House of Commons

Treasury Committee

Oral evidence: Autumn Budget and Spending Review 2021, HC 825

Monday 8 November 2021

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Watch the meeting

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

Questions 216-305

Witnesses

I: Paul Johnson, CBE, Director, Institute for Fiscal Studies (IFS), Dr Gemma Tetlow, Chief Economist, Institute for Government, Torsten Bell, Chief Executive, Resolution Foundation, and Nina Skero, Chief Executive, Centre for Economics and Business Research.

Examination of witnesses

Witnesses: Paul Johnson, Dr Gemma Tetlow, Torsten Bell and Nina Skero.

Chair: Good afternoon and welcome to the Treasury Committee and our inquiry session into the Budget and the comprehensive spending review. We are delighted to be joined by four witnesses this afternoon. I will ask each of them to introduce themselves briefly for the public record, please.

Nina Skero: I am Nina Skero, the chief executive at the Centre for Economics and Business Research.

Paul Johnson: Paul Johnson, director of the Institute for Fiscal Studies.

Dr Tetlow: Gemma Tetlow, chief economist at the Institute for Government.

Torsten Bell: Torsten Bell, chief exec of the Resolution Foundation.

Q216 **Chair:** Thank you very much. We have had the Budget. We have some headroom against our fiscal targets. There has been much speculation as to whether there is enough headroom. We know from the OBR's blue book that the amount of headroom is not great by historical standards, and we also know that those who have had headroom in the past have failed to deliver, despite the headroom. Doesn't all that point to the fact that the Chancellor in his Budget has not allowed enough headroom against his fiscal targets? Could I start with Paul, please?

Paul Johnson: You are right: it is a limited amount of headroom. I think the OBR has said that he has a 55% chance of making it.

Q217 **Chair:** Can I just stop you there, Paul? What has the OBR said in the past? Have they always said of previous Chancellors that, broadly, it is about 50:50, yet they have never done it?

Paul Johnson: Well, they've quite often said that the chances are of that order—55% or 60%—so they have always made it clear that these things are significantly uncertain. And as you say, quite often they are, in the event, not met, not least because of shocks like covid. It is a huge issue for the Chancellor. If the next time there is a Budget it looks like he is significantly out of headroom, or the OBR say he is going to miss his targets, he's got some pretty unpalatable choices. He has already put taxes up really very dramatically this year, so would he do more of that? Would he cut back on the spending numbers he has put in place this year, or miss the target? He does have a degree of space, in that he has put something like £10 billion a year into the reserve, so he could take some money out of the reserve, but I guess he is hoping that that is not what is going to happen.

Q218 **Chair:** Apart from the following risks, which I think we have all identified—interest rates, inflation, supply chain bottlenecks, demand-supply mismatches in the labour market, general threats to growth, other externalities, and the course of the epidemic and so on—what else is out there that might be a problem and surprise us on the downside? Or have we covered it?

Paul Johnson: You've covered it.

Q219 **Chair:** Can anybody else think of something that is lurking, or might be lurking, that wasn't in my list? No? Okay, what might surprise on the upside?

Paul Johnson: Well, of course, growth might turn out better than expected.

Q220 **Chair:** And why might it be better than hoped?

Paul Johnson: Partly, it is just a reflection of the huge uncertainty that we have at the moment. It might be that these supply bottlenecks open up really quite quickly. One of the things we have seen about the economy is that it has proved more flexible than most people expected. Of course, we could get bigger growth externally from the rest of Europe and the rest of the world, which could help the UK. There is uncertainty about the level of inward migration, which could make a difference to what happens. We might end up with higher productivity growth than expected, although it is not clear what would drive that. I do not think there is any particular reason to think that the risks are all on the downside, because all of the things you listed as negative risks could turn out better than expected.

Q221 **Chair:** Sticking with the question of what there could be on the upside that surprises, the scarring assumption might be one of them, I suppose. Could I throw it over to other panellists to focus on that for a moment? Torsten?

Torsten Bell: Substantively, therapeutics. If you step back and say, "Why are we in a better situation today than we might have thought we were this time last year?", the answer is vaccines. It is important to remember that this time last year we didn't even know that vaccines would definitely work. We knew they would do something, but we didn't by this point know that they would definitely offer an exit strategy. And the big change today from where we were three months ago is that therapeutics offer a substantial chance. That is important for what normal looks like—what does a country where you have an endemic amount of this disease look like? Therapeutics are really important to that—that is, are people actually scared of dying on an ongoing basis because of this disease? That is a really concrete thing on the upside, particularly if you are in the States, which is going to get first access to the new effective ones. I think that is really important. Obviously, on the downside, you have the rest of the world, which does not have access to the vaccines—let alone the therapeutics—at this point.

Most of the pages of the OBR's report are obviously focused on second-guessing what happens to total factor productivity four years out after a large pandemic. I think we should be slightly more humble than having the OBR and the Bank of England now herding to both predicting exactly a 2% scarring assumption. What is the reality? It could be lower and it could be significantly higher, and we don't know. We should be wrestling with that uncertainty and then focusing on the things we do know, which is that this thing is caused by a virus, and we are seeing significant progress on the medical side.

Q222 **Chair:** Gemma and Nina, did you want to come in on any of these points?

Nina Skero: On the scarring assumption, certainly for the private sector forecasters—including CEBR—a scarring assumption is looking at the pre-pandemic forecast on a particular time horizon to '23 to '24 and comparing it with a current forecast on the same horizon. That part is easy; what is difficult is saying what part of that difference is down to the pandemic, because that is not the only thing that has been happening since forecasters and economists made those forecasts in early 2020.

If you look at CEBR's difference between our last pre-pandemic forecast, which we would consider our February 2020 forecast, and our current forecast after 2024, the difference is still around 3.5%, which is larger than the OBR's current 2%. But it would be very difficult for me to say with a huge amount of confidence exactly what of that differential is just down to the pandemic and therefore the post-covid scarring, and how much of it relates to our changing assumptions around what has happened to Brexit in that timeframe and what has happened to inflation—again, some of the impacts in terms of inflation will have crossover areas with the other areas mentioned. So that would be my view on scarring: our expectations are a bit higher than the OBR's, but I can't say with certainty that that is due only to the pandemic.

Chair: Thank you. That's helpful. Gemma?

Dr Tetlow: I don't have anything to add.

Q223 **Chair:** That's fine.

In the Chancellor's speech, there was a cri de coeur moment, where he said, "I've done all these things. I've spent loads of money, because we've got a bit more. I've had to put taxes up, but I really want to get taxes down by the next general election." What is the path to that, and how realistic is that possibility—that aspiration—do we think? Is it absolute pie in the sky, given what's going on, or do you think there is a real chance that he might be able to deliver that? It is a very wide question, I know. Torsten is itching to answer.

Torsten Bell: If we do a literal interpretation of what the Chancellor actually said and ask, "Is it possible that a tax can be lowered before the next general election?", obviously yes is the answer. Eighteen billion pounds of headroom is tiny in terms of changes that could happen to the forecast between now and then. I think 2% of GDP is the average error on current deficit, three years out. So it's tiny compared with that. It's not tiny compared with what you need to make any cut, for example in income tax; you need around £5 billion to cut income tax by one penny. So the headroom is enough to do that. Remember: there's a reason why it's a rolling target. This is, "I promise to be fiscally prudent sometime in three years' time," not a target to actually definitely hit something before the next general election. So there's wriggle room on that front as well.

So, on the current forecast, could the Chancellor cut taxes? Yes. Would he be sensible to do that, given zero headroom as Paul says? No. But the big picture, stepping back, is: are we going to go into the next election with lower taxes than what we had coming out of the 2019 one? We are going to go in with significantly higher taxes, because the Chancellor has announced them all. So, taking a literal interpretation, it is a reasonable thing to do. You can marginally reduce taxes in future if you are prepared to do other things on the spending side. There is a reason why, if you look at, for example, what has happened with aid spending, the Departments have not been allocated the money yet, as in it's pencilled in as a separate line, to be allocated in the year ahead. In terms of the spending review, it has not been allocated to the FCDO and other Departments yet, so there is lots of wriggle room. As Paul says, there is room in the reserve; you can do other things. So there is wriggle room. But the big picture, which is that taxes will be higher at the next election than they were at the last one, is pretty much baked in now. Smaller economy. Spending a lot more money on health and care.

By the way, in the debate on this, all the attention has been on the health spending increase, understandably, because that is what's happening on the resource side of public spending. But there is also a cross-party consensus on wanting to have a much higher amount of capital spending. This is the first recession where we won't come out of it cutting capital spending, for decades. We always cut capital spending coming out of recessions, but we are ramping it up this time. On the economics of that, I think it is a perfectly reasonable thing to do, but it needs your state bigger as a share of GDP and, given that you have a debt target, it also means it's contributing to the pressure on putting up taxes.

Q224 **Chair:** Does anybody else want to come in on the tax question?

Dr Tetlow: I agree with Torsten that if the OBR's forecasts turn out to be exactly right, there is headroom against the deficit and debt targets, and therefore you could cut taxes in the orders of magnitude that Torsten was just talking about. The one other pressure that might make that difficult is that although quite a lot of extra money did go into spending in this spending review, there are still areas where it looks like it is going to be a struggle to deliver the kind of services that the public might be expecting on the settlement that's gone in.

Q225 **Chair:** What are you thinking of particularly?

Dr Tetlow: Social care, particularly, is the one that looks difficult, although it is supposed to be adding more money in year 3 once the NHS backlogs have been dealt with. Most of that extra money was really going in to help meet the new expanded offer that was announced in September. There isn't really extra money to meet the pre-existing gaps in social care provision, which were already baked into the system.

Paul Johnson: There is a wider point here. While clearly we could have some headline tax cuts between now and the next election, I would be really surprised if the tax burden in 10 years' time were lower than it is now or lower than it will be after the currently pencilled in tax rises. All the pressures are in an upward direction—from health, from social care, from the population ageing and, in general, from the continued pressures after a decade of cuts in various areas. There are big choices one could make there, but I do not sense much political consensus for significant cuts in spending to pay for those pressures in health and elsewhere. If you ask me to lay a bet, it would be that we will get a headline tax cut before 2024, but by 2030 the tax burden will still be higher.

Torsten Bell: To reinforce Paul's point, countries are path—dependent, and this country has been through the last decade. What is it that this Prime Minister would want to cut that George Osborne did not? That is a good way of thinking about whether the state is getting bigger or smaller. I think it is pretty obvious that, with the exception of funding for parliamentary watchdogs, the answer is basically zero.

Q226 **Harriett Baldwin:** Aid? He did cut that.

Torsten Bell: I think the possibility of aid returning as a cut for the next election is not impossible. It may return to live another day—let's see. That is an easy bit of public sector pay where it is achievable, but overall, does anyone think we will go into an election arguing for big spending cuts in particular areas? This is not 2010, and it is not 2015.

Nina Skero: I also think it is important to acknowledge that a higher tax burden and higher tax rates do not always equate to higher receipts. There is an optimal rate of taxation that optimises receipts. The view is very different among economists of where that rate is. Even now, at the levels we are looking at, the CEBR would be in the camp of thinking that we are already past the optimal levels of taxation for maximising tax revenues. It is not just the case of saying that if we have some tax cuts there will be a drop in receipts. That is quite a general statement.

Q227 **Chair:** Are you saying that at the tax burden level, or are you thinking of specific taxes?

Nina Skero: A number of different taxes, particularly with what was announced before the Budget statement and what is coming for companies in terms of higher contributions for NICs. That is an example where we are probably past the optimal point, so I guess we are getting a little further away from what was specifically said in the Budget. You would want to do that particular analysis on a tax-by-tax level, not at an aggregate one. In general, there are risks associated with the UK climbing down in tax competitiveness league tables globally.

Q228 **Chair:** We are not at the top of the league table, if you look at the EU, are we? There are various European economies that have higher tax burdens than we do, and presumably are still raising more as a consequence of having that. I see nods elsewhere.

Nina Skero: I would not say that the UK is in the worst position it could be in. You made reference to the statements by the Chancellor towards the end of the Budget about his vision for going forward. I think the explanation of that vision is something we found quite encouraging, but there was no timeline or specifics associated with that. I hope that that vision will come to fruition, otherwise risks are more on the downside.

Q229 **Chair:** Thank you very much, Nina. I will ask one more quick question, then I want to get on to R&D. If a magic wand came out and productivity went back to the kind of level that it was before the financial crisis, how would that change your answer to my question about whether it is possible to cut taxes in the longer term and still afford social care and all the other demographic pressures? If we could solve productivity, what would it mean in that context?

Torsten Bell: Let's leave aside what solves it. Let's assume it magically solves itself.

Chair: That's the magic wand.

Torsten Bell: Yes. The Treasury Committee has waved its wand and we have the productivity growth back. That does transform the situation of public finances, particularly the further out you look. The good news is that if productivity went back to pre-financial crisis levels, yes that would solve a lot of these problems.

The productivity norm baked into these numbers by the OBR is 1.3% in the medium term. That is the normal, outside-of-recessions norm. If you look at what actually happened over the last 10 years, we are nearer 0.5%. Obviously, before the financial crisis it was bigger than 1.3%. They have basically triangulated between the land we dream of, before productivity growth ceased, and the land we have actually lived through for the last 10 years, and pencilled in 1.3%. Could it be higher than that? Obviously. Could it be lower than that? Well, the past 10 years tell us that it definitely could be. It is not a one-way bet.

Paul Johnson: Productivity growth tends to come with wage growth and so on, so in terms of controlling spending, quite a lot of that gets eaten up quickly, certainly in the medium term, by higher demand for public services and higher wages—

Chair: Frozen thresholds for income tax.

Paul Johnson: As I say, it helps you a lot in the short run, but that of course then increases the tax burden even further. A consequence of higher expected inflation and one of the curiosities of raising taxes by freezing things is that this is a bigger tax rise now than it looked like in March, because inflation will be higher. The same will be true if real earnings rose as well. However, if you look 10 years hence, higher productivity will make us all better off, although when we are all better off we also demand better public services, but at least that gives more scope for a Government to make choices about public services, whereas at the moment, just to keep them as good as they are takes all the money that is available. With a growing economy, you can make services a little better and reduce spending as a fraction of the total, although history tells us that they tend to go up with the economy. Particularly in the short to medium term, that gives you more flexibility.

Q230 **Chair:** Thank you. A final question from me is on R&D. The Chancellor announced a two-year slippage in meeting the target of £22 billion for public investment in R&D and various changes to tax credits and so on. Would anyone like to comment on where you think we are overall on supporting R&D as a consequence of the Budget? Are we broadly in the right place? Do you have any observations on the various aspects of the announcements that have been made?

Dr Tetlow: There was slippage in when the money is going to be spent, but it is still a big increase in R&D funding in this Budget compared with where we were. That is probably the big picture that we need to retain: there is still a big uplift in R&D.

There is obviously a balance between, is this being done through R&D tax credits, to which tweaks were made in the Budget, and is this direct Government spending? There are pros and cons in both those approaches. With direct spending, the Government can more directly ensure that the money goes where they want to get it to. On the other hand, the reason why Governments do not typically do all this spending directly is that they are not always well placed to know which are going to be the most promising investments, and therefore the tax credits have the advantage of giving the incentive to all types of R&D, including the ones that the Government just do not know about yet but that may be the next big thing.

Q231 **Chair:** Does anyone have a view on the dead-weight element in R&D tax credits—significant or not significant?

Paul Johnson: Certainly significant. The best evidence we have, which is from work done at the LSE and Oxford, is that we probably get between £1 and £2 of additional R&D spending for every £1 spent on the R&D tax credits, so it is not brilliant value for money relative to some things, but as far as the evidence goes it is not too bad. However, most of that evidence comes from medium-sized companies; it is actually less clear how impactful it is for the biggest companies. Within that is a lot of dead-weight, then the marginal stuff on top seems to be just about enough, or a bit more than enough, to justify the spend.

Chair: Very briefly, Torsten.

Torsten Bell: It is worth thinking about what is changing underneath, in terms of how we approach R&D. A caricature of the old system is, the state funds the pure end of the market, then the tax system facilitates others—companies, basically—to make choices about the R&D they do. We are moving to a system in which the state funds more of it directly and tries to get further upstream, because it wants to fund more practical R&D. Within that, we see that that fits with part of this industrial activism more generally—the state making choices about what does and does not happen, in the form of UKRI—rather than leaving corporates to make some of those decisions. Depending on where you sit on the "Who makes the right decisions?" spectrum, this is a different system.

Q232 **Harriett Baldwin:** For some time, I have been very worried about the potential for inflation to overshoot. When we spoke to the Governor, as early as January I think, he was saying, "We're below target now. We could peak at 2% or 2.5%", and now we are hearing, "We could peak at 4%, or 4% to 5%." The Bank did nothing on interest rates last week, and I was quite surprised by that. Looking at the autumn Budget and spending review—and some of the quite worrying points that Professor Charlie Bean made when he gave evidence to us about the risk of a bond market collapse like the one we saw in 1994—how vulnerable do you think this Budget and spending review are to a wage price spiral at a time when you have the Bank still going flat out on the floor in terms monetary stimulus, a lot of fiscal stimulus and a deliberate policy by the Government to raise the wages of the lowest paid and to enable strong wage growth for everyone? To start with you, Nina, how worried would you be about a wage price spiral?

Nina Skero: I share your concerns about inflation and the trajectory. For some time, CBER and a lot of private sector forecasters have been forecasting inflation well above target. Based on the latest OBR estimates, those forecasts have now moved closer to what the consensus was before. I would say that we still expect slightly higher inflation than what the OBR published in its latest outlook, and we also expect it to be somewhat more persistent throughout 2022-23. In terms of how that relates to interest rates, our expectations are not hugely different from the OBR's.

Q233 **Harriett Baldwin:** The OBR's forecast is 3.5%, I think.

Nina Skero: It is expecting the interest rate to be at 0.75% throughout by the end of 2022; we are expecting it to be 1%, in line with market expectations. That is not a huge difference, but it is not a negligeable one either.

Q234 **Harriett Baldwin:** I am just checking my notes. Professor Bean said: "We assume that the MPC raises rates temporarily up to 3.5%".

Chair: That it is if inflation hits 8%.

Harriett Baldwin: Is that a typo in my *Hansard*?

Chair: He was speculating on much higher inflation, I think.

Nina Skero: I think on its central view, the OBR's expectations are for the interest rates to reach 0.75%, which would assume a couple of rises between now and the end of next year. If you account for higher inflation, that alone already eats up a lot of the fiscal headroom that was allowed for in the Budget. With that in mind, we are a little surprised about the degree of fiscal and monetary laxity at the moment.

Not to get side-tracked from your question, but in terms of the Bank of England decision that you mentioned, the risks of raising rates—that is obviously the next step—are smaller when moving a little bit too early than a little bit too late. If you move a little bit too early, you can always wait longer than you otherwise would have before any further rises. The situation is much harder to control if you have waited too long and have let inflationary pressures build up too much.

I share your concerns about inflation. The title of our quick reaction to the Budget was, "If inflation subsides…this Budget will look like a masterstroke", but I would say that that is a big if, and it is probably the single biggest macroeconomic indicator we should be keeping an eye on.

Q235 **Harriett Baldwin:** Paul, have you ever seen an autumn Budget and spending review so exposed to the potential risk of having to pay higher interest rates on the increased debt that is now factored in?

Paul Johnson: We know there is a lot of exposure because so much of it is held by the Bank and therefore the cost comes immediately and in quite a big way—not just interest rates, but because alarm—

Q236 **Harriett Baldwin:** Can you quantify that? Professor Bean said it would be something like £60 billion over two years.

Paul Johnson: I cannot remember the numbers. I am sure one of my colleagues has them to hand.

Torsten Bell: Do you mean if you get a 1% rise—

Q237 **Harriett Baldwin:** Every 1%. Under the scenario that Professor Bean was saying was not impossible, you could be looking at £30 billion, £40 billion, £50 billion or £60 billion of risk to this Budget from interest rates over the next couple of years.

Nina Skero: I think the quote was each 1 percentage point rise in interest rate adds £10 billion to annual debt interest spending.

Q238 **Harriett Baldwin:** Paul, have you ever seen a Budget that is more exposed to rising interest rates than this one?

Paul Johnson: Well, we have had a period of a decade when interest rates have undershot expectations. I remember a number of George Osborne's Budgets where there was more money to play with than anyone expected because interest rates were going down. Presumably, we are going to be on the upside of that risk at the moment. That is a substantive risk. The risk around both inflation and interest rates is pretty significant.

Q239 **Harriett Baldwin:** But have you ever seen a Budget that is more exposed to that risk?

Paul Johnson: I really don't know the answer to that question.

Torsten Bell: I think you have to look at debt interest risks in the round. Have we ever seen a Budget where there are bigger risks to debt interest payment by the Government? It is hard not to say, "Of course we have," first, because they used to be much more volatile and, secondly, because they used to be much higher.

In the end, why do countries go bust? It is because the amount of their tax revenues that they have to spend on debt interest hits a point at which they are not prepared to do that any more. Traditionally, that is our view. We are nowhere near that point, so the idea that the risks are now at the highest they have ever been is hard to square.

There is a separate question: is the volatility—the chance of movements—larger than it might otherwise be? Statically, looking at the APF, yes, clearly having things in the Bank of England and the way we are financing reserves means more volatility, if you think narrowly about it in terms of what bank rates would do to the debt interest payment of the state. If those of us who had the joys of pre-2010—actually, pre-euro crisis—debt financing for states step back and think, "What is the big difference between where we are today versus where we were pre-euro crisis?" It is that markets have totally changed their view about what QE means about sovereign risk. That is the big thing that has changed.

If you went back to sending poor old Treasury officials off to Singapore to run roadshows about selling our debt in 2008 and 2009, when it was going through the roof, people have not internalised that; if countries were happy to do QE during downturns, they would find it much easier to finance their debt. You need to consider this in the much broader sense of what are the risks to your debt interest bill. You can take account of the fact you are starting from a low level, but yes, clearly, the static volatility around that directly from inflation interest rate changes is specifically raised by the existence of a large stock of QE.

Q240 **Harriett Baldwin:** What about this point I added about the Government deliberately wanting to see wages rise quite sharply, particularly for those lowest paid, Gemma?

Dr Tetlow: There are two reasons why wages can rise. One is that there is strong demand in the economy and strong productivity growth, and that pushes up all our wages because we are doing more. The other reason is that there is simply a limit, a supply constraint on the number of workers, that pushes up wages without us producing any more value in real terms. That is much more problematic.

Q241 **Harriett Baldwin:** Which is part of the deliberate policy stance of the Government, as I understand it, at the moment?

Dr Tetlow: Yes. There seems to be some element of rejoicing in wage rises that were being driven by a shortage of workers. That is more problematic because that is just increasing costs that have to be passed on somewhere and will drive up prices for things, which is likely to drive higher inflation. Ultimately, that would mean that across the economy as a whole people are not better off in real terms because wages may have gone up a bit, but workers in non-shortage occupations may find that their wages are not rising as much as inflation is rising.

Q242 **Harriett Baldwin:** If you were a policy maker and you were trying to engineer a wage price spiral, are there any things that are not currently being done that you can think of?

Paul Johnson: The thing you are driving at is exactly this issue of a wage price spiral and the risk. The Bank is saying this is a temporary spike in inflation, which will come down because this is driven by the supply side constraints. If you just take a reasonably simple view of the economy, broadly speaking that is what it looks like. The risk, which I think is a risk although it's hard to know what probability to put on it, is a combination of the fact that we have got this new spike in inflation now; the fact that it is very salient, because people see it in their energy prices, fuel prices and so on; and the fact that it is also salient because of the HGV problems and the shortages; and the fact, on top of that as it were, that the Government are talking up wage levels does leave some risk that what should be a temporary blip becomes embedded.

Q243 **Harriett Baldwin:** But also, in economist-speak there are symmetric risks and asymmetric risks. This one really seems skewed to the upside. Can I ask anyone on the panel: are there are any other policy levers you would be pushing if you wanted to really try and create a wage-price spiral at the moment?

Torsten Bell: There are lots, but I think we should be a bit careful on this wage-price spiral. There is definitely none of that happening right now, in terms of people seeing higher prices and therefore being able to negotiate for higher wages; I think that seeing that in the evidence is hard.

If you look at what is actually going on with inflation, new inflation has been coming down since July. It will go up again, because of the energy price in October and it will go up again in April, but so far, are we seeing sustained month-on-month price rises that wages will deliver? No, we're not. And there are a number of other reasons.

I don't want to say there is no risk, and I agree with Paul on that scenario—I mean, that scenario is very problematic, particularly for our institutional framework, given the pressure it puts on the Bank of England. So, for a whole host of reasons, it is a really bad situation if it occurs.

However, are we about to see a wage-price spiral? We don't have incomes policy; this is not the 1970s. We don't have trade unions in most sectors of our economy that are actively involving a large percentage of our workforce. And we don't have sectoral agreements, which is the main mechanism via which prices tend to be falling through. If we think there is a wage-price spiral, it has to come from individual-level bargaining, with workers saying to their employer directly, "I want a pay rise because of what I'm seeing on prices".

What does history tell us? We saw a price spike after the financial crisis, driven by energy prices, just like we are seeing now. Did it lead to a wage-price spiral? No, it led to no increase in nominal wages and it led to real wages falling, because of inflation. What did we see after Brexit when we saw a depreciation-led inflation spike? No feedthrough into wages; real wages fell.

What is the most likely scenario now? We are seeing an inflation spike; with a lot of certainty, we know that is causing real wages to go down in the short term. That is definite—a real risk. There is then a possibility of factors the other way, which is, "Could there be a feedback loop from that into higher wages in future?" The answer is that it is possible, but on the balance of reading of the last decade, where we have seen this happen twice and that didn't happen, I think we should be cautious about thinking that that risk is a real probability.

Also, if we look at our institutional structure, if the Prime Minister was really serious about being a 1970s-style politician and actually pushing wages control directly, he doesn't have the levers, because he has no incomes policy and he has no sectoral bargaining system whereby literally he could implement it.

Q244 **Alison Thewliss:** I have some questions about net zero within the Budget and I will start with Dr Tetlow. It could be argued that the Chancellor's Budget was not a particularly green Budget, and a statement delivered a few days ahead of COP would have been a bit more focused on the measures needed to get the country to the Government's net zero target. What's your view on this?

Dr Tetlow: There wasn't a huge amount of mention of net zero in the speech—I think it was mentioned once—and the set of new policies, particularly on the tax side, weren't pushing in the right direction; for example the changes to air passenger duty. I think there was one positive, which was that there was speculation in the run-up to the Budget that there might be a cut to VAT on fuel duty, but that was not in the eventual numbers. I think that was positive, in terms of the impact on net zero, as well as not increasing the distortions in our VAT system.

Beyond that, I think there is a bit of a gap at the moment in the Government's policies on paying for net zero. In the week before the Budget, rather than in Budget week, the Treasury's net zero review was published, and that left some quite significant questions about where the costs of getting to net zero are going to fall.

We have seen £25.5 billion of spending on net zero over this spending review period, which could be enough to get us to net zero, but it relies on significant private sector spending on net zero as well, so I think there are still questions about whether that money—that spending—will come in and how it will end up being distributed across the population.

Q245 **Alison Thewliss:** Are there things that you would have expected to see here—things that you think the Chancellor could have been doing to incentivise growth in that particular area, or to tax things?

Dr Tetlow: There are certainly gaps in the Government's tax approach to net zero. There are bits of the existing tax system that provide perverse incentives in relation to net zero—for example, in the business rates system. If you make improvements to a business property to make it more energy efficient, that will tend to push up your business rates costs as well. Changes could have been made on that. Things such as having a

VAT exemption for new builds, but charging VAT on the refurbishment of properties, also pushes in the wrong direction. Obviously, the most extreme direction of the tax system would be to have a comprehensive carbon price in the economy. That is a very big step, but there are certainly intermediate steps that you could take to change the current tax system to more effectively support the net zero transition.

Q246 **Alison Thewliss:** Thank you. Torsten, the Budget obviously froze fuel duty and cut passenger duty for domestic travel. What is your take on that as a measure?

Torsten Bell: I agree with what Gemma said, and I think that is a good way to frame how you evaluate what has happened. If we take the Treasury's net zero review, which did not tell us as much as we might have liked about lots of things but set out an approach to hitting the net zero target that is private sector-led and carbon price-led, versus where the debate has shifted more generally over the last year towards a greater role for regulation and a smaller role for price incentives, the argument being made there is, "You've got to do this via carbon pricing, and it has to be done by the private sector." Obviously, that is not massively consistent with a £1.5 billion cut in fuel duty. I know the focus has been on the APD cut, but the Chancellor is obviously right to say that it is small: £70 million, compared with the £1.5 billion on fuel duty, and the fuel duty obviously comes on top of tens of billions of pounds-worth of tax cuts.

If you are in favour of carbon pricing as your main mechanism because you believe the route to net zero primarily lies through private sector individuals changing their behaviour on the basis of price signals, we are not doing what was in the net zero review, obviously. There is then a bigger question: do we have the right balance between price incentives versus regulatory incentives to deliver change? That leads into how much of this is public sector spending versus private sector spending, both of which push down on private consumption—we should not pretend that one of these is doing so intrinsically. They are both pushing down on private consumption. The question is how you finance the investment needed up front to get us on a net zero trajectory, because it is all infrastructure today for savings tomorrow. That is all that the debate is about.

Our judgment would be that we are optimistic on the level of private sector spending, particularly for households, which can deliver the speed of transition required, particularly for the heating systems in the 2020s. Given that you have a huge increase in capital spending taking place—it is really, really big—over the course of recent years, it is surprising how little of that is being used to fund *the* issue that we face today—funding the net zero transition—rather than being used on transport or other priorities in BEIS. The big picture on the spending side is that we have the right thing happening—lots of public sector investment—but it has not massively been prioritised towards net zero.

Q247 **Alison Thewliss:** This is the 12th successive fuel duty freeze. What is the wider effect of that?

Torsten Bell: Well, it is really expensive. It is cheaper for me to fill up my car, and it costs the Chancellor lots of money—that is the really boring and blindingly obvious answer. I do not think it is surprising. What it does, though, is tell you something: when people tell you that they can rely on a carbon price to deliver a huge percentage of the transition, they should at least have an answer to why that has not been what has happened in the case of fuel duty.

At one level, this is a time-limited problem, because the bigger problem that is coming down the track is obviously zero fuel duty revenues. From a tax purist position and a carbon pricing position, it clearly does not make any sense doing what we are doing on fuel duty. If the Chancellor gave me a straight choice between his having gone ahead with this increase in the middle of a tough time for the cost of living, versus actually setting out a plan for how he will get on with road pricing, which is the actual thing he needs to do to protect any of these revenues beyond the next 10 years, I would have preferred that he had got on with solving the long-term problem and I would let him have the little political win in the short term. But it would have been even better if he had done both.

Q248 **Alison Thewliss:** Yes. He has just left that gap for later.

Torsten Bell: Someone else gets to pick up that gap.

Q249 **Alison Thewliss:** Paul, the Chancellor told us last week that he believes the £30 billion allocation for net zero spend over the course of the Parliament is sufficient, including to cover the up-front spending required. What do you think on that?

Paul Johnson: I think it goes back to what Gemma and Torsten were saying: it depends very much on the degree of private sector investment that comes alongside that. The strategy relies on quite a lot happening in terms of what boiler manufacturers, landlords and energy supplies do, and quite a lot of regulation on them. With some of these measures, we need to be careful about speed. You need to ramp up gradually things like spending on heat pumps, to make sure we get the appropriate outcomes.

I would have preferred something that took even baby steps toward a sensible carbon price, because in the end, if we are not just to have an effect in us getting to net zero, but to have an impact on our consumption emissions, which clearly really matter, the only way we will get there is by bringing in a carbon price.

Let’s be fair: the net zero strategy we saw a couple of weeks before the Budget was a genuine step forward in terms of where Governments have been—the first time we have seen something reasonably serious laid out that gives us some sense of where we are going to go. That is not to say that there are no gaps in it; it is more focused on things like regulation and private sector delivery and perhaps less focused on some issues where public sector spending would have been ideal.

The strategy was a big step in the right direction, but there are some big gaps, the biggest being carbon pricing. If we are to get to net zero in a serious sense—really taking account of our consumption as well—we need to get moving in that carbon pricing direction, and we need to be beginning to get a lot more clarity than we have now on how we are going to do this, particularly for buildings, for agriculture and within industry.

We tend to think we have fixed electricity. We have done really well—we have gone a long way down that route—but I am not sure it has really taken root how much further there is to go, not least because we will need two or three times as much of it in the future.

Then there are the real infrastructure challenges, particularly around charging for electric cars. It seems pretty clear that we will get to a point where electric cars themselves are being built and are competitive in terms of buying price, but do we know exactly what the Government strategy is to make sure we have the electric charging infrastructure, both in-home and on-stream? I don't think we do. There is a big challenge there. Hardest of all remains heating buildings, where we are still right at the bottom of the foothills in terms of knowing how we are going to get there.

Q250 **Alison Thewliss:** You mentioned in relation to impacts the role the private sector have to play in all this. Do you think they are sufficiently signed up and sufficiently incentivised to do their part?

Paul Johnson: In some areas. In the electricity market, a lot of, in effect, money has been thrown at creating a market which has worked reasonably well, if a little expensively; but across the economy as a whole, because we do not have a coherent carbon pricing strategy at the moment, I would say not. What is the price incentive for moving away from gas boilers? There is a negative incentive, because gas is effectively subsidised by the tax system, so we will need to offset that with additional regulation or additional subsidies for moving away from that. It is variable in different parts, and it is certainly not there across the piece. We do not talk much about agriculture, but it is clearly not there in agriculture.

Q251 **Alison Thewliss:** Absolutely. The OBR told us last week that there is no emissions scorecard, to determine the impact of all these fiscal measures on net zero. Would you support such a thing in their reporting?

Paul Johnson: It would be quite useful. The Budget is not necessarily the right place to do that, because how the amount of money that goes to the Department for Education or the Department for Transport translates into emissions is more to do with the way the Department works. A scorecard for the net zero strategy that was set out and for some of the headline measures in the Budget would be really useful. If I were the Chancellor, I would be nervous of that, because as Torsten was saying, the big headline measures in the Budget were freezing fuel duty and cutting APD, so the emissions scorecard for the Budget would have looked rather bad. However, the emissions scorecard for the announcements in the month running up to the Budget would have looked rather good. I think one needs to look at it holistically.

Q252 **Alison Thewliss:** Nina, what kind of economic benefits would we be likely to see from the UK taking earlier action to address climate change? It is often talked about as a cost, rather than an opportunity.

Nina Skero: It rather depends on the timeline you are considering. If you are considering a very short timeline, a lot of long-term beneficial changes come up as a net cost, which is why the question was asked earlier about the incentives for the private sector. Sometimes you need carrot and stick types of incentive. Outside what the Government are doing directly, there is rising awareness and rising demands from consumers of businesses they buy goods and services from in terms of the steps they are taking to lower their environmental impact.

On the economic benefits, having anything that is more planned out, more gradual and realistic, and tied to strict timelines, will have a more favourable economic outcome than a very far off target that has to be addressed in the outer years. Mainly, the answer depends on the time horizon you are looking at. I think the problem is that a lot of the analysis is done on a very short time horizon, at which point a lot of things look more like a cost than a benefit.

Q253 **Julie Marson:** I have some questions on business investment. Torsten, we heard from the OBR last week about the impact of the super-deduction—that the impact was less on the overall medium-term level of investment than on the timing issue; it was likely to bring forward investment, and that was not necessarily a bad thing if you wanted to promote or kick-start recovery. Do you agree with that assessment? What are the implications?

Torsten Bell: The OBR has quite a punchy view of the impact of the super-deduction: they think it is going to do a lot, but, as you say, what it is doing is bringing investment forward rather than increasing the overall level of investment. That is doing quite a lot of the work. When the OBR talks about the size of the fiscal impulse from the Government into next year, that is doing quite a lot of the work in bare numbers. We will see whether that is actually so. I am a little less optimistic about the scale of the impact, in part because the number of firms is not that large. This is about big firms—in very large part, we are talking about BT, which will certainly respond.

So the OBR thinks that on timing, there will be a big impact but on levels, no impact, which I think is a reasonable assumption. If you step back and ask why this super-deduction is happening, the answer is that it is happening because corporation tax is going up. That is the only reason, because without the super-deduction, the incentive to invest would have gone down because everyone would have to delay investment and wait for the higher corporation tax rate, and therefore the higher deduction they would have got under the old system.

Hopefully, the OBR is right and the super-deduction is delivering a large bunch of investment this year, which has the effect in its numbers of a significant fall-off in investment in the immediate aftermath of the super-deduction. Maybe BT will dig up all our roads next year and do none the year after, which is basically what the numbers are saying. Personally, I think there is only so much digging our roads can take, so I would not be surprised if the impact is not quite as large as the OBR is anticipating, but we shall see.

I think the OBR is slightly underestimating some of the other fiscal action that is going on. Going back to the interest rate question, there is this slightly mad discussion where we are all very focused on what the Bank of England does and tiny changes in interest rates and what that does to the macro-economy. That is all tiny; all the action is on the fiscal side. Right now, whether or not you think that the macro stance is too tight or too loose should almost all be driven by your view on what is happening in fiscal policy.

The OBR is very focused on what is happening on the super-deduction, and more broadly the Chancellor has moved to provide more support via generalised public spending and some increase in universal credit spending next year, but the overall position is that fiscal policy is moving into a retrenchment phase from broadly around now. That is what we should be focusing on.

Q254 **Julie Marson:** Nina, do you agree with Torsten's assessment? Do you share his view?

Nina Skero: Broadly. On business investment in general, I think there are factors that contributed that go beyond the Government policy and what is happening on that hand. I am conscious of what is happening in terms of business confidence and what is impacting that. When you ask businesses—there are a number of measures of business confidence out there—what is driving their level of confidence at the moment, they certainly mention some of the Government incentives and Government policies, but they much more mention other factors, like skills shortages, difficulties in recruitment, and the cost of input materials. Those are their words directly, so I would focus as much on those factors when looking at what we expect to happen with business investment, which, like the OBR, we expect to increase substantially next year. That is because this year it has been either flat or around zero, year on year. Broadly, I would not strongly disagree with any of Torsten's comments.

Q255 **Julie Marson:** Thank you—that is really interesting. Do you think that there is a case for extending the period of the super deduction? Do you think that would make a material impact or, because of the reasons you have said, is it not so important as using the other measures on skills potentially to increase business confidence and investment?

Nina Skero: I wouldn't say that it is not all that important in terms of what the exact timelines are. I suppose it depends. Again, the point is more on the timing rather than the overall level, so I would not think that there would be a material difference either way if the timelines were slightly shifted.

Q256 **Julie Marson:** Thank you. Paul, did you have any thoughts on that?

Paul Johnson: One thing that really matters in tax policy is having something reasonably consistent. Having said that there was a time limit for this deduction, then to add another year would not help. Then I think people would begin to expect that it would be for another year, and so on, so I would certainly caution against doing that. We know that on the whole these sorts of incentives can have quite a big effect on investment.

One of the issues at the moment is that we also know that they have much less effect on investment when there is a lot of uncertainty around, and clearly there is a lot of uncertainty around at the moment. I would have thought that the most important thing for our corporate tax system now is to get rid of the uncertainty in that bit of the investment picture and have some consistency over time. On your specific question, I would be quite nervous about coming back and saying, "Ah. It's all right, guys—we'll give it another year." It is also very expensive.

Q257 **Julie Marson:** You referenced earlier some of the other issues, which are not necessarily pandemic related but may be related to leaving the EU, such as the supply shortages—bottlenecks, I think you called them. Do you think that the Government should focus more on some of those specifics, like labour shortages and supply chain shortages? Do you think that they would make more of an impact in some areas?

Paul Johnson: It is difficult to know quite where. As I said, alongside that the economy in many ways has shown itself to be pretty flexible and responsive, so I think the Government need to be quite careful not to get in the way of the economy adjusting to some of those things. We have already seen that we have not had—I am not making a prediction here—headlines about a lack of petrol at the pumps for some weeks now. There was a little help from the Government there, but in the end the market sorted itself out.

There may well be—this is way beyond my understanding of the specifics of every individual industry—areas where this proves to be necessary. The creation of carbon dioxide appeared to be one of those where it really was necessary for unexpected reasons, but I think it needs to be in those really quite specific, targeted areas, because it is urgent and the market does not have time to respond without causing something really quite dramatically bad. On the whole, it is about having the permissive environment, rather than the Government diving in and saying, "We're going to be the ones delivering petrol for the next six months."

Q258 **Julie Marson:** Thank you very much. Gemma, we heard from Professor Bean last week that our business investment lags behind that of a lot of our international competitors. How much of an issue is that going forward? Does that mean that we are perpetually trying to catch up on existing investment, and trying to get ahead of the game?

Dr Tetlow: Part of the reason why countries see different levels of business investment is the structure of economies. We a have relatively service-heavy economy that is relatively less capital-intensive. That would partly explain why we may look different from other countries, but as Paul and others have pointed out, business investment is heavily affected by uncertainty about the economic outlook. We have had several years of a lack of clarity about exactly what the UK's trading relationship with other countries is going to be. Now we have some lack of certainty about the future of labour supply, post-pandemic. That makes it difficult for businesses to know whether it will be worth while making some of the big investments that they might if current circumstances are going to be permanent. It is a mixture of those two things.

Q259 **Julie Marson:** Thank you. I think I have time for one quick question about SMEs, perhaps to Torsten. We heard from the OBR that SMEs are more vulnerable to longer-term scarring when it comes to investment. Would you agree with that, and what do you think the Government could or should do about that?

Torsten Bell: I think they are making two related points. One is to do with which firms have come out of this crisis with more difficult balance sheets compared to others. The evidence shows that, overall, the deterioration of balance sheets is not as severe as certainly I expected it to be. I was definitely wrong, by a very large factor. That is mainly because the level of Government support has been so large. It is not just the direct support for firms—the furlough scheme. Why do firms take on debt during a crisis? Paying wages is pretty high up the list.

The overall position is good. It is worse for smaller companies. Research we did last February—which would be worth updating now, if we have time—also points in that direction, so I think it is a fair statement. Overall, and definitely compared to the financial crisis, the reasons for expecting scarring on that side are lower. There is obviously a different situation for smaller firms, who tend to find it harder to raise capital than larger firms. For example, your ability to raise bonds directly yourselves is not as easy and the price is higher. Their ability to cope with a more difficult balance sheet is more significant. I think that is a fair point to make.

Overall, though, I would say that most of this is small fry on the scale of what actually matters for investment, which just agrees with what others were saying. If you look at what happened before the pandemic, for the three years after the Brexit referendum, the monthly change in private sector business investment was minus 0.1% versus 1.7% every quarter. That is what matters here. We have a paper out next week on private sector investment—not in the context of Brexit, I hasten to add, but on this longer-term issue about how Britain's economic strategy fits with its level of investment. I would say that it is a pretty big feature of our economy. Even once we take into account the structure of our economy, the low levels of investment are very material and are a long-term driver of lower productivity and living standards. Obviously, in the short term our consumption is higher because we are investing less. That is why this is difficult.

People say we need loads more investment. I broadly think that is true. We are definitely going to need it in the next decade because of net zero. Those of us who say that should also own the flip side, which is that that investment comes from somewhere. Investment is a cost now for higher consumption in future, and it either comes from lower consumption for the economy as a whole today—us—or it comes from abroad, and we have already got quite a lot of that going on. We should not pretend this is easy; there are trade-offs here, but broadly our low level of investment predates the pandemic and is a big, big problem.

Q260 **Gareth Davies:** I am going to take growth and scarring and address it in relation to three things: productivity, debt and consumption. Paul, you said that it is not clear what would drive productivity growth, but in the spending review and in the Budget, we heard of a raft of new measures to increase infrastructure spending, to mobilise more private capital, to boost skills training and to uplift R&D investment. Even the humblest student of economics would regard those measures as being helpful to productivity growth. What would you do to, as Torsten put it, wave the magic productivity wand and get productivity growth?

Paul Johnson: All of those things help, but there is next to nothing that you can do that will sustainably increase productivity growth in the next two years. That is the key thing. The Government can, and have in the past, sustainably increased productivity growth over a significantly longer period than that, and the sorts of things that you have described are exactly the sorts of things that will help with that. We have always known that it is a combination of the education and skills system, the infrastructure system, housing, transport, the competition regime, the trade regime—all those things together are good for productivity in the long run, alongside good management practice in firms. There are huge amounts of evidence of the value of that.

I could run through some of the things that one might do in some of those areas. We know that there is a problem—as there has been for a very long time, although it has become worse over the last decade—in technical and vocational education, and in terms of the gap between A-levels and degrees. The returns to a lot of those sorts of qualifications are very high, and there are shortages there. It is one of the areas in which potentially lower immigration will cause an issue. That is one obvious area.

We know that some forms of transport infrastructure, particularly in the context of net zero, are good for productivity. To throw something in, whether £100 billion on HS2 is the best way of doing that is, at least, open to question.

Then there are decisions that we may make knowing that they are bad for productivity. We know that there is a lot of difficulty around the planning regime changes. Additional housing and a more open planning system in the south-east of England would be good in the long run for productivity, but we may politically, perfectly reasonably, make the decision not to do that because we value other things. In a sense, at least in some parts of the political world, we have implicitly made that kind of trade-off, just as, presumably, we will if we do not have a third runway at Heathrow. That will be more to do with climate change than anything else.

Investment in really high-quality fibreoptics for very high-quality internet access across the country will be really important, both for net zero and for productivity. But in answer to the Chairman's question at the beginning, which was about changing productivity over the next two or three years, I do not think that there is a great deal one can do immediately. It is a general issue about the timescales of these things—you absolutely can change it over a long period, but it is hard to make big changes over a short period that are sustainable.

Q261 **Gareth Davies:** For the sake of ease, let's take that long-run period. One of the struggles of successive Governments is to sufficiently mobilise more private capital for things such as infrastructure. Do you think that we are doing enough at the moment to mobilise private capital for infrastructure, and do you think that will have a material benefit for infrastructure stock, which the OBR tells us is much more important to driving productivity than the level of spending on infrastructure?

Paul Johnson: I am no expert on the various bits of that. Clearly, we have mobilised enormous amounts of private capital for low-carbon electricity infrastructure over the last decade, essentially through a tax and subsidy system—so maybe it is wrong to call it private mobilisation. The right balance between private and public sectors in all this is difficult, but there are significant incentives in the corporate tax system, both on R&D and in terms of capital write-offs. I am the wrong person to ask about how it works for the water system, the telecoms system or what have you—

Q262 **Gareth Davies:** As a general principle, does anyone want to add anything on that?

Torsten Bell: Not on the details of the water system, no. I will leave that to someone who knows more about sewers. On the public sector side, there is a lot of investment going on. There, if what you care about is long-term productivity, the exam question should be: are the decisions that we are making about how that is allocated actually targeting productivity, or something else? I will leave you decide whether that is what we are, or are not, doing with our public sector investment right now.

If we look at private sector investment, too much of our debate is taken up with our saying, "Can we get our pension funds to invest their money in this tram system in this city?", because in the end, public/private is marginal for the overall productivity effect of those decisions. Clearly it matters for your spending control, if you are the Chancellor, but overall it doesn't matter for the economy as a whole. What matters on private sector investment is that we have not got any. We should not lose sight of the big picture. The big picture is: no business investment growth in the four years running up to the pandemic; weak business investment through the pandemic, for obvious reasons; and high levels of uncertainty coming out of the pandemic for all advanced economies, and particularly for the UK, given the overlap of covid with Brexit, which means businesses do not want to invest at the levels we would like. Everything other than resolving that—solving the productivity problem, rather than making it worse—is small.

We have to focus on the big picture, and a way of thinking about that is: what does the last decade look like? Why was the last decade so awful? If you think about it, before the financial crisis, we had more than a quarter of a century with no income falls. We had consistent income growth for, I think, 26 years before the financial crisis. We are about to enter our fifth phase of falling incomes in 14 years. We have not had more than four years in a row without a real income fall. Every Parliament since the financial crisis has seen real income falls.

These disasters are to do with macroeconomic disasters, some of which are in our control, and some of which are outside our control. That level of uncertainty, matched by policy uncertainty, is telling businesses, "You can't rely on demand for the stuff you invest in; and you can't rely on the policy environment within that." It is not surprising that the private sector is looking at that and saying, "The money is going elsewhere." Don't think it is about small twiddles, whether on the tax side or the pension fund side—that it is about saying, "x funds y." This big stuff is what matters, and it is a catastrophe.

Q263 **Gareth Davies:** I think I will move on slightly, because the OBR has forecast that our economic recovery from this crisis will be driven by household consumption. It has already said that it has rebounded pretty well from lockdown levels, and is due to be at the pre-pandemic peak in early 2022. Gemma, to what level are household savings driving that household consumption-led recovery?

Dr Tetlow: I must confess that I do not know the answer on the OBR forecast. I know that the Bank of England, for example, is assuming that households have run down 10% of the excess savings that they accumulated over the past year and a half. That means that they are still sitting on quite a lot of extra savings. In a way, that seems plausible, because the types of households that have increased their savings over the past year and a half are typically the higher income households, which do not tend to have a very high marginal propensity to consume. There is a big split in the population. Lower-income households, as the work done by Torsten and colleagues has shown, tended to see their cost of living go up during the pandemic, and their income come down, so they are in a worse financial position.

It is the higher-income households that are sitting on quite a lot of extra savings. Some of that will help to stimulate consumption demand, but in some ways, there may be a limit to that, because the sorts of things that people did not do during the pandemic were things like going out, and going on holiday. You might do a little bit more eating out, and perhaps you take an extra holiday, but you probably don't recoup all the lost consumption.

Q264 **Gareth Davies:** You question the durability of the household consumption drive for the economy because of that.

Dr Tetlow: No, I am not questioning the durability of it; it is just that what the Bank of England says—I am not sure to what extent the OBR has a similar assumption—seems plausible to me. It says that only a minority of the savings that have been built up will get spent down over the next year or so as the economy rebounds, given that, considering the types of things that people were not spending money on, they are probably not going to go out and do more of the consumption they did not do in the last year and a half.

Nina Skero: The evidence of that already abounds, so it is not just a matter of going forward. In the data on consumer expenditure from the last couple of months, and in even more timely data points, such as credit card transactions, we are already seeing evidence of what Gemma has alluded to. That pent-up demand is very much drawing down for the exact reasons she mentioned; there are only so many extra holidays you can take.

For a few months over the summer as lockdown was ending stage by stage, you saw some counter-cyclical spending behaviours as consumers were shifting their spending habits from the types of things they were able to spend on during the lockdown to the types of things they were not able to.

Gareth Davies: Pizza ovens and exercise bikes.

Nina Skero: Yes. Paint, DIY materials, board games and picnic blankets, as the different stages of the unlocking proceeded. The most recent data is already showing that that pent-up demand is being exhausted, so I do not think it should be materially important for even short-term forecasts, and certainly not for medium and long-term ones.

Q265 **Gareth Davies:** Torsten, you must concede that the increase in the national living wage will help mitigate some of the impact of inflation and help the lower-income households, right?

Torsten Bell: The national living wage is a complete triumph—yep, absolutely. The 6.6% rise next April will make a lot of difference to around 2.5 million workers, so we should be very positive about that. That is a higher-than-average nominal rise. It is a big rise, and it is even bigger for the age group just below that, because they are trying to smooth the introduction of that group into the main rate in the following year, so that is very good news. It will help some people. Inflation will be going up at the same time. When the increase comes in, inflation will probably be around 5%, so you are talking 5% versus 6.6%. You have a significant real-terms rise, but probably not as significant as we expected when we saw the 6.6% headline, because inflation is so high. But they will be doing significantly better than other groups, and that will make a difference.

Those who are on the national living wage but were not affected by the removal of the £20 a week in universal credit will probably be better off come April, so that is very good news.

Stepping back and looking at the bigger picture, it is not really about the year-to-year change in the minimum wage. The lowest paid workers in our economy have seen 50% higher wage growth for the entire last two decades because of the minimum wage policy. That is a big public policy success. It is much bigger than lots of us thought possible, and we have not yet hit up against big problems from doing that. Will we ever? At some point, probably, but so far we should be very perky indeed.

Q266 **Chair:** You were referring to those who are in work and on universal credit; the change there is the taper benefit. There is the national minimum wage increase as well. What would that mean for somebody in that situation, albeit that one accepts that not everybody is in work and will benefit from the taper? For those who are, what is the combined effect?

Torsten Bell: The complicated answer is that a lot of tax, benefit and national living wage changes are happening in April, and different people are affected in very different ways. We published a whole list of case studies at the back of our Budget report this year, which I shall send across, which explains who does and does not do well.

Stepping back, the universal credit change is a big one. Again, while we are being perky about things, £3 billion extra going to working universal credit claimants is a big change in direction from the last 10 years, where we have been retrenching the working age benefit system while maintaining some other bits of the benefit system. That is a big change. It has a big impact on people’s actual living standards. Over 2 million households will get £1,000 more on average, just looking at this change specifically. There is a static thing—higher incomes—and there is a big improvement in work incentives for large chunks of those households. It is a really good thing.

When you step back and think, “How does that and the £20 removal come together?”, you must think about it in three parts. The poorest in the universal credit system and those who are not working are getting absolutely hammered. The highest-earning families on universal credit are big winners. You could be net up by £1,500 just from the universal credit changes alone if you are a higher-earning universal credit household.

Remember: because of the change, people earning up to, say, the high £30,000s will be on universal credit, because we are tapering people further up the earnings distribution. Lower earners who are on universal credit, have lost the £20 and will gain something from the taper changes will generally be losers, and the tipping point will be somewhere, but the loss will be much less than it would have been had they only had the £20 removal. The tipping point will be somewhere in the high teens for most, but not all, household types.

Chair: Thank you. I will have a look at your case study with interest.

Q267 **Anthony Browne:** I should declare at the outset that I am on the advisory council of the Institute for Fiscal Studies. I want to follow up with one question about the universal credit taper, but my main questions will be about the fiscal rules and interest rates. The stated incentive for giving £3 billion to the universal credit system was to improve incentives to work and make work pay. Do you think that it will actually do that? I will ask Torsten first, then Paul, as the IFS has done work on this.

Torsten Bell: The short answer is yes, because millions of people will see a lower deduction rate. The taper rate goes from 63% to 55%. Let's park the work allowance change, which also helps the moving into work incentive.

Q268 **Anthony Browne:** Does it mean that people work more? Are they more likely to work more, or are they just going to collect the money?

Torsten Bell: It will have a marginal effect on some people working more. If we step back, the last 25 years of playing around with policy in this space, both in the UK and elsewhere, show us that it will have an effect, particularly for second earners in couples where, if we are honest, the universal credit system was deeply sub-optimal in terms of the incentive that it gave them to both enter work and then progress in work, because they were the ones facing the highest deduction rates, and they are the most sensitive.

First earners in couples will basically go out to work even if there is a 90% deduction rate and it makes very little difference to their decision to supply labour, although it would make a difference to the amount of labour. I would expect that this would have an effect on second earners. It is not perfect, because we still need a work allowance for second earners to get people into work, but it is still a very big improvement indeed.

Around 300,000 families will see their incomes go up because they are now eligible for universal credit, if they work that out and claim it, but they will see their work incentives fall because they will move on to the universal credit taper rather than the tax system, and that is a very big increase.

Q269 **Anthony Browne:** And from a tax point of view that is a pure dead weight cost as well.

Torsten Bell: It is not dead weight in the sense that it supports households, if that is what you care about, but it isn't improving their work incentives.

Q270 **Anthony Browne:** Paul, I think the IFS has done work on this. Charlie Bean referenced it.

Paul Johnson: Yes, over time we have done plenty of work on this. We put something out this morning illustrating the extent of, in a way, one of the trade-offs, which is that the taper has been cut and the work allowance has gone up. We are now in a world where a single earner couple with children, or a lone parent who is a higher-rate taxpayer, could easily still be on universal credit. That is particularly odd since they are having child benefit withdrawn at the same time. That is just an inevitable consequence of making these things more generous. As Torsten said, for people who are drawn into the universal credit system, that is going to reduce their incentives to work some more.

As with a lot of these things, quite a big part of any impact will be seen in the longer run rather than immediately. It is as much about whether it is worth taking a promotion or moving to a new job as it is whether it is worth doing the extra hour or two. For a lot of people, that will make a significant difference if they are looking at a job that will now net them about half of what they would have got, rather than about 40% of what they otherwise would have got. Torsten is also right that the biggest effects here are normally for second earners in a household.

Q271 **Anthony Browne:** My main questions are about the fiscal rules. We have a new set of them. Isn't that exciting? Obviously, their primary objective—there are various sub-objectives—is to get the public sector net debt falling rather than the deficit, which is the normal primary target for fiscal rules. Does it make sense to target debt rather than deficit? I am open to everyone, but I know that you, Paul, do a lot of work on this.

Paul Johnson: In a way, the two go together. We are looking at a sort of deficit around the level of the target that is just about consistent with getting debt down over time given the level of investment spending, so the two are fairly closely interlinked. In the long run, if we could run up huge deficits and the debt was still going down that would be fine, so in a sense it is the debt over the long run that is the primary point of concern.

There are two issues with this. One is that having an arbitrary date at which it starts to come down is always difficult. Secondly, knowing the appropriate level is always difficult.

One of the things that struck me most strongly from the OBR's fiscal risk report this summer was that it talked about how we dealt with the covid problem and what the lessons were for the future. The big thing the OBR drew out of that was that we have no idea what the risks are and what will happen in the future. The most important thing is to have some fiscal space. Again, we have no idea where the point of debt is that means you do not have the fiscal space, but worrying about that seems to be the primary issue. Obviously, the level of deficit feeds into it directly.

Dr Tetlow: I would add a couple of points. You are right that the main target is now debt and we have a supplementary deficit target, whereas previously we had both a debt and a deficit target. I have to say that it was not clear to me that the choices made in this Budget were any different through having the deficit target as supplementary rather than core.

Paul is right that in a sense, in principle, the level of debt to GDP is the thing you really care about. That determines whether a country is fiscally sustainable. If you have much stronger real-terms economic growth, that allows you to borrow more because you are getting much richer over time. In practice, debt targets of this type are much more easily gamed.

Anthony Browne: Student loans, and whether they are on the balance sheet or not.

Dr Tetlow: Yes, and asset sales at exactly the point you want something to go down. In practice, it might make more sense to focus more on the intermediate targets rather than debt.

Q272 **Anthony Browne:** The second point is that you have this rolling target three years ahead. The Office for Budget Responsibility used this slightly arch phrase, saying that it was "Augustinian", which I took as a reference to St Augustine of Hippo, who said, "Make me virtuous, but not yet."

If you are always targeting three years ahead, you could always have policies to bring debt down in three years but never actually implement them. You can carry on being non-virtuous for ever and still always meet your targets. Is there a real risk of that? When we asked the Chancellor about it, he said that there is no perfect way of doing it. You have an arbitrary date; as you get to it, it constrains you so much that you cannot respond to short-term fluctuations. What do you think are the pros and cons of this?

Torsten Bell: There is definitely a risk, because you can eat the pizza but not get on the exercise bike year after year after year, as we discussed before. That is definitely an issue. In general, I am not a fan of rolling targets as a way out of the "bad stuff can happen". A three-year rolling target does not even work, because it is not long enough. If a crisis happens, a three-year target ain't going to get you out of it in most cases anyway, so it is the worst of all worlds.

In normal times, you no longer have a binding target and what you should have, rather than a rolling target, is a knock-out clause if bad stuff happens. It is not going to work to deliver that objective anyway, so I do not think that a rolling target is the right way to go. As you say, it means that the Government does not ever have to hit its target.

To go back to what Paul said, if you leave aside the second point, we have a view of less focus on debt and more focus on the whole balance sheet, for exactly the reasons you mention about gaming, which brings me to the other measurement difficulties. Without getting into that, the state of the balance sheet, whether via debt or the overall balance sheet, does matter.

Where are we heading? If we step back, what is going on? We are going along with flat levels of debt, and we are then hitting crises and ratcheting up our debt levels—by 40% of GDP in the last crisis and by 15% to 20% in this crisis—and continuing as flat as we are. The Chancellor says, "I am going to get debt falling," but what he means is, "I am going to get debt bouncing along." It is not falling. That is the discussion we need to be having now.

I slightly disagree with Gemma; I do not think I am worried about debt as the ultimate thing. What matters is debt interest payments in terms of ultimate fiscal sustainability. Debt is important, because it gives you a way of thinking about the risks, given fluctuations to interest rates and the rest of it; it is a really important component part of that, and the truth is that we are basically silent. The collective consensus in politics is that we will stick where we are and will not worry about fiscal space, as Paul mentions. Personally, I would be more relaxed about the short term on the fiscal and less relaxed about the medium term.

Q273 **Anthony Browne:** Paul, rolling targets or fixed-date targets?

Paul Johnson: I do not think fixed-date targets work terribly well. They certainly do not work for debt and for deficits, because all sorts of things change and, with a year to go, what you do not want to be doing is suddenly lurching to a new tax or spending policy just to meet your target next year. Even in normal times, OBR forecasts can be out by £10 billion or even £20 billion, so then you need to build in an awful lot of headroom, which would be equivalent to having a tighter fiscal target than the one you have described.

In terms of the risk around rolling ones, oddly enough we did not have a target explicitly back in March, but we had a completely implausible pencilled-in set of spending plans. That made it look like we would meet current Budget balance in three years' time, but literally nobody believed that those spending plans would come to pass—and indeed they have not come to pass. Putting in place implausible-looking plans like that can make it look like you are going to meet the target, and once you get beyond the spending review period the Chancellor can pencil in whatever he wants. On at least a couple of occasions in the past, the OBR has been quite outspoken—certainly we have—and said, "Yes, you are meeting your target on these numbers, but these numbers, because they are not actually OBR-approved on the spending side three of four years out, just look completely implausible."

I have some sympathy with the Chancellor. There is no perfect way of doing this. It is much better now that we have an independent OBR who are able to say yea or nay to these things, but I cannot remember the number of targets we have had over the last decade—it is a very large number—and nearly all of them have been broken and replaced. You need to think what is the purpose of these targets. Partly, frankly, it is for internal Whitehall management, to provide some limit to what the Chancellor says he can provide to Departments, and it is partly to provide some sense of direction for the markets and some kind of—

Q274 **Anthony Browne:** If I remember rightly, the Treasury Red Book quotes OECD or IMF research that says that long-term borrowing costs go down if you have fiscal rules, because it reassures the markets. I do not know if that is true.

Paul Johnson: It is credibility that is effective, rather than the specifics of the fiscal rules. We have talked about this for years; I don't think there is any ideal answer. What has been suggested is as good as any set of fiscal rules.

Q275 **Anthony Browne:** Nina, do you have anything to add?

Nina Skero: I did not have a particularly strong reaction to the new fiscal rules. At a very high level I would say I interpreted them as slightly more lax than they have been in the past, but I agree with the point that credibility around best efforts to meet those rules is more important than the rules themselves. They in no way changed our outlook on anything.

Q276 **Anthony Browne:** You didn't go, "Phew, we've got them on track now."

Finally, I want to ask about interest rates, and we touched on them earlier with Harriett's questions about inflation. Torsten, I think you couldn't say whether this was the biggest risk that any Budget had in terms of interest rates, but it is certainly one of the biggest threats to this particular Budget. An interest rise of 1%—£23 billion. If interest rates do rise by 1%, or indeed more, what are the options for the Chancellor? That is more than the headroom he has, so presumably he has to raise taxes, cut spending or break his fiscal rules. What will happen if interest rates go up?

Paul Johnson: It depends on what goes alongside that. Interest rates have gone up over the last year, and I think debt interest spending this year will be £15 billion more than forecast back in March, but tax receipts have come in at £50 billion more.

Actually, in terms of tax receipts, the nominal size of the economy also matters, so higher inflation alongside somewhat higher interest rates can often, at least on the tax side, bring more in. Where you have problems is if you have higher interest rates and no additional growth, either nominal or real. You just have the standard set of options: you raise taxes, you cut spending or you bust your fiscal rules. I can't think of a fourth option.

Torsten Bell: It is worth joining up your last two questions. In terms of what you do, your rule choice will affect that to some degree. The focus on debt is in slight tension with the focus on high levels of investment spending. If you go to his credibility, the tax rises the Chancellor has already done are the thing that is reassuring everyone. When asked to make a difficult decision, he has whacked up taxes by £40 billion. That is your fiscal credibility.

What happens if you hit a crunch again on headroom? If we accept debt as the primary target—rather than getting into the weeds of that—my view is that investment spending is going to come under pressure. Basically, that is what history tells us happens, and although the Government have a strong preference for the current high levels, they are not going to fire nurses or put up taxes the year before an election. I would have thought that what you do is start massaging down your public investment levels. I would not think that a good thing, but that is probably the direction of travel.

It is worth noting something on that front. The Chancellor has said that he does not want to do a full fiscal Budget in March, when we get the next set of OBR forecasts. But the headroom is low and the target will not roll on again, so in March the Chancellor could be missing his fiscal targets and not taking any action. If that does happen, at one level I will be impressed because he will have been the first Chancellor who was prepared to sit there. That is probably the right economics because the numbers move around all over the place by huge amounts and policy responding to them is obviously madness. But it will require a different handling of the House of Commons than we saw a few weeks back.

Q277 **Anthony Browne:** You were talking earlier, collectively, about it being quite a fiscally expansive Budget—that is, economically putting your foot on the accelerator slightly. Does that make it more likely that there will be interest rate rises and that it is actually trading off fiscal policy with monetary policy?

Nina Skero: Yes, in a fundamental high-level sense a very fiscally expansive stance has the potential to continue contributing to inflationary pressures. It is one of the controllable factors feeding in. I would not say it was the main one, but I suppose it is a little bit of a circular point: are the announcements we heard making higher inflation and an interest rate rise more likely, and putting the Budget announcements at risk?

You could claim that there is a bit of a circular risk there. But there are other, external sources of inflationary pressure, which I have mentioned, coming more from global supply chains, skills shortages and rising wages, which would not have been as easy to control in the Budget.

Dr Tetlow: The Budget was quite expansionary in the next couple of years; if you look at the medium term—at the end of the forecast horizon—there was about a £30-ish billion improvement in the borrowing forecast. Most of that got banked; there was only about a £5 billion increase in spending. So there is much more fiscal stimulus going on in the next couple of years. I guess it comes back to the previous question. **Anthony Browne:** Forcing the Bank of England to put on the brakes.

My last question is that if interest rate rises are the biggest risk to this Budget, could the Chancellor do more to reduce it? Obviously, he could borrow less and control spending more and all that other stuff that we have been talking about, but what about debt management, for example? With quantitative easing, there is obviously the Bank of England, but could he do more there? Could there be fewer bonds that are index-linked or something? If you were the Chancellor and worried about this big risk, what would you do to reduce it?

Dr Tetlow: I would go for issuing more green bonds. There seems to be no meaningful sense in which the issuance of green bonds increases this Government's green investment. The Treasury's net zero review—

Q278 **Anthony Browne:** It is not hypothecated at all. Greenwashing!

Dr Tetlow: It is not hypothecated at all. The Treasury said in its net zero review that it would not do any additional investment to meet net zero. But the markets have revealed that if the Government issue green bonds, they are willing to loan them money at a lower rate than if they just issue a regular bond.

Torsten Bell: They may at some point work out what is going on, but right now that is brilliant advice—it is a ludicrous scheme, but the markets are coughing up for it.

Q279 **Anthony Browne:** Apart from green bonds, Paul, how would you, if you were Chancellor, reduce the risk of an impact from interest rates?

Paul Johnson: I am not sure that interest rate rises are the biggest risk to the Budget; there are clearly bigger risks associated with the economy just performing a lot worse than currently forecast. Within the context of interest rates and debt itself, there is limited scope. Personally, I think having more index-linked gilts is probably a good thing, for all sorts of reasons, even if in the short run it is potentially more expensive for the Government. Longer-dated gilts are, on the whole, helpful, but they will not help very much in the short term, because we are just stuck with the stock of debt we have.

If the question is a narrow one about managing the cost of interest at the moment, I don't think there is much that the Chancellor can do, except hope that interest rates do not go up. As I say, though, I would not have prefaced the question with, "It's the biggest risk that the Government face." It is one of the risks.

Torsten Bell: The other thing is which kind of interest rate risk you want to manage. It is the bad interest rate risk, the bad rise in interest rates, that we want to reduce the chance of happening—the asymmetric risk to the UK and not to the rest of the world, which you cannot manage. The most important thing there is to have strong institutions, with people in the Bank of England and the Treasury thinking about how they will handle a difficult situation. The coming together of a sustained period of high inflation with a wish to sell off our quantitative easing at a time when the Prime Minister wants to spend money—that is when you are into institutional pressure. It is a tail risk and it is unlikely to happen, but that is what you should spend your time worrying about in terms of bad interest rate rises. That, rather than abstract worries about wage-price spirals, is where we would be best focused, because that is when we are in real trouble.

Anthony Browne: I would love to continue this conversation, but I have run out of time. Thank you.

Q280 **Rushanara Ali:** Good afternoon. I am coming back to the overall tax burden and the size of the state. I know you touched on it during the Chair's questions.

Gemma, the UK's tax burden is the highest since the Government of Clement Attlee. Would you say that we have the public services to show for it? Paul Johnson said publicly that much of the spending is about addressing the last decade of underspending in certain sectors, rather than responding to the covid pandemic; is that where the public spending increases have necessarily had to go—to healthcare and so on—rather than being pandemic-related? Is that what is going on?

Dr Tetlow: The reason we are ending up with high levels of public spending and high levels of taxes to pay for that is not really pandemic-related. It is the result of a long-term trend, and the demographic trends in our population increasing demand particularly for health and, more recently, social care spending—and more social care in the forecast. That is what has driven it. It is not a UK-only story. Most other developed countries are seeing exactly the same pressures.

In previous periods, other types of spending have been cut back to make way for more health spending. We had a big cutback in defence spending, then a squeeze on things like policing in the 1980s. We have had a decade of cuts to lots of areas of public spending, while health spending has been going up. Even pre-pandemic, it was clear that that was hitting the buffers, and in the 2015 spending review, lots of those plans had to be topped up, to deal with things like growing levels of violence in prisons; more money was put into schools; more money was needed to top up social care in local authorities.

Q281 **Rushanara Ali:** We heard earlier about productivity, investment challenges and the rest of it. In the longer term, do you think that in terms of the impact of the pandemic on young people, schools and education—the catch-up tsar talked about £15 billion being needed, and the Chancellor talked in this Committee about putting about £5 billion into schools—the Chancellor is missing a trick to improve longer-term economic growth and prospects by not putting in appropriate investment linked to pandemic impacts on that group?

Dr Tetlow: Overall in the spending review, looking back to the alleged spending envelope set out in September, it had the very odd feature of having cuts in the first year, very low growth in the second year, then a big increase in the third year. That looked really strange in the context of lots of services outside the NHS facing backlogs from the pandemic, so I think it was good to see the Chancellor putting more money into years 1 and 2 in particular of the spending review when the final numbers were announced.

Q282 **Rushanara Ali:** My question was about education. What is your view on that?

Dr Tetlow: Education was clearly one of the relative losers from the spending review. Certainly, the £5 billion that has gone into education isn't large enough to meet our estimate of what might be needed to catch up on lost learning, and I agree with your concern that poorer skills in the cohorts going into the labour market over the next few years does run the risk of having longer-term impacts on productivity.

Q283 **Rushanara Ali:** Would others like to come in? I just want to probe a bit deeper into your thoughts about what the precise impact on productivity will be of the failure to put in that necessary investment for catch-up in education. If anyone has a number, that would be helpful.

Torsten Bell: We definitely don't have a number. We are looking at some work on this for the months ahead, but I don't think we have anything that helps do the quantification that you are after.

Paul Johnson: You can certainly come up with a very big number, in the sense that—

Rushanara Ali: The catch-up tsar quoted some numbers.

Paul Johnson: If you assume even that the result is an average loss of a few months of skills at the end of education and allocate a normal education return to that, you can come up with numbers in the hundreds of billions. Quite how useful that is, I am not sure, but I think the more important issue is probably less the average and more the dispersion among children. In expectation, I think a lot of children won't lose very much at all, but we know that the big losses are among those who are from the least well-off backgrounds.

For reasons that I confess I don't know, if you look at the most recent Department for Education figures, they show much bigger losses in the north-east, the north-west and Yorkshire than in the rest of the country, so there appears to be a regional issue.

Q284 **Rushanara Ali:** Which would undermine the levelling-up agenda, would it not? Unless anyone else wants to come in on these questions, I am going to move on.

The former Treasury permanent secretary, Lord Macpherson, commented that raising as much tax as the Chancellor plans to raise over the forecast period will prove difficult, either because it won't be possible to increase tax yield by as much as is forecast, or because, if successful, the Chancellor will be politically required to reduce taxes. What does each of you make of that?

Paul Johnson: That has been Nick Macpherson's sort of shtick for decades, frankly. At one level, you can see where he's coming from, because tax take in the UK has been pretty stable for quite a long period of time. It has been gradually inching up for the last 15 or 20 years. It is not obvious to me why he would think there is the sort of ceiling he is describing, given what we know is the case in other western European countries. I am sure there will be political kickback in particular ways. We know that it has been very hard to even maintain fuel duties. That said, the increase in the VAT rate from 17.5% to 20% back in 2011 seemed to go very easily politically.

Certainly, for many of the taxes—basic rates of income tax, national insurance contributions and so on—I don't think there is any evidence that we are at the point where you cannot raise additional revenue. It is worth saying that one of the biggest differences between us and many western European countries is that they have much more from their social insurance taxes, but they have something much closer to our social insurance system, so people see a proper link between those. I am considerably less sceptical than Lord Macpherson about the capacity to do that, though I may be misjudging the political economy there.

Q285 **Rushanara Ali:** Would anyone else like to come in on this point?

Dr Tetlow: The only thing I was going to add is that, as Paul says, other countries do raise more taxes as a share of GDP than we do. One thing that is notable is that they tend to raise more from across the distribution. It is middle-income people paying more; it is not just raising more at the top. From that point of view, the recent health and social care levy is an interesting one, because that is a tax that hits right across the income distribution. That was evidence that Governments can pass taxes that hit most of the population.

Nina Skero: I wouldn't want to comment on the political implications of that. I said earlier that I think that the overall tax burden and a number of taxes are at a point where we are going to see diminishing receipts as a result of further increases, but I would not want to comment on how politically palatable it would be.

Q286 **Rushanara Ali:** Paul, I am going to move back to you. You said that this Budget is "awful. Yet more years of real incomes barely growing. High inflation, rising taxes, poor growth keeping living standards virtually stagnant for another half a decade." When I saw that, my heart sank, because obviously constituents such as mine have really suffered over the past decade, and some of the changes to UC, even with the taper rate, will not help a significant number of people. Can each of you talk us through the winners and losers? We have touched on that, but you mentioned the north-east education. Who are the big losers in the Budget, despite the higher investment in public services and so on?

Paul Johnson: To be clear, I was not describing the whole Budget as awful, just the prospects for living standards. In terms of what we are expecting over the next period, there is quite a lot going on here, as Torsten said earlier. Minimum wage people on universal credit are going to be quite significant winners over the next year or two, but it looks like people on average sorts of earnings are going to be worse off in a year's time than they are today.

Do I expect a big increase in income inequality over the next couple of years? No, not really. Sitting here a year ago I would have said yes; I was really worried about that, because it looked like low earners, young people and people from ethnic minorities in particular had done a lot worse over the covid pandemic, but—broadly speaking—they have caught up, back to where they were previously.

One group we might worry about most going forward is older workers; a very large number—relative to what was happening pre-pandemic—have left the labour market altogether. For some of them, that may be a decision they have made with good information—they have seen what it is like being at home for a while and they have decided that they want to retire early, and that is fine. For others, that may not be the case, and there is clearly a potential economic cost from doing that.

It remains the case that the economic circumstances mean that winners will continue to be people who have assets, particularly housing assets, given what has happened in the housing market and how low interest rates are. One of the things that may happen from all the additional saving that people are not going to spend is that it is another thing that could push up the cost of housing. On earnings, there is no evidence of a big increase in the disparity between high earners and low earners, or old and young, but we may see yet more travel in the same direction, with those with little in the way of assets falling behind those with more in the way of assets.

If you look at the specifics of the Budget, there was not an enormous amount of action in it. As I say, there were some big winners from the universal credit changes, and if you happen to drink certain sorts of wine you might be a little bit better off, but it is the macroeconomic framework that is driving the changes. To follow on from what Torsten was saying about the catastrophe—or was it the disaster?—of the last 20 years or so—

Torsten Bell: Either of those.

Paul Johnson: We are continuing to see remarkably little growth in incomes. Economically and in terms of people's living standards, that is disastrous and has political consequences, too.

Q287 **Rushanara Ali:** I was going to come on to "catastrophe". We know about the hit on productivity from Brexit and covid; the lack of investment, which you pointed out; and the longer-term impact of covid on our society, education, mental health and a whole series of things. What is your sense of whether the spending review and the Budget combined have encapsulated that enough? We talk about net zero and a whole range of longer-term as well as shorter-term issues. What is your sense of the extent to which the Chancellor's Budget statement, and the spending review that has been set up, address those longer-term challenges? Do they go part of the way, or do they need to go much further for us to be confident that there is a game plan? Or will you come back in the future and say it is still catastrophic? Are we a nation that is facing decline?

Torsten Bell: Right—

Rushanara Ali: You used the word "catastrophic".

Torsten Bell: The past is definitely catastrophic, and the forecasts of the OBR are catastrophic taken together, although within that they have upside risks—as we discussed at the beginning—and downside risks, assuming at some point we get the productivity growth that they keep promising us and that has not turned up for the past decade. To try to do justice to that large question, let us deal with what happened narrowly in the Budget, and then with the big picture.

Within the Budget, I would think about it distributionally in two ways. First, narrowly, within universal credit, three quarters of the population on universal credit are winning and a quarter losing. That broadly splits out as

I discussed earlier: those not working, which is over half, losers; low earners, smaller losers; and higher earners on universal credit, winners.

Secondly, if we look at what the Chancellor has done as Chancellor—to take all the policies together and to look at their long-term effect, so I will not go into what he did during the crisis, which in general has been to protect average incomes well, with big dispersion within the averages—I would say the big effect is to make universal credit more generous, which is very welcome and has pushed up incomes at the bottom on average, and to raise taxes quite significantly on the middle and top of the distribution. He is putting in place 2% to 3% income falls by the middle of this decade because of the tax rises. That is a very different political economy from those we have seen from anyone since the 1990s, particular for a Conservative Chancellor.

A big difference: it is progressive in general—the tax rises overall are large and they are progressive in general. On aggregate, they hit the top by 3% and the middle by 2%, broadly. Those are big falls in income on top of the macroeconomically driven living-standards squeezes. That is a big deal; you might say that what he is doing on that front is a gamble, but I could not possibly judge.

Generally, the tax changes will be inequality-reducing, on top of a high level of inequality that the country has been stuck with since the 1980s. That comes on the back of still rolling through some benefit cuts, but on average the changes the Chancellor has made to universal credit will deal with a lot of that, in terms of aggregate. You just don't want to be a large family out of work, basically, because they will be big losers from the overall changes in the benefit systems. However, a middle-earning universal credit couple will be doing well.

On the big picture—which is that we have this catastrophe going on—the bad news is that countries tend to go through long cycles of catastrophe. If you go back to the 1980s and look at all the articles in academic journals in the United States, they were all panicking about how the new Italian economic model would overtake the US shortly, because of its high productivity from small family businesses. That was what was needed for the future, because Italian growth was really strong—remember, Italy overtook the UK during that phase. Since 1990, however, Italy has managed three decades of really severe relative decline.

We have managed 15 years—a bit less than that—of relative decline since the financial crisis. Measure it by our gap to the frontier countries of the US and Germany, for example, and we have got worse. If we carry on doing that, and that tends to happen from a mix of bad luck and feedback loops from politics to economics, which you tend to see when things start going badly—there is a reason why Berlusconi turned up and lasted a long time—then that is when relative decline kicks in, when we are not taking the system of governance seriously. So, we should worry about that.

The optimism case for a country in the position of the UK with an economic strategy is that it is not impossible to imagine that productivity growth coming. The big reason I would give for optimism on that front is that we are not at the frontier. If you are at the global frontier for productivity, to be confident that an advanced economy can grow and get back to previous productivity growth levels, you would need to have quite a lot of optimism about what has been going on. However, if you are saying, "Could the UK plausibly get nearer to that global productivity frontier?", yes, because we have fallen a long way behind it in the past decade, the past 15 years. We have had phases before—the late '90s, under John Major and into the new Labour Government—when we saw periods of productivity catch-up with that frontier. It can happen, but it needs to happen with a combination of good governance, economic strategy and luck.

Rushanara Ali: Thank you. I will hand back to the Chair, unless anyone has anything to add.

Dr Tetlow: I agree with what has been said. Looking at the Budget as a whole, there was not a clear sense of a growth strategy in it. It was not clear what this Government think they can do to support stronger economic growth, whether through institutional reform, a concerted skills policy or a concerted approach to infrastructure investment. You did not really get that from the substance of it.

Nina Skero: On the aspect of whether the Budget addressed every concern arising from Brexit and the pandemic, no, but that is probably quite a wide merit for the Budget. Overall, I would describe this as a pretty confident Budget and if some things go in the Government's favour around inflation, interest rates and growth in 2022, we could look back on this and think it was quite a competent move. If overall economic performance surprises on the downside, more tough adjustments are probably going to be necessary, so there is that wider area of uncertainty.

I was generally encouraged by the last few remarks of the Budget, around looking at the way forward and expecting a smaller Government in the years ahead. My reading of this Budget was not that catastrophic. If anything, I do not think that it would be good to have a major fiscal event every six months in the UK. In a way, it is good that not everything was mentioned, that it did not try to be the universal credit Budget and the green Budget and the productivity Budget. Those are all worthy topics, and I think there is a platform for each one, but this may not be the best place for all of them. There is something to be said for a more focused approach.

Q288 **Emma Hardy:** Good afternoon, everyone. You will be pleased to know that I am nearly the last person questioning you this afternoon. There are two areas I want to ask about. One is about who are the winners and losers in terms of Departments in the Budget generally. The other is around the health and social care levy. My first question is for Gemma: what are the key lessons we learned from the spending review settlement as to what the Government's priorities are over the spending review period?

Dr Tetlow: As I think I said before, one of the big news items from the spending review was extra money going in for the first couple of years, making more money available across several Departments for tackling some of the covid backlog issues. That came out as one of the priorities. Looking at the Departments that got the biggest real-terms increases in this spending review, one that stood out for me as a winner was the Ministry of Justice, which got one of the biggest settlements this time, in stark contrast to the settlements it got in 2010 and 2015. That is a clear statement from this Government on wanting to put more money into courts and the prison service. That deals with the knock-on impacts of recruiting 20,000 extra police officers and makes more money available for dealing with courts' backlogs and some of the pre-existing issues in the courts and prisons system. That is an interesting statement of priorities.

There was quite a generous settlement for transport, consistent with the Government's desire for more infrastructure spending in that area. Health was inevitably one of the relative winners. It remains to be seen how much of the health and social care levy ends up in social care. The Department for Education was one of the relative losers. In the last couple of spending reviews, education was one of the areas that got relatively big settlements but this time it got one of the smallest increases. Even though the Chancellor hailed in his speech that per pupil spending would go back to its 2010 level, it is pretty remarkable to have a decade with no real-terms growth in spending in schools. That is quite unusual and not a strong signal of prioritising improved skills in the UK.

The other loser was local government: spending power there is going up more than it has in recent spending reviews, but once you strip out the money already ring-fenced for the increased generosity of the offer on social care, it still looks like they will have to cut services on non-children and adult social care to try to make enough money available to deal with existing pressures that were already there.

Q289 **Emma Hardy:** Paul, I read that you said, "For the chancellor to have felt it appropriate to draw attention to the fact that per pupil spending in schools will have returned to 2010 levels by 2024 is perhaps a statement of a remarkable lack of priority afforded to the education system". I am afraid I have to admit my bias now, Chair, having been a teacher in schools until 2015, and having had the rationed glue sticks—only eight a year—and the one pencil of each colour per table. I also saw the declining number of hours my teaching assistant had, year on year. I was witness to this declining prioritisation of education. All of you are talking about the importance of raising productivity. Is it surprising that education is not being given the funding and support that it needs?

Torsten Bell: Yes, broadly, on schools funding. I should caveat that by saying that if we are looking at this in the round since 2010, there is a whole set of winners and losers that did not get announced in the Budget: there is the reform of HE and FE finance, which we are waiting to hear about in the Augar response. That is meant to come by the end of November, so we have three weeks for it to emerge—we shall see.

I raise that because it speaks to the bigger picture. Although everyone talks about the state shrinking since 2010, there are some areas where it has significantly increased, and the HE sector would definitely be one of them, even if that is not totally visible via our public spending figures. We have underfunded schools—and, I would say, the FE sector in particular—since 2010, while putting more money into HE in a complicated way.

Q290 **Emma Hardy:** Paul, do you want to add to your comment?

Paul Johnson: In a sense, the comment speaks for itself. It is extraordinary that while, over a much longer period, health spending has continued going up as a fraction of national income, overall, education spending has not done so particularly—and clearly it has fallen as a fraction of national income since 2010. You might have added, when you spoke about being a teacher, that the real earnings of experienced teachers are now at least 8% or 9% lower than they were.

Emma Hardy: Yes.

Paul Johnson: That is a pretty big reduction. Private sector earnings have not gone up enormously, but they have not gone down by 8% or 9% over that period. Of course, you are right: getting a well-educated, highly skilled workforce is absolutely crucial for productivity and future living standards. Of course, there is a lot more to it than simply spending. We obviously need assurance that the money is well spent. Even compared with schools, though, sixth forms and FE colleges had much sharper cuts over that period; and we know that when it comes to that group, and those sets of skills, we are already somewhat behind the rest of Europe, in particular. In a way, the details are probably more important, but when it comes to the overall picture—the framework—the fact that we are delivering education with a budget that has not increased in a decade and a half is quite surprising.

Q291 **Emma Hardy:** We were talking to the OBR last week, I think it was, and it was talking about the economic scarring, this generation of lost learning, and the fact that if children are not able to catch up on the learning that they have missed, there are long-term economic consequences. It seemed a little shocking to me that the Government put more money into tax deductions for whisky than education catch-up. What will be the impact on the economy if we do not resolve the issue of lost learning and education?

Nina Skero: A point that has not come up yet in the context of the impact of investment and educational matters on our economic trajectory is what happens to immigration. It is probably looking ahead, rather than looking backwards, that we see it is more risky to not have the homegrown skills that you think the economy will require, given that, despite the rhetoric, it has not really been made easier in any meaningful way for people to move to the UK for jobs. Investing in education is obviously a very long-term strategy, and you need to think about the very long-term horizon. We have already seen from the more acute, sector-specific examples over the past few months that finding very short-term solutions, such as adding new occupations to the occupation shortage list, does not really produce the desired effect, because that is just not something that is meant to be addressed on such short timescales.

Paul Johnson: I was going to repeat what I said earlier. I think the real worry here is the unequal effect. It is quite hard to know what the overall effect will be, but there is a real danger that we will have a fraction of the cohort who are going into the labour market with very poor basic skills and very poor educational qualifications. Indeed, I think there is some evidence that some children have become quite disengaged from the education system. We do not know yet what the long-run impact on skill acquisition and learning will be on average. It may not be very big. It may be that people pick that up.

Q292 **Siobhain McDonagh:** But we do know that 200,000 children transferred from year 6 to year 7—so primary to secondary school—unable to meet the reading levels required.

Paul Johnson: Absolutely, the short-term impacts are there. How they will translate long term, we do not know. We have had glacial improvement in educational inequalities over the last decade. The real danger is that this will take us back to something worse than where we were 10 years ago. That obviously has big social consequences, but it can have economic consequences as well.

Torsten Bell: I agree with all of that. The educational scarring aspect of this is obviously not something that we have seen previously. We have not shut schools down during recessions. For lots of what we are talking about here—changes to investment, to labour market participation, and in productivity after recessions—we are aiming off from previous experiences, admittedly with huge amounts of uncertainty and errors in the process. On this front, we have not been through it before. There is some evidence from the States that shows you the optimistic case, which is quite a fast bounce-back for some children once they are re-engaged with the system, but for children that have become significantly disengaged it is a really serious problem.

We should worry about it a lot. We should feel no certainty about the scale of the long-term effect, and we should focus on the children who are the hardest to reach. Anyone who has spent any time in any school over the course of this pandemic knows that headteachers are desperately trying to get in contact. It is no good saying that kids who are struggling are allowed to come into school even when everybody else is told that they can’t, because they cannot get hold of them. Every headteacher who I have spoken to in the last year has said the same thing. They have all been despairing about what they can do about hard-to-reach kids, who are having a really tough time during the pandemic.

That is something that we are going to be living with to an uncertain degree for years to come, and you can see elements of that in some of the broader mental health challenges that some people are reporting. They may or may not be bigger than long covid—we will find out—but there are big uncertainties about what the lasting effects are on us as humans, rather than as economic agents.

Q293 **Emma Hardy:** Yes. Do you expect—not that we can anticipate what the Chancellor will do—that greater priority could be given to that in the future? Aside from the moral argument, there is an economic argument if we do not address this.

Torsten Bell: What I would say is that, stepping back and looking at the education discussion since the pandemic started, there has been a lack of urgency. There was a lack of urgency during the crisis on making sure that we were looking after people who were disconnected from the system very early. I even saw that at our primary school, which is a very lucky primary school, but it was a disastrous free-for-all, basically. You didn't want to be a kid whose parents weren't—you did not want to be my kid either, but you definitely didn't want to be a kid who was struggling to connect.

I am afraid it also applies when you look back. Did we see huge urgency in terms of putting in place catch-up provision over the beginning of this year, when we knew that we would hopefully be sustainably reopening? No. The new Education Secretary is now talking about some measures that will make more significant changes, so we will see what happens, but have we seen the urgency that we would want, given that, although we do not know the size of the problem, we know that it is very acute for some people? No.

Q294 **Emma Hardy:** Thank you. The other part that I wanted to talk about was a health and social care levy. I raised that with the Chancellor and with the OBR. The Chancellor seemed very confident that he had given enough money and that all would be well, as we have £1.6 billion extra. What is your assessment of how well the changes that the Government have made in terms of national insurance and the new health and social care levy will fund adult social care, and of the problems and the crisis facing it? The example that I gave was from my personal knowledge of two different authorities—one urban and one rural, one Labour and one Conservative—both saying the same thing: that adult social care is in crisis at the moment.

Torsten Bell: The first thing to say is that it is a large tax increase to fund money going to health and care. That is a big deal, it is broadly progressive, and it is on something that is in the right direction of travel, as in it is in line with where societal changes and public preferences are taking us, and where need is. That is the big picture. Within that, there are two sets of issues. One is that, obviously, it is called the health and care levy. Within the next three years, it is principally a health levy rather than a social care levy. There is a prioritisation of the two, whereas over the past decade, the funding of those has been relatively generous to healthcare but a disaster for social care. Then, within the social care component—the £5.4 billion-odd—we are spending money to change who pays for care. Again, I support the socialising of the bad luck of having high care needs—we are changing who pays for that.

What we are not doing, as Gemma mentioned earlier, is putting in money to deal with the underlying challenges of very large unmet need—a very poor-quality system. We are changing the funding of existing care. There is a slight overlap between the two, but broadly, we are funding who pays for existing care, in a social democrat direction, and we are not dealing with the underlying lack of cash in the system for the volume and the quality of care. That is what comes back to, is there going to be more pressure for more top-up spending on social care in the years ahead? I presume we have lots of views on the actual tax mechanism as well, but that is on the spending side.

Emma Hardy: Any other thoughts on the levy?

Dr Tetlow: I agree with what Torsten said. The extra money from the levy may well be enough to pay for more people now being eligible for care because of the £86,000 cap, but it does not deal with the problem that was already there. Lots of people were technically eligible for state-funded care before this reform, but over the past decade, fewer and fewer people have been receiving it, which is quite strange given that the size of the elderly population has been going up. That is just a signal that local authorities have had to ration who is getting the care and how much they are getting. That problem remains, and private providers are really struggling to survive.

Q295 **Emma Hardy:** The Chancellor said to me last week that he does not think raising levy rates would be necessary in this spending review period—that they have enough money. Do you agree?

Torsten Bell: I think that is a slightly literal interpretation of the hypothecation that is going on. Credit to the Treasury, because there was one thing they did hypothecate, as they were worried about you all criticising them. They increased the amount of money they thought they were going to get from the levy, and actually passed it through into higher funding, largely for the health service, so they have hypothecated in the short term.

In the medium term, are we really going to see the Chancellor adjusting health and care spending to match what goes on with what is basically just national insurance plus a bit of dividend taxation? No. I would not think about it in terms of, "Does he have to increase his levy because of this?" The question is just, "Does he need to spend more on health and care in general?" Our answer is, yes, there is going to be ongoing spending pressure on the quality and volume of care, because we have not even tried to address that in the system.

Even within that, there are also huge uncertainties because system change is going on here as well. It is not just about the simplistic thinking around the cap and what it would do to what individuals pay, because to implement it we have a lot going on under the bonnet in basically bringing all private users of social care—or even people who do not use it but who could—into the local authority system to get themselves priced so they can start the tab running, or start the clock ticking, on whether they will hit the cap before they stop needing care, which happens for bad reasons rather than good in most cases. That is going to lead to quite a lot of system change.

What I do not think we have a good handle on is what that does. That will stop the cross-subsidy that happens between private and local authority-provided care, which is why, I should say, the Government have put some more cash in on that front—it is not just what I mentioned earlier. There is now a strong incentive, which did not exist before, to come into the system to get yourself certified. On how that plays out in terms of increasing the need in the ecosystem of care homes, once you say to them, "You cannot cross-subsidise between private payers and local authority payers," those things on their own could bring with them significant spending pressures on top of the existing baseline pressures. I cannot tell you with any certainty how that will play out.

Q296 **Emma Hardy:** Is our current model for funding adult social care sustainable, then?

Torsten Bell: It is not sustainable in the sense that they are changing it. The Government have clearly come to the view that it is not sustainable.

Q297 **Emma Hardy:** Even with the changes they have introduced, is it not sustainable?

Torsten Bell: With these changes, what we are setting ourselves up for is, one, social care being a bigger part of general election campaigns to come, because parties will now start competing on where the cap and thresholds sit, because you've just built a system that is much more visible. I don't think this is the end of the process. If you want a reason why the state is going to get bigger in the 20 years ahead of us, one is because we have just built a system that is basically a ratchet for more protection of assets from the risks of social care in the decades ahead. The Government have said it is not sustainable by introducing this new system, and I would have thought that successive Government are going to decide that the existing system, as put in place by this Government, is also not sustainable, because they will need to be dealing with the ongoing pressures from an ageing society and rising care costs, and they will also need to compete over what the new social care cap should look like in future.

One last thing I should definitely say is that the workforce is clearly not sustainable. If you believe in a high-wage economy, that is clearly not the approach we are taking to funding our social care system, which is that we are basically using a combination of wage-inelastic workers plus migration to push down public spending pressures within the care system. If you look at where job growth is coming from going forward, it is likely to be in that area again, and it is not clear that we have a sustainable workforce on that basis.

Q298 **Emma Hardy:** The OBR said to me last week that it thinks 80% of the costs of this adult social care levy will be passed on to workers in terms of lower wages, and 20% passed on to consumers in higher prices. Is that right in terms of who is paying?

Paul Johnson: On the impact, half of it is just a tax on wages anyway, and that will almost certainly simply reduce incomes by that amount. Most evidence is that most of the employer part of it will also be passed on to employees. Part of what is in the forecast for living standards going forward is that this is a big tax rise, and it will push take-home pay down.

Q299 **Emma Hardy:** You will either end up with lower pay or higher costs anyway.

This is my final question. When I was talking to you, Gemma, you said that one of the losers was local government, and local government is in a desperate situation with adult social care. As social care funding will take up more and more of its budget, which is decreasing, do you expect there to be cuts to local services? In your opinion, which services are most likely to suffer?

Dr Tetlow: Certainly the trajectory we have seen in the last decade, when local government has had repeated tight spending settlements, is that more and more of the budgets have just focused on the statutory duties of local authorities, which are principally adult social care and children's social care. If there continues to be pressure for more spending on those areas, that means you need to find savings from everything else. After 10 years of doing this, everything else is a smaller and smaller pot of money.

In some ways, it is striking that some of those other things that local authorities do are the sorts of things that the Government have talked about as being important civic capital for local areas as part of levelling up. That means things like youth centres, parks and roads, and all those sorts of things are within the rest of the local authority budget that has been squeezed over the last decade.

Obviously, what we haven't really talked about is that that plays out quite differently across the country. Some local authorities don't have social care responsibilities, particularly district councils, because that is done at the higher-tier level. Some parts of the country obviously have much larger older populations or poorer populations who are much more reliant on publicly funded social care. On the revenue-raising side, some local authorities raise much more if they do a 1% increase in council tax than other areas do. It is a very mixed picture of how social care spending pressures play out and the extent to which local authorities have levers that they can pull to try to increase their budgets to cover some of these costs.

Emma Hardy: Torsten, do you want to comment on that?

Torsten Bell: I agree with every word Gemma said. I would only add one thing. You were referencing parks and I cannot remember the name of the micro-parks that he announced—

Dr Tetlow: Pocket parks.

Torsten Bell: Pocket parks. I am pretty sure I live next to one of those. It is called a bit of scrap-land, but I am in favour of pocket parks.

What is going on is that we are in the business of—this comes back to what I was saying earlier about whether you have an economic strategy with a big increase in capital spending and whether it is focused on productivity—what we are doing is holding down local government spending, broadly continuing the pattern to a much less significant degree than we saw in the last decade, but still tough given the spending pressures, but wanting some of the things that local government traditionally provided to improve, which is the feel of the place—the town centre, the high street—and doing that with targeted capital spending, which we tend to be delivering via funds that local authorities bid into to provide those increases. That brings with it some short-term wins in terms of people seeing some construction activity taking place on their high street or otherwise. I doubt whether it is sustainable, given that local government is the underpinning institution that thinks about place; it is housing associations in some areas, but it is largely local government that thinks about that. Local government does not have the current or capital spending to maintain that. We definitely have tension within the system. We want to dole out the cash as capital, but we do not want to give control and revenue spending to local authorities.

Q300 **Emma Hardy:** They want to do things that are big, new and shiny so they can have a photograph outside them, but they do not want the dirty, boring, everyday running costs.

Torsten Bell: I am not the expert on photographs, but you might well think that.

Emma Hardy: Nina or Paul, would you like to make any comments?

Nina Skero: No.

Paul Johnson: No.

Q301 **Siobhain McDonagh:** I want to ask some questions about levelling up and housing. The Chancellor told us this week that levelling up is a mindset. Do you think that the Government's definition of levelling up is tangible and sufficiently well defined?

Dr Tetlow: I think levelling up is still a pretty broad ambition. The most concrete statement seems to be what we had from Michael Gove in his party conference speech. That was pretty broad, including that it was about improving living standards, particularly where they are lowest. That seems to cover quite a lot of what Government do. I do not think that it is very precise yet. In terms of what we saw in the Budget and spending review, there was not a lot of clarity, particularly if you look at the priority outcomes that were published for Departments alongside their spending review settlements. Those looked very similar to the priority outcomes that they published a year earlier, so there does not seem to have been much development or honing of the objectives of levelling up.

Torsten Bell: I think that is fair. We have not got the White Paper that was meant to come out before the spending review and then got delayed. It was reasonable that it got delayed, given that three different white men were appointed to come and oversee it and so they need to agree what their new way forward is. That is understandable. But that is where the rubber hits the road on "Is there an agenda?"

Why is it difficult in this area? Some of it is obvious. It is politically advantageous to cover a broad range of things, but that is less useful in driving your agenda within Government. It is partly because if you stand back and ask, "What is the big problem in terms of geographical inequalities?", there are lots and they overlap but they are different. You have got a regional problem on output gaps growing, that is GDP, whereas our living standards gaps have been falling but are still large. We do not have a thought-through way of dealing with how those different things interact and whether we care about opportunity, which is how the Prime Minister tends to frame it. If you ask him for one sentence about levelling up, the answer tends to be "equal opportunities." Basically, that is another version of Nick Clegg or Tony Blair on social mobility, broadly defined, possibly with a bit more "You can have that by staying put", rather than having to move for opportunities to universities and so on. Broadly, that story is similar.

On the economic side, we do not have a clear sense of how the output and the living standards fit together, given that they are not the same thing and your policy would be different if you are trying to deal with one of them. Broadly, if you are worried about regional gaps, then it is the output gaps that should be your main point of concern.

Paul Johnson: As you have heard, it is certainly not well defined at the moment. There are lots of things you could aim at. If you are thinking about what are the big differences between regions that you can see, as Torsten suggested, in terms of average after-housing costs incomes, the differences are not that enormous.

Torsten Bell: And there are four-decade lows.

Paul Johnson: Certainly, if you are looking at the differences in the wages of graduates or non-graduates in different places, they are not that different. Where are the differences? First, there are regions with very large numbers of graduates and some regions with very small numbers, so average earnings in some areas are much lower than in others. If I were to have a single measure of whether things were getting better, I would be looking at health and mortality.

Siobhain McDonagh: I am coming to that.

Paul Johnson: You know what is going on there. You cannot mismeasure that—you certainly cannot mismeasure mortality.

Dr Tetlow: Sorry, I am slightly shaking my head because some of the life expectancy by small area numbers relies on looking at the death rates of people who live in that area, which is obviously not the same as the life expectancy of someone born into that area. There are parts of the country where low-income people in poor circumstances end up ending up.

Paul Johnson: That is absolutely right. That is a really interesting measure of what is going on, in a sense. Partly, people born into certain areas have lower prospects, but also people move sometimes to areas with lower prospects. A lot of the areas where people start off with low prospects of getting on through higher education and so on, for example, nevertheless have a net outflow—they do not produce many graduates, but they nevertheless have a net outflow of graduates, with an inflow of people with lower skills and lower earnings and on the benefit system. There is a whole set of issues there. Even if you were just to focus on opportunities, as the Prime Minister wants, it is obvious that opportunity is very different for getting through the education system in different areas.

Looking at the other end of life, it is also obvious that health and mortality are very different in different areas. Focusing on all those things, that is part of the problem—it is so amorphous; you can focus on so many things. But some of that is what the new permanent secretary in charge of this, Andy Haldane, intends to sort out.

Q302 **Siobhain McDonagh:** Nina, the Industrial Strategy Council stated that Government's "proposed approach" on levelling up "appears over-reliant on infrastructure spending and the continued use of centrally controlled funding pots thinly spread across a range of initiatives." Do you agree?

Nina Skero: You could colour that statement in a lot of different ways. Would devolution of decision making away from a central source make some difference? Probably, but it has been an ongoing debate for quite some time. I do not think that focusing on that element of the conversation is the right way forward for the levelling-up agenda.

I wonder about the appointment of Andy Haldane and how new discussions will evolve in the light of what the pandemic has done to ways of working. Perhaps that will slightly decouple the location of a person and the location of an opportunity. However, some of the research that happened over 2020 in that space perhaps slightly overestimated how long term the changes to working patterns and remote working were going to be. It now seems that we are already at a halfway point—possibly already closer—back to the old ways of working.

Devolution of decision making is a big topic, however, so I would say that I neither agreed nor disagreed with it. It would depend on what exactly we were discussing.

Q303 **Siobhain McDonagh:** A common misconception is that levelling up is between the north and the south, but there is big difference within regions and even within London boroughs. Some of the biggest differences are in London boroughs. To take my borough of Merton, if you are born and brought up in Wimbledon, you live on average nine years longer than if you are born and brought up in my constituency. I do not think that that is necessarily my personal fault, but that is nevertheless the case.

When south London was chosen for one of the Prime Minister's new hospitals, the decision was made to downgrade St Helier Hospital, in the area of poor health, and to move the services to the area of higher life expectancy and better health. Do you agree that levelling up should be a requirement, not just a consideration, for major spending decisions such as that? In every report, you would have the impact on equalities and on all sorts of things. Should levelling up be a paragraph at the bottom of every report on public sector spending?

Nina Skero: It will not make a huge difference if it was a paragraph at the end of a report, because actually, a lot of considerations for where spending goes—levelling up—are actually the opposite, in a sense. In high-density areas, areas of already high productivity, you can make a much better cost-benefit assessment of a lot of different types of investment. You would probably need to make a more fundamental acknowledgment that you were looking to change that, more than doing the assessments the same way and then adding a paragraph on: "But, on the other hand, this might be good for—

Siobhain McDonagh: I just want them to acknowledge that they are doing this.

Dr Tetlow: I would generally be in favour of trying to be clear about what metric you are trying to improve, and measuring your progress towards that. There can be a tendency for these kinds of impact assessments to be a bit of a tick-box exercise, not really affecting the first decision-making stage. To your precise example of a hospital, I think you would need to ask the broader question: where can those services most effectively be delivered, and what access do people have to the services? People travel from a broad area to get to services. Do we have them distributed appropriately across the country?

Q304 **Siobhain McDonagh:** Torsten, you may be aware of the Tudor Hart law—that the areas in the greatest health need are those statistically less likely to receive better health services, and that health services migrate to wealthy areas. Is that a fair reflection of health services across our country?

Torsten Bell: I don't know. I am not enough of an expert. To join that up, though, with what you were just referencing, it is always good to look at where we have learned and maybe changed our own mind. In the 2000s, if you had asked me how we should make decisions about where major public sector investment and service provision goes, I would have given you a more technocratic answer focusing on delivering services, the quality of the individual institution and the rest. Reflecting on the challenges that we have that make me think that you cannot buck a lot of the economic geography that comes from private sector development, I think that we probably should take a bit more seriously the role of public service provision in not exacerbating some of those within-region challenges that you are raising.

There are things that go the other way. I do not want to do that when it comes to the provision of children's heart surgery, where we need very high volume if we are to make sure that really good people are doing the surgery, because the health outcomes are very variable. When it comes to other things, I would include where courts sit. The last Labour Government obviously closed lots of courts. The next Government also closed lots of regional courts in small areas. I would now probably take the view that that was less of a clearly good decision than I did in the past, but you would need a health expert to answer your question, or at least someone with more health expertise than me, on whether that law has been a strong driver of our outcomes.

Q305 **Siobhain McDonagh:** My final question is to Paul, then Nina. One in 10 adults own a second home, while four in 10 do not own their first. For them, levelling up appears to be just an electoral catchphrase. Should the Budget have done more to make housing more affordable for first-time buyers and those who live in the private rented sector?

Paul Johnson: In a sense, those two statistics are flipsides of one another. Who are young people renting from? They are renting from their parents' generation on the whole. The fraction of people in their 50s and 60s who own second homes is remarkably high. The fundamental issue is house prices, which is partly down to supply and very significantly down to interest rate changes that have through pure chance—happenstance—favoured one generation over another. The bigger question, in a way, is what we can do that would substantively change that in fiscal policy, or whether we have to start learning to live with a world in which people are renting for significantly longer.

If you think about the things that could substantively change that, you probably need to start really ramping up taxes on second homes, or on people who were buying houses to rent out. Then you are at risk, as you reduce the private rented sector, of whether that will also bring house prices down. If it doesn't, you really are causing problems for people who currently rent but can't afford to buy. But if your overwhelming objective is to rebalance those with second homes and people getting on the housing ladder, you would need to do something really quite substantive over a period of time to the tax system. I am not sure I would necessarily recommend that because, as I say, that potentially creates issues in the rental sector. You need to do that very carefully.

In the end, that is a really big choice that we need to have a serious discussion about. Do we live with the fact that there is a generational change in home ownership? What is the best way of managing that and helping people who are renters, making sure there is the right regulation there? Or do we do something quite different from what we have done before with the tax system when it comes to taxing people who own more than one home? How might you do that in a way that gradually moves that balance? I think that would be really interesting. I have not thought that through further, but it is a really big issue.

Nina Skero: I agree that it is important to consider the question of what share of private sector renters are there because they cannot afford to buy. I think there is a good chunk who are choosing to be renters and are happily renting. One area I would look at to make a large positive impact in a relatively short amount of time would be stamp duty land tax. There has been discussion around how to incentivise people to downsize, if appropriate. Obviously, having a transaction tax in place will not help with that. We saw SDLT cut temporarily during the pandemic. The decision made sense; if anything, I would have made the changes more permanent, although in that specific example I do not think there were the correct assumptions around how relatively well the house market was going to do, partially as a result of accumulated savings and people being able to pay a deposit. I would say a very good area of focus to start with would be long-term rather temporary adjustments to stamp duty.

Chair: That brings us to the end. It feels like it has been a long session, for some reason.

Hon. Members: It has been!

Chair: There is obviously a good reason for that, because it has been a long session. I think the nights drawing in is probably part of it, which is a good metaphor for the discussion we have had about the economy, the pressures, the uncertainty and all we think is going on.

I thank all four of you, particularly Nina, as I think this is the first time you have given evidence in person to Parliament.

Nina Skero: It is.

Chair: Thank you very much indeed. As to our usual suspects, you are the usual suspects for very good reason—you are always fantastic in the analysis and insight that you provide. We are all deeply grateful to all four of you for your time.