

Richard Hughes: We are explicitly forbidden from providing advice to Government on what they should do with fiscal policy; we just take account of what they do with fiscal policy.

I suppose what I can say is that, compared with what we thought in March and then compared with what we saw before, we have been pleasantly surprised at how successful the Government's coronavirus rescue package has been in preventing what we thought could have been much higher levels of unemployment than we have seen, and also in preserving businesses so that they could go back into trading once public health conditions allowed them to do so.

However, I should also say that what we have not seen yet is an economy that is not being provided with significant amounts of life support from the public finances, and we will have to see how that performs in the coming months.

Q33 **Anthony Browne:** I will repeat the request to keep your answers concise, because we have a lot of questions.

My question is focused on the fiscal rules and the new fiscal mandate. There are two features of these new fiscal rules that particularly strike me. One is that the primary target is the public sector net debt rather than deficit net debt, excluding Bank of England, and the other one is the fact that it is a rolling target.

On the first point, and I do not know whether it is a question for Richard first, do you think it makes sense to target the net debt rather than the deficit, which is the traditional thing that has previously been targeted?

Richard Hughes: Andy will have thoughts on this as well, having seen lots of fiscal rules in practice and having assessed them from his position at the OBR, whereas I used to set them when I was in the Treasury.

It is unique to have debt falling as the sort of headline mandate for Government; it has always been the sort of supplementary target and the logical corollary of what the Government was trying to do with borrowing or with the current balance. It is generally the case at the moment that when you balance the current budget, debt starts to fall, because you get borrowing to around 3% and GDP catches up with the debt stock.

One thing that I would say about debt is that it is something that is under much less of the Government's control; it is a stock variable rather than a flow variable. It is easier for Governments to affect the annual flow of tax and spending than it is to do something about the stock of something, which has its own price—right?—which is the interest rate. So it is something that is less under the direct control of Government, and in our experience it is something where the Government have been more along for the ride, in terms of how it performs.

It is also the kind of target that in the past has driven some perverse behaviour, including around—

Anthony Browne: Student loans.

Richard Hughes: Yes, the sale of the student loan book was a way of getting debt to fall by a certain number of billions of pounds, and it did not really matter what price you sold these things at, because you just recorded the fall in liabilities and not the loss of the asset. There are other features of debt-falling rules that can either be good or bad, depending on your perspective.

Q34 **Anthony Browne:** You have just listed a whole series of cautions about targeting the debt. Are there any positive arguments for targeting debt rather than deficit?

Richard Hughes: One thing I would say for the way that Government have specified it is that it is net debt excluding the Bank of England, which means that what it could have done was to have taken account of the fact that the Bank of England is selling off a bunch of assets over the next few years, which are the ones they took on during the financial crisis. That makes net debt including the Bank of England fall like a stone, but not for particularly interesting fiscal reasons, and they really just reflect a change in the composition of the Bank of England's balance sheet. So they have actually made it harder for themselves to meet than they otherwise would have.

Maybe Andy has some other thoughts.

Q35 **Anthony Browne:** Andy, what are your thoughts about targeting debt rather than deficit? And again, any arguments in favour of it?

Andy King: The main thing I took away from this is that I would not get hung up on which is the primary mandate and which is the supplementary target. My take on the Chancellor's presentation was that he has a debt rule and a current balance rule, which is exactly what Gordon Brown had and exactly what George Osborne had. He put less weight on the expenditure caps that are supplementary targets.

The new charter is interesting in having quite a lot of other balance sheet metrics to be watched, as opposed to targeted, so the ways of playing with public sector net debt to get it to do what you want in a forecast will not do the same to the broader balance sheet metrics. In the charter, it is clear that he is alive to the temptations that history shows of playing with public sector net debt.

If a forecast for public sector net debt falling in the target year were achieved by moving cash around, because debt is a cash metric, or by selling something for less than it is worth, as was the case with the student loans, it would be on the front page of the OBR's documentation and the first thing it would mention. There are lot of problems with public sector net debt, because it is narrow and cash based, but they all seem to be recognised in the charter and the institutional framework around it.

Q36 **Anthony Browne:** So there are sufficient safeguards around it. You mentioned Gordon Brown's target—from memory, having covered that as a journalist at the time, it was that net debt should be less than 40% of GDP. Here, the Chancellor does not have a numerical target; it just says a sense of direction and it should just be falling. What are the arguments around that? It sounds like a slightly looser definition and like it is just setting a direction, rather than absolute amounts. Is there an argument for setting an absolute amount?

Richard Hughes: The risk of having the target for it to fall is that there can be an incentive to get it to rise in the first two years, so you can get it to fall in the third. Because it is a rolling target, it is always retreating into the future, so another perverse incentive could almost be to give the economy a bit of a fiscal boost in the near term and then drag it back in the third year, to get the profile that you want. Given that you only have three years to meet it, that is an awful lot of fiscal manoeuvring that you have got to do in a short space of time.

Professor Bean: Can I just add a little bit of support for debt falling? In a big picture sense, it is a sensible thing to focus on. If you look at the history of public debt, it basically goes up in bad times—war, financial crises, pandemics—and you then have to bring the debt to GDP ratio down in the good times, to build up fiscal space to deal with the next really bad shock that comes along.

Anthony Browne: Mending the roof while the sun is shining.

Professor Bean: Yes. One of the virtues of a debt falling rule is that it is actually focusing on what you should be doing in the good times: mending the roof, building up the fiscal space. There are the problems that my colleagues have addressed about manipulating it and things like that, but if you look at it in a big picture sense, it has something to recommend it.

Q37 **Anthony Browne:** May I come to this rolling target, which you mentioned, Richard? I think it was St Augustine of Hippo who said, "Lord, make me virtuous, but not yet." Is there not a risk that by targeting something in three years' time, you never need to meet that target, because it is not a definite date? What are the arguments for and against a rolling target versus a fixed-end target?

Richard Hughes: The arguments against are the ones that you highlight—that it retreats constantly into the future.

Q38 **Anthony Browne:** It is mathematically possible that you could always meet your target but never have debt falling.

Richard Hughes: Which is what you saw when the previous Government had rolling targets for the current balance. In the EFO, we have charts that show these things just migrating along and, in the end, they were only met in one year—2018-19—out of all the years in which they were meant to be in force, from 2010 onwards.

The advantage of having a rolling target is that when making policy you assess the situation that you are given at the time, and you give yourself a bit of time to make things up, but not unlimited time. If the world looks radically different in a year's time than you thought—perhaps the pandemic is worse and fiscal policy needs a bit more flexibility to deal with it—it makes sense to take the world as it is given to you on the day, rather than as it was when you set the targets a year ago.

That is a bit how the inflation target works in monetary policy, in that you are always trying to get inflation back to 2% but, as a monetary policy maker, you take the world as it is given to you when you are having a MPC meeting and making those decisions.

Q39 **Anthony Browne:** There is a coda to that. The Monetary Policy Committee is always aiming to get it back to 2%, and you should find that out-turns are distributed reasonably symmetrically around that 2% target. There should be an analogue result here, so if the Chancellor were to stick with this debt falling rule over a number of years, assuming he has no headroom at all and is always trying to get it bang on, then you should find that debt is falling roughly half the time and slightly rising roughly half the time. If he has headroom, you should be observing it in falling territory more than half the time. You can still police the rule; it is not quite as transparently policeable as the fixed date target that we had in the past.

Q40 **Anthony Browne:** I am out of time, but I will sneak in one quick question. There are other supplementary targets, such as caps on spending. We have had welfare caps in the past, and they are understandable. There is a cap on investment spending of 3% of GDP. I was surprised by that, in the sense that we would normally think of investment as a good thing. What are the arguments in favour of capping investment spending?

Richard Hughes: You are right that given the forecasts and assumptions we make, the logical corollary is that if you balance the current budget and you have debt falling, basically that allows you to invest roughly 3% a year, which is where they have set the cap. In so far as we can understand the motivation behind it, it seems to serve the same purpose as the welfare cap, which is basically to provide an envelope for an amount of spending that can be enforced on the rest of Government when making decisions, rather than something that serves an explicit fiscal function. It is more of a budget constraint than an objective.

Q41 **Anthony Browne:** A constraint on infrastructure spending.

Richard Hughes: Yes, I suppose so, so the impression is not that the sky is the limit on the amount that the Government can invest.

Q42 **Alison Thewliss:** I would like to ask about the impact that Brexit has had. Mr Hughes, you said that the impact of Brexit will reduce long-term GDP by 4%. Can you tell us a wee bit more about that figure and how it was arrived at?

Richard Hughes: Since the referendum, we have included in our forecast an assumption that leaving the EU would reduce our long-run potential output by around 4% over a 15-year period. That was based, at the time, on our assessment of the body of economic work done on the impact of arriving at an average free trade agreement with the EU. It is important to remember that when we first made that assumption, the negotiations were ongoing. They were only just concluded a bit more than a year ago. More importantly, they only really came into force in January this year.

We did a forecast back in March, but we had very little data on what was going on with trade flows at the border. You will also remember there were health checks imposed on lorry drivers and things to do with the pandemic, which also disrupted the first few weeks of trade flow data between us and the continent. This was really our first chance to check that assessment.

That 4% number was arrived at based on a relationship between trade intensity and output. We assumed, in arriving at that 4% number, that the volume of our imports and exports of goods to the EU would fall by around 10% to 15% over the medium term. This was our first chance, in doing this forecast, to check that assessment.

Since January we have found that assessment has turned out to be broadly correct: our goods imports and exports from the EU were down by about 10% to 15% since the trade and co-operation agreement came into effect. Once you take that and use what is considered to be a pretty standard relationship between trade intensity and potential output, that gives us reason to believe that the 4% assumption that we have included in our forecast for some time is, for the moment, something that we think is valid. We will, of course, keep it under review as we get more data about our trading relationship with the EU, but for the moment it seems to be a reasonable place to be.

Q43 **Alison Thewliss:** You said around 4% over a 15-year period. Are you able to put a pound figure on that cost?

Richard Hughes: GDP at the moment is around £2 trillion, so 4% of that is about £80 billion, by my reckoning.

Q44 **Alison Thewliss:** That is a significant figure. In the forecast, you stated that in the UK, supply bottlenecks are being exacerbated by changes in migration and trading regimes following Brexit. The Chancellor said that he thinks the bottlenecks are caused by global imbalances. Can you tell us how much you attribute to a global imbalance and how much is Brexit?

Richard Hughes: In the near term, it is more difficult to disentangle. Most of the supply bottlenecks we are seeing are a global phenomenon, to do with the difficulties in our being to access goods from abroad. In specific markets—HGV drivers is one—it is clearly more difficult for us to access workers from the continent, by virtue of the fact that they are no longer allowed to work here as freely as they used to be able to. There are also restrictions on those that do make deliveries here—their ability to do what is called cabotage, which is picking up and making local deliveries while they are in the country—which also reduce our logistics capacity here in the UK. So it exacerbates the supply chain problems; I would not say it is the underlying cause of our supply chain problems or bottlenecks, but it does make things more difficult.

Q45 **Alison Thewliss:** In areas such as construction, there are real pressures in terms of HGV drivers being able to bring things into the country and prices from the EU. I understand that the majority of the timber we import comes from the EU, where prices have skyrocketed by up to 74%. Can you talk a bit about the impact that has on the wider economy—these kinds of increase on sectors such as construction?

Richard Hughes: I confess that I am not an expert in the timber market. A number of things are going on in the housing market: there has been a big surge in demand for housing and for home refurbishment during the pandemic, which has been difficult to judge and predict. There are demand and supply components to that. My colleagues may have something more to say about what is going on in the housing market.

Professor Bean: The builders have just left my house, but I had to wait the best part of six months for them to be able to start, precisely because there was a rush of people wanting to do things as the pandemic eased, coupled with shortages of both materials and people to do the building work. You have a lot of these both demand and supply elements in lots of different markets. It is fair to say that quite a lot of this is global—things like the shortage of semiconductors, which is holding up car production. That is about problems in Asia, where most of them are produced, covid outbreaks at factories, which have had to be closed, and things like that. Layer on top of that the problems of transporting goods between countries, containers backing up at ports and things like that, there are long consequences thereafter until they all unravel. It is difficult to unpack all those elements, but I think it is fair to say that a lot of the product market issues are primarily global, whereas labour market issues tend to be more local or domestic in nature.

Q46 **Alison Thewliss:** You talked in your report about the impact of migration and the changes that has made to the economy. Are you able to put any figures on the impact of reduced migration to the UK from the EU?

Richard Hughes: It is part of our general scarring assumption that we assume that we lose about 160,000 in total from the labour force, but that is a mixture of UK residents leaving the labour forces and going into inactivity by taking early retirement and other things, and an element of loss of migrants who otherwise would have either come here or stayed here to stay in the workforce. That is a minority of the effect on the labour force, but it is none the less significant. There is a chart somewhere in the Blue Book which compares the profile of what we had previously assumed about net migration into the UK—if I cannot find it now, I will send you a reference to it.

Alison Thewliss: I think I remember seeing the chart, so that’s okay.

Professor Bean: It is on page 35.

Q47 **Alison Thewliss:** Yes. That is very interesting. I know you do not get into policy decisions and things like that, but do you feel that there is a financial cost and an impact on your forecasts from reducing migration from the EU?

Richard Hughes: There will have been, at the time we made the assumption about having lower long-run potential output, because some of the output would have been taxed. Another thing to say about the profile of migration is that EU migrants were particularly favourable to the public finances, in the sense that we tended not to pay for their education, they came here and were largely in employment, and they oftentimes did not bring dependants with them. What we did not know was whether they were going to stay and collect a pension, or go home. Compared with the profile of migrants from the rest of the world, they had some fiscal advantages. But it is also important to say that these numbers are still relatively small in the grand scheme of things, in terms of the public finances. The bigger loss comes from the fact that we have a less trade-intensive economy; we are less connected, in terms of trade links, to the rest of the world. That has consequences for the long-run productivity of the economy as a whole, rather than necessarily the individuals who were either here or not here and working.

Alison Thewliss: Thank you. I have loads more questions I could ask, but I don't want to go over my time.

Q48 **Anthony Browne:** My questions now are about climate change and reaching net zero, and the money allocated to that—you have a very nice box in your report about it. The Treasury estimates that the amount of net zero spending up to 2024 will be £25.5 billion; that is the aggregate of all the different pots that it is spending. Do you think that that is a sufficient amount to meet the net zero target by 2050?

Richard Hughes: I might ask Andy to take this one, as he is somebody who specialised in putting together the announcements we did back in July on climate change as well as in the box.

Andy King: Of course, "sufficient" is not a question that the OBR can answer, but stepping back—

Q49 **Anthony Browne:** You do an estimate of the cost of reaching net zero, or you have assumed it from the Climate Change Committee.

Andy King: Indeed. What we did was to present some scenarios of what the fiscal cost could be, given different assumptions about the share of total investment to get to net zero that would be borne by the public sector. Implicit in that is decisions that the Government would take about which tools to use to get to net zero. Public spending is just one. Regulation is obviously a key tool when, essentially, you are trying to bring something down to zero. Tax is another tool—for pricing carbon more highly to incentivise the route to net zero.

We can compare the Government's numbers to what we had in the main scenario we presented in July, which is the nice box, as you kindly put it, and the numbers are pretty similar over the first four years, but it's four years out of 30 where the amount of investment ramps up significantly over the first 10 to 15 years and the amount of gains from net zero technologies really ramp up towards 2050 as we are driving more efficient cars and so on. It really is for the Climate Change Committee to be the quango that says whether these numbers are sufficient.

The one reflection I might offer is that my job on this committee, in terms of the fiscal implications of the policy measures in the Budget, means that what is known as the Budget scorecard, with every single policy measure, has attached to it a pounds and pence figure that has been through external scrutiny, so you know the answer as to whether the fiscal measures are sufficient to meet the fiscal targets. There isn't the same institutional infrastructure around the emissions effects of these measures; there isn't an emissions scorecard and there isn't an emissions me who is looking at the Budget in real time. So, the question of whether it is sufficient to get to net zero is an open question, whereas on the fiscal question—subject to the uncertainties around our forecasts—there is an answer to it on Budget day.

Q50 **Anthony Browne:** So the way we calculate it effectively makes it seem more like a cost rather than a benefit, in terms of tackling carbon emissions, because you're not counting the cost of the emissions, which is a classic market failure argument.

Andy King: Well, there are no emissions numbers attached to these public spending numbers. It doesn't say, "This gets us x% of the way there." It's similar to the fuel duty measure, freezing fuel duty—we don't know that this takes us x% further away—and to the other incentives that were there for more net zero investment and for curtailing the longest long-haul flights. There isn't actually an emissions number that says, "This is 1% of the"—

Q51 **Anthony Browne:** Presumably the Climate Change Committee will be looking at that at some point.

One of the things that you highlight is that when the Treasury does its figures for net zero, it looks at the gross amount rather than the additional costs. The example you give is that it has the cost of an electric bus, but not the counterfactual-cost of buying a diesel bus. The figures that the Climate Change Committee say are needed are the net additional costs. Does that matter? What difference does it make—does it make the figures look larger than they might otherwise be?

Andy King: I think that the conclusion we reached was that it could go both ways; in the bus example, clearly the gross cost is greater than the net additional cost. If the Government are choosing to subsidise an activity with a subsidy that is worth less than the net additional cost, so some of the cost is borne by the private sector, then it would go the other way—the public sector gross cost would be lower than the whole economy net additional cost.

We were not in a position to reach a conclusion as to which side of the line these pluses and minuses would leave you. Again, I think it is likely that the Climate Change Committee will want to look at how their numbers from prior to the Budget line up with those that are now in the spending review and Budget.

Q52 **Anthony Browne:** On the issue of taking earlier rather than later action, I understand that you have looked at the costs, or the benefits, of that. Do you agree that there are economic benefits to taking earlier rather than later action? Is it right that the costs will be less?

Andy King: We looked at a scenario that involved delaying action, and then going really hard to still meet the 2050 target; in that scenario, the costs were double those of a smoother process.

The key here is that there is a lot to do and doing it in an orderly way over 30 years will be better and cheaper than trying to cram it into 20 years. Think of the 28 million houses that need insulation and a heat pump; it is easier to deliver this over 30 years than over 20 years.

Anthony Browne: That is fairly obvious, really.

Richard Hughes: May I add that there is a fiscal dimension to this as well? We assumed in the scenarios that we did that the Government were also introducing a carbon tax, as a way of helping the economy along the way to net zero and providing an incentive to reduce emissions. Another dimension to what you lose if you go later is that you lose the opportunity to tax some carbon while you are still creating it—to help offset some of those costs. You must remember that in the meantime the Government are losing tax revenues from fuel duty as more and more people move to electric vehicles. The earlier you make all the fiscal decisions that get you to net zero, the lower the net fiscal costs, because you have to take into account the fact that you are also missing opportunities to tax carbon along the way.

Q53 **Anthony Browne:** That is my next question. Clearly, the Government do lose certain revenues, and fuel duty is the obvious one as we move to electric vehicles. Moving to net zero, how big a fiscal hole is created by losing tax revenues that we would have otherwise got?

Richard Hughes: North of £30 billion, is my recollection.

Andy King: Ultimately, 1.5% of GDP; roughly £30 billion from electric vehicles. It is one of these areas where consumers' choices are running ahead of assumptions that we have made in the past.

Q54 **Anthony Browne:** In what way? That the take-up of electric vehicles is faster than predicted?

Andy King: Yes. Take-up is increasing at a faster rate. Looking around at some of the other countries in the world: Norway has had a really very dramatic change in the take-up of electric vehicles. Once some people on the street have them, the roll-out happens quicker—the behaviour is changing quite quickly.

Q55 **Anthony Browne:** Norway is a far richer country than the UK—it is easier for them to afford expensive cars. I am half-Norwegian; I can say that.

My last question is on that fiscal hole that you say is £30 billion. This may be outside your remit, but is there any reason why that should be met by taxation on motoring, rather than just as part of the broader mix of taxation policy?

Andy King: I think this is something that the Government have said themselves, in the Prime Minister's 10-point plan and in the net zero review. These look at the issue that this is essentially a tax cut on motoring, and there are things beyond just carbon emissions that you would worry about with motoring.

Q56 **Anthony Browne:** Like congestion?

Andy King: Congestion being the obvious one. I think the way it has been described is that the Government will look at maintaining the tax burden on motoring, but the precise tools are not for the OBR.

Anthony Browne: I look forward to hearing more about them in the future. That is all we have time for. Thank you.

Q57 **Julie Marson:** I have some questions about the spending plans. I will start by putting them in context: we have seen that total Department spending is due to rise, in real terms, by 3.8% every year for the life of the Parliament. We have seen that a lot in the press. Can you confirm that that is the largest real-terms increase in Department spending this century?

Richard Hughes: If you compare it with multi-year exercises done in the past, the real percentage growth is similar to what you saw in the rate of growth in resource DEL in the spending reviews done in the early 2000s by the then-Government. I seem to remember that the 2002 and 2004 spending reviews had real growth rates and resource DEL of around 4%. So, in cash terms, that may be true, but if you look at growth rate terms, it is slightly under some of the spending reviews done in the Blair/Brown years of the early 2000s.

Q58 **Julie Marson:** Thank you. They are still large, obviously. How do they feed through into your inflation forecasts? I am thinking of things like the end of the public sector pay freeze, for example. How does that feed through to the inflation forecasts?

Richard Hughes: We look at these things in the round, because you have to bear in mind that the impact on the economy is not just what is happening to spending, but what people are paying in tax and what is happening to the benefits system. As Charlie alluded to, we do see some inflationary effect, and then therefore some consequences for interest rates in the fact that, in net terms, this Budget delivered a net fiscal stimulus to the economy.

It was on the order of adding about 0.25% to interest rates, and that obviously feeds into our forecast for inflation, which is that it picks up to above 4% over the medium term. However, I should say that that is mostly driven by what is happening to global energy and product prices, not, in a large part, to what the Government is doing with spending.

Q59 **Julie Marson:** In a way, the risk is that actually Departments will not get as much of a real-terms spending increase, because of the risk of inflation being factored into it.

Richard Hughes: That is a challenge for the way in which we do departmental budgeting, which is that we set cash limits for Departments three years ahead to give them predictability about their spending plans, but if inflation turns out to be on the upside, they are essentially asked to absorb those costs, unless they can get more money out of the Treasury in the middle of a spending review. That is then a matter for Departments and the Treasury, but the principle of multi-year spending rounds is that your budget is fixed in cash terms, and you absorb inflation within that.

Q60 **Julie Marson:** Back in March, the OBR economic and fiscal outlook report observed that there were risks that spending could be greater than forecast due to spending pressures on health, social care, local authorities and transport. To what extent do you think those risks still exist, notwithstanding the level of spending that has been announced?

Richard Hughes: The ones that we highlighted, in both our March forecast and the fiscal risks report, have been, in large part, addressed by the profile of Government spending over the next three years. The money given out to the Departments for Health, Education and Transport was very much front-loaded over the next three years to deal with these post-pandemic catch-up pressures.

However, I should say a few things about that. First, the health system has been perennially under pressure, and it has been the revealed preference of Government to top up the health budget with more, whatever they get. That can be particularly true when it comes to pressures on pay.

Secondly, on the transport side, it really remains to be seen what the financial model for transport is in the long term. We don't know to what extent people will start returning to work five days a week. Revealed preference seems to suggest that people will work from home more. That has a big impact on the fare boxes of the rail system and the underground, so assumptions about when ticket revenues into the transport system will recover to pre-pandemic levels must be kept under constant review. It may be the case that there is a permanent revenue hole in the rail system, the London underground, and local transport systems, which Governments may need to subsidise in perpetuity if they do not want to cut services.

Q61 **Julie Marson:** I want to move on to information on the Government's levelling-up agenda. Would the OBR welcome the challenge and the ability to produce regional data, to track what regions are doing, and to produce forecasts, so that we could measure the Government's success against its levelling-up agenda?

Richard Hughes: I can see why people want this information, and I can see why this Committee would be interested in it. It is not something that we produce and see as being within our mandate to do, mainly because we do not need it to meet our legal mandate, which is to do an economic and fiscal forecast for the Government, to inform your deliberations on the Government's macro policy, and to look at long-term fiscal sustainability. We can certainly see why some people would want that information, but we just do not think it is necessary for us.

Q62 **Julie Marson:** So you wouldn't welcome a change in the remit?

Richard Hughes: We will always deliver whatever remit we are given with the resources that we have. For the moment, it is not one that the Government has given us, so it is not something that we do.

Q63 **Julie Marson:** What have you looked at, and what impact do you envisage the Government's investment in infrastructure and skills will have on UK productivity? Is all of that impact incorporated in the forecast that you have done?

Richard Hughes: One important thing to bear in mind with investments in both skills and infrastructure is that it is not the flow that matters, but the stock, in terms of our overall productivity. Nowadays, we invest around 3% of GDP a year in public infrastructure. The public capital stock is several times GDP, so the ability of small amounts of investment to make a material difference to the stock of public assets, which is what matters for the long-run performance of the economy, is pretty marginal.

Large amounts of investment over sustained periods of time can make a big difference, but over the five-year forecast horizon that we use, it is typically too small to take account of. But there are exceptions to that. When the Government announced its big increase in public investment back in the March 2020 Budget, we did actually take account of its impact on long-run potential GDP. But generally speaking, small changes to the amount that we spend on transport, and small changes to the way in which the Government delivers skills, take a very long time to feed their way through the workforce and the capital stock in ways that could make a material difference to our forecast over the medium term.

Julie Marson: That is very interesting.

Q64 **Rushanara Ali:** I have a couple of follow-up questions on growth and the longer term, and then something on universal credit. The OBR predicts very low economic growth in the last years of your forecast—1.3%, 1.6% and 1.7%. We talked earlier about the longer-term impact of Brexit being 4%, and the impact of covid is 2%. A recent report by the IMF states: "The coronavirus crisis is set to bring more longer-lasting damage to the UK economy than any other country in the G7". To recap, the fund's "global forecasts showed that while most advanced nations would return to the economic growth expected before the pandemic struck, Britain's economy would still be 3 per cent smaller in 2024."

Can each of you talk us through what you think are the long-term prospects of this country's economy, just for our constituents to better understand what the future holds for us? The Chancellor painted a picture of optimism in his Budget, but the reality seems very different.

Richard Hughes: Maybe I can say a few words, and I am sure my colleagues will have thoughts as well. The way I characterise it is that we have made it through the pandemic with—fortunately, in our view—relatively light scars on our economy, compared with the kinds of scars left by the financial crisis in 2008 and previous shocks that the UK has faced. That is partly because the vaccines have been so effective in allowing our lives to go back to normal, and Government support has been so effective in keeping the economy alive in the meantime.

But all the challenges that we faced before the pandemic—low productivity and an ageing society with a workforce that is not keeping pace with the number of people in retirement and drawing a pension—are all still there and remain to be tackled. In that sense, there was nothing coming out of the pandemic that led us to radically revise our view of the long-run productivity of the economy, apart from the level effects that we saw as a result of lower levels of innovation during the pandemic itself. The productivity challenges and the skills challenges that we had pre-pandemic are all still there for us to confront.

Q65 **Rushanara Ali:** We have talked about the impact of Brexit, and we have had much deeper lockdowns as well. In previous evidence sessions, we have heard a lot about the difference in how Britain has been affected by the pandemic. Are we entering a period of long-term decline in this country, or are we likely to meet the productivity gap that seems to have eluded us in the past?

Professor Bean: I wish I knew the answer to that. The one thing I would stress is the overriding importance of productivity. The scarring from the pandemic and Brexit are small compared with the shortfall in productivity relative to the pre-financial crisis trend. It is something like 20%, which is absolutely huge. We do not fully understand the sources of that productivity slowdown. As I said earlier, it is partly an international phenomenon; it is not purely a UK phenomenon.

We also know that the UK's productivity, even before the financial crisis, was lower than that of some of our international peers. Ideally, one would address both the slowdown in productivity to get dynamism up, if you like, and some of the issues that have led to our poor relative productivity performance.

That second one is probably easier, because we understand more about its sources, which are to do with the relatively low educational attainment of the workforce and relatively low investment compared with some other countries. It is also partly connected with managerial practices. We have a relatively long tail of underperforming companies. Our best companies are really good—they are world class—but there is quite a long tail of underperformers.

There may also be some structural elements in there as well, in that we have an economy that is relatively more service-intensive and a bit more consumer-intensive, which has some marginal effects as well. That is not something that you can solve overnight.

Q66 **Rushanara Ali:** And we have not seen the investment that, for example, the catch-up tsar recommended to the Government for education. That suggests that there will be an even deeper impact on the economy, on top of what you just said.

Professor Bean: Certainly, if there are lasting effects on the education and skills of the young people coming out now, they will have an effect for the rest of their working lives. The thing about these investments, whether that is public investment or investment in the workforce—which goes back to an earlier question about what account we take of public investment; Richard made the point that it does not have much effect over the few years of our short-term forecast—is that their effect is around for a very long time. I do think that it will be key to try to address those sorts of shortcomings.

Q67 **Rushanara Ali:** Mr King, do you want to come in on that point? I have one other question, then my time will be up.

Andy King: I will add one quick thing from my past as an official rather than an OBR-er. I always found it striking that the long tail of management performance looks very similar to the long tail of educational performance—the best is very good.

On investment, I was always struck that in the UK, investment is low compared with internationally, whether you look at public investment, business investment or residential investment. So there is something holding back investment in general, rather than that being specific to a particular type of investment.

Q68 **Rushanara Ali:** One more question on universal credit. In your forecast, you state that you have not made any adjustments to the number of hours worked in the economy as a result of the reduction in the UC taper rate and the increase in work allowances, because "any induced employment among these groups is likely to be at relatively low numbers of hours a week and at relatively low hourly pay" and therefore "negligible relative to the economy as a whole." How did you come to this judgment?

Professor Bean: There are empirical studies of the response of different segments of the workforce to changes in benefits and so forth. The Institute for Fiscal Studies, in particular, has done quite a lot in this space using microdata—data on individuals. The evidence from that work suggests the biggest effect here is for families with children—lone mothers and couples with children. It has a relatively low effect on single males, females and so forth.

If you apply the elasticities from that work, it leads you to get an hours effect of something like plus 0.05 percentage points, so very small. The effect on potential output is even smaller, because most of the extra hours worked are in relatively low-productivity occupations, so it is sort of de minimis for our forecast. That said, of course, it matters quite a lot for the welfare of the individuals who benefit from the reduction in the universal credit taper and so forth.

Q69 **Rushanara Ali:** Although millions will not benefit, because of the removal of the £20.

Professor Bean: That raises another issue, actually: the changes in benefits, the national living wage and so forth have different effects on different people. Some of the people benefit from the changes, others are made worse off, and it is therefore difficult to make a single statement that encompasses them all.

Q70 **Harriett Baldwin:** Am I right in thinking that you have not updated your assessment of the increases in the national living wage since March last year?

Professor Bean: Not really. The Government announced their plan to raise the national living wage over a number of years up to two thirds of median earnings. We have a profile, and our forecast was conditioned on an assumption that it would go to £9.52 as opposed to the £9.50 that was actually announced, so give or take two pennies, it is in the forecast.

Q71 **Harriett Baldwin:** That is really helpful—so, even though you had not had sight of the Low Pay Commission's report, you had taken that trajectory into account in your projections. Overall, what is your assessment of the impact of the minimum wage increases on the economic outlook?

Professor Bean: This change, because it is a step on a road map that has been laid out, is relatively small, of course. When the Government originally announced their plan, we made the assumption—which is conditioned on the available empirical evidence—that it would have a small effect in reducing employment, because it prices a few people out of jobs. The effect of the overall increase up to two thirds of median earnings is to add about 0.1 percentage points to the equilibrium unemployment rate, so that is a cost of about 50,000 jobs.

Q72 **Harriett Baldwin:** Help me understand: you said it was relatively low, but it is a 6.6% increase for an adult on the minimum wage, in terms of the absolute percentage increase. Do you think that will have any knock-on impact in terms of public sector wage pressures and in the negotiations that are upcoming, and therefore on the public finances?

Professor Bean: Yes. Certainly, the way we arrived at the number I gave you in our original figuring, when the policy was announced a year or so ago, assumed that there would be some knock-on effects. If you pushed the floor up, some of the workers who were close to that point now want some differential improvements. It has ripple effects up the wage distribution, but obviously smaller and smaller the higher up the wage distribution you go. That is part of doing this calculation.

Q73 **Harriett Baldwin:** We obviously do not know what the public sector pay negotiations will result in, in terms of the outcome and recommendations of the various different expert bodies. Do you think that public sector wage growth is fully reflected in your projections?

Professor Bean: We would not go into the very micro-detail about how it would affect pay settlements, particularly in Departments or anything like that. We would take a view about the overall public sector pay bill, which feeds into things like the Government expenditure deflator, which is where it shows up in the direct inflation element.

Q74 **Harriett Baldwin:** How does furlough ending on 30 September interact with the increase in the national living wage? Do you anticipate that employers who rely on people on the national living wage will reduce their workers' hours? Will they reduce the number of workers? That is incorporated in your 50,000 assumption, I presume.

Professor Bean: For this increase, which is roughly one fifth of the programme of small increases that were laid out originally, you are talking about, say, 10,000 jobs that might be affected here. That is relatively small compared to the consequences of the closure of the furlough scheme. When the furlough scheme closed there were about 1.3 million people still on it. The big question for us in this forecast was how many of those 1.3 million were going to end up staying with their employer or be looking for alternative employment.

About half of those 1.3 million were already on part-time furlough, so it was reasonable to assume they would all go back. Then the question was, what about the ones who are on full-time furlough? Are employers going to keep them on even though they no longer get any public support? They might well want to do that because, although the demand for their product might not be there now, they might see it coming soon. Airlines, for instance, are just starting to get going again. In some cases, staff might be kept on, but in others the ending of the furlough scheme might be the trigger for those workers to be laid off and join the unemployment pool.

We assume that about a couple of hundred thousand of those people on furlough are essentially looking for alternative employment. Some of them may be able to get jobs directly, because we know that there are some segments of the labour market which are tight, but some will enter the unemployment pool and spend time searching for a job. That judgment may not turn out to be right. It is one of the big unknowns—exactly what the consequence of the ending of the furlough scheme is.

Q75 **Harriett Baldwin:** Vacancies are at an all-time high. They have gone up at a startling rate, haven't they?

Professor Bean: Yes. In some respects, we need some of those workers who are on furlough to be looking for jobs to fill those vacancies. If that does not happen, the labour market is looking alarmingly tight—that might be overstating it a bit, but in a world where you have not got many workers looking for jobs and vacancies are at a very high level, that is the sort of thing where the central bank start thinking, "Approach, this is going to stoke wage pressures."

Q76 **Harriett Baldwin:** That's great, because it leads me into my last question. We have had the Governor in and asked about inflation. As you know, they have been stating that it is very temporary, but the thing that could affect it would be change in expectations of inflation. We have a 6.6% increase in the national living wage, a record number of vacancies and, as you just said, a potentially alarming shortage of labour in the economy. Is that not a recipe for potentially quite a big supply of labour shock to inflation and inflationary expectations that are not factored into your forecast?

Professor Bean: Essentially, that is the sort of scenario in our labour market high-inflation scenario box. It is not in our central forecast, and that is because we assume that some of those workers on furlough—the 200,000 I mentioned earlier—will be looking for jobs. We also assume that some of the workers who went into inactivity during the pandemic, because there was no point in looking for a job in those circumstances, will now start coming back in, and that some of the migrants who left will come back. They are very important to relaxing some of those labour shortages. If that does not happen, you are absolutely right, and that is precisely what the labour market scenario is.

Q77 **Harriett Baldwin:** I did not want to interrupt but, given how tight time is, will you spell out for the Committee what in that high-risk scenario is the impact of the higher interest rates on the public finances, in terms of the annual cost to the Treasury?

Professor Bean: Over the next couple of years, that particular scenario, which is conditioned on a particular assumption of how the MPC responds—it may respond in different ways—would produce a rise in the cost of debt interest over the next couple of years of about £30 billion each year.

Harriett Baldwin: So £60 billion in total.

Professor Bean: Yes.

Q78 **Emma Hardy:** I want to ask about the social care precept. I want to know how much the 1% increase will cost per household and why it was not included in the scorecard.

Richard Hughes: The health and social care levy was included in the scorecard, to my recollection.

Andy King: Do you mean the council tax precept?

Emma Hardy: Yes.

Andy King: I do not have a per-household figure, but the council tax measures in general do not appear on the Budget scorecard, because they are considered to be borrowing-neutral. They increase council tax revenues for local authorities, and the local authorities are assumed to spend it, therefore they are fiscally neutral. The numbers appear in our council tax forecast and our local authority self-financed expenditure forecast. To the best of my knowledge, the Treasury has never included a council tax measure on the scorecard itself.

Q79 **Emma Hardy:** I find this really interesting. To give a bit of context, my constituency straddles the East Riding, which is rural and Conservative, and Hull, which is urban and Labour. Both councils come to me to say, "Social care is in crisis. We are absolutely desperate. Do whatever you can to lobby the Government for more funding." Therefore, my assumption is that, despite the differences—rural or urban, and political—they are both looking to raise the precept to the maximum limit. I therefore just wondered whether you do any calculations on how likely that will be to be reflected around the country—the maximum rise in council taxes and therefore the impact on expenditure generally.

Andy King: The precept has been around for a few years now. With the baseline 2% before a referendum needs to be held, we assume an outturn of something like 95% of the amount that could be increased is increased—that is not to say that everyone goes for 95%; it could be that some do not go at all. It was somewhat lower last year. I think that was pandemic related, just because the financial flows to and from local authorities were very uncertain. So we have assumed again that 95% of the maximum of the baseline plus precept will be enacted by local authorities.

Q80 **Emma Hardy:** Okay, so the assumption is that that is another thing that will have an impact on the cost of living. Were you surprised that the Government chose to announce significant changes to national insurance and the introduction of a new tax outside a fiscal event without an OBR assessment of the cost?

Richard Hughes: We were not surprised, based on past practice. As we have noted in previous forecasts, the pandemic has had its own timetable and logic, and it has required the Government to react more or less in real time. We thought it was understandable that they would have to make major policy announcements outside a Budget cycle, but outside the pandemic, the Government have also tended to make major fiscal policy announcements, particularly about the health service, outside the usual fiscal policy-making timetable. I think it is a matter for you and the Government to decide whether it is wise to announce major fiscal decisions when you do not have a forecast against which to assess their macroeconomic impact.

In this case, it was not particularly a pandemic-driven decision; it was about medium-term levels of tax and spend in the health service and on adult social care. The Government decided to announce that when they did. The logic of fiscal decision making is that you should have a look at the macroeconomic outlook—the outlook before measures—and then look at what your measures do to that overall. Because these decisions were taken in September, they did not have that complete picture.

Q81 **Emma Hardy:** Why do you think the Chancellor chose to keep the OBR out of the loop on this?

Richard Hughes: I would not say that we were completely out of the loop, in that this stuff had been trailed in the press since the summer.

Emma Hardy: You found out through the press, like the rest of us.

Richard Hughes: They keep us informed of policy decisions as they emerge, although what they announced in September was based on their own costings and their own assessment of its fiscal impact. We then re-costed it when we incorporated it into our Blue Book, with some slightly different numbers on what the tax would yield.

Q82 **Emma Hardy:** In your economic forecast, you state: "The Social Care Levy will have indirect effects on the public finances that we have not isolated and quantified because they are wrapped up in our broader judgements about the overall effects of the Budget and Spending Review on the economy". Does that mean that you have made no judgment on how much demand will be taken out of the economy based on that specific significant tax increase, and that you have just done it as a total package?

Richard Hughes: That is right. We look at the scorecard as a whole, as it were, because what matters for individual householders is not just the impact of the health and social care levy in particular, but what is going on with universal credit and what they may be dealing with in terms of other tax changes announced in this Budget, including changes on the goods they consume. We also assume that public spending has its own impact on the economy, through the Government's procurement of goods and services. We have to look at those things in the round rather than assessing individually their impact on household decision making or aggregate demand.

Q83 **Emma Hardy:** Given the assumption that 95% of local authorities will probably increase that to the maximum, and that in my anecdotal evidence, despite rural and political differences, everyone is struggling with social care, it slightly concerns me that there has been no specific look at the tax—that surprises me a bit. If the Government make big new spending announcements, would you not include an element of that, using the multiplier to calculate the impact on GDP growth?

Andy King: I think there may be some confusion between the precept and the levy. The health and social care levy is the really big national insurance-like tax that is being brought in; the precept is the council tax addition, which is a smaller tax measure. The levy—the national insurance-like charge—has a very specific impact. Its employer component is assumed to be passed on into lower wages than would otherwise have been the case, so we were able to split that particular effect out and quantify it directly.

The Budget itself is a very large tax and spend event, and, overall, it is a net fiscal giveaway because the increase in public spending is larger than the increase in tax, and the increase in tax is very largely the health and social care levy. The net effect on demand is to boost demand. Theoretically, you could take each element of the Budget package and put a number on it. That is not something that we do, largely because it is the net effect that matters, and you would get into a world of spurious precision of "This tax measure takes this much out, but because that tax measure is used to finance this much spending, this much goes back in. The net effect is not precisely zero because we used slightly different numbers." That would probably be unhelpful.

The passage that you have read out was just specifically to let everyone know that the health and social care levy had two what we call indirect effects—two effects flowing through the economy. One is that the employer component would be passed through to wages, which was specific to that measure. Then there is another, which is the aggregate demand effect, where the fact that it finances public spending means that to say, "It takes money out, and then puts it back in and gets you back where you started" was not something we thought was a helpful addition to our already copious word count.

Q84 **Emma Hardy:** Thank you for that. What proportion of employers do you anticipate will pass on the cost of the additional national insurance contributions to employees?

Professor Bean: The assumption we make is that ultimately the burden is all passed on to the workers.

Q85 **Emma Hardy:** So the assumption is that the whole thing will be passed on?

Professor Bean: Yes: 80% comes in the form of lower pay and 20% in higher prices. Some firms charge higher prices, and that means real wages for the workforce as a whole are lower. However, this passthrough of the tax is not instantaneous. In the first year, firms absorb some of the costs, so 20% is actually borne in lower profits temporarily. Then by the second year, firms have basically either said to their workers, "You're going to have to accept the cost of this in a lower pay settlement this year", or they have passed it through into a higher price level. That assumption is based on empirical assessment of similar tax changes in the past.

Q86 **Emma Hardy:** So first the company pays, then the worker pays, then the consumer pays.

Professor Bean: Yes, and workers and consumers are the same at the end of the day. They bear 100% of the burden at the end of the day, even though it is the employer who nominally pays the tax.

Q87 **Emma Hardy:** Ultimately, then, the worker pays.

Professor Bean: Yes.

Q88 **Emma Hardy:** Have you made any estimate of whether such a large increase in health spending will be inflationary within health markets?

Professor Bean: Not directly in health markets. What is true is that the extra demand has an inflation effect. It is part of the indirect effects mechanism that Andy referred to, which is basically the macroeconomic consequences of the tax and spend package. As well as affecting activity, it ends up affecting inflation—wages, prices and so forth.

Q89 **Emma Hardy:** So the workers are paying for a net zero increase, because inflation means it would wipe out the extra money that they are getting. Is that correct?

Professor Bean: As far as the workers are concerned, they get lower money wages at the end of the day, and they also face higher prices.

Q90 **Emma Hardy:** And our health system does not benefit because it pushes up inflation.

Professor Bean: Well, the health system itself will benefit because it is getting the resources.

Emma Hardy: But you just said that there would be inflation—

Professor Bean: No, but that does not erode the increase in resources that the health service itself gets. It commands resources in the economy, which are essentially being taken from the workers.

Emma Hardy: Yes—we all pay.

Professor Bean: Yes.

Q91 **Siobhain McDonagh:** Right, I will have to do this very quickly, but can I thank all of you? I have found this really fascinating, so thank you very much. I want to look at the building safety crisis and the new tax on residential property developers. If I get a chance, I would also like to ask you about the outlook for first-time buyers, but I might not.

In your assessment of the uncertainties of costings, you described the residential property developer tax as having "medium-high" uncertainty. Could you tell us more about what uncertainties there are and why you came to this judgment?

Andy King: The tax itself is a new one, and new taxes are always somewhat more uncertain than changes to existing ones, because you cannot use tax data to inform the costing. The way we thought about this tax as we went through the costing process is that it is somewhat like the bank surcharge but for property developers, so we were looking at uncertainty around the data, which had to be drawn from other sources, basically—from company accounts-type sources—and uncertainty about whether taxpayers would respond to this higher tax rate either to reduce their liability or to reduce house building. We felt that there were relatively limited opportunities for that, but it is a new tax and therefore it is a judgment rather than entirely evidence based. That is where we get to a medium-high. It is a new tax. It could prompt behavioural responses, and the evidence base is somewhat limited.

Q92 **Siobhain McDonagh:** The Government's remediation for unsafe cladding does not cover buildings below six storeys. They are instead asking residents to borrow money in order to fund it, despite the problem not being of their own making. I was interested to see in your economic and fiscal outlook that you expect residential investment to rise in the short term and then drop back down. How significant do you think cladding remediation is for residential investment?

Professor Bean: I have to say that we did not explicitly include anything in our residential investment forecast for that component. The thing that is driving residential investment is what we know about housing starts, the normal lag between housing starts and completions, and the general strength of the housing market. We have been surprised at the buoyancy of house prices, and we think that there are several reasons for that. That also plays into the strength of the residential investment forecast, but there is not an explicit component in there connected with cladding.

Q93 **Siobhain McDonagh:** We have already seen social housing landlords deciding not to develop further in London because of their concerns about the costs that they are going to be required to meet. I would like to ask about your assessment of the Budget's impact, or lack of impact, on our housing market, particularly for first-time buyers. What assessment have you made of the impact that the withdrawal of Help to Buy, the demand for ever-increasing deposits and the potential rise in interest rates will collectively have on first-time buyers?

Professor Bean: Andy may want to say something about the Government policies specifically, but I have already said that house prices have surprised us on the upside. Part of that was due to the stamp duty holiday, although we do not think that that was as important as we previously thought it was in driving house prices. We think that some of the so-called forced savings that a lot of households made during the pandemic, when basically income was supported by Government policies but spending opportunities were reduced—that is worth £200 billion or something of extra savings—has fed into the housing market.

On top of that, we know that with more people working from home they have been looking for bigger houses—the so-called race for space, moving out of city centres into further afield if they are not commuting as much, and so forth. All those sorts of things have been feeding in, in a world where interest rates have been relatively low, mortgage rates have been low, and the availability of mortgage finance has been quite good, partly because of the supporting actions of the Bank in keeping cheap funding available to the banks. The consequence of that has been high demand for housing, pushing up house prices. The consequence of that, of course, is that first-time buyers will now face a higher price to get on to the housing ladder.

Andy King: In terms of the end of Help to Buy, the forecast assumes some modest reduction in transactions, prices and residential investment as the scheme rolls off.

Chair: That brings us to the end. We have been remarkably good with our timings, so thank you to the Committee, but particularly thank you to our three witnesses for having been so concise in the answers that you have provided. It is always a pleasure to have you appear before us, but particularly on this occasion, because we have had both the Budget and a spending review, and we have the Chancellor this afternoon, so you have armed us with lots of thoughts and information—things that we will ask him about in great detail.

Could I also wish a very fond farewell to you, Charlie? I think this is unfortunately going to be the last time that you appear before this Committee, because you are obviously retiring from the OBR, but on behalf of the Committee can I thank you very much indeed for a long career of distinguished public service, and not just with the OBR? I know that you were with the Bank of England for a considerable period of time. You have also done work at the London School of Economics, and I believe in your past you were also a special adviser to this Committee.

Professor Bean: I was indeed.

Chair: That must have been the highlight of your illustrious career. On behalf of us all, Charlie, thank you so much for all that you have done. It has been important not just for this Committee and the institutions that you have worked for but for the country as well, so thank you very much indeed.