



Treasury Committee

Oral evidence: [Autumn Statement 2013](#), HC 826

Monday 9 December 2013

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Members present: Mr Andrew Tyrie (Chair), Mark Garnier, Stewart Hosie, Andrew Leadsom, Mr Andrew Love, Mr Pat McFadden, Mr Brooks Newmark, Jesse Norman, Mr David Ruffley, John Thurso

Questions [1–75]

Witnesses: **Robert Chote**, Chairman, Office for Budget Responsibility, **Professor Stephen Nickell CBE** and **Graham Parker CBE**, Members of the Budget Responsibility Committee, Office for Budget Responsibility, gave evidence.

Q1 Chair: Thank you very much for coming to give evidence to us this afternoon, Robert Chote, Steve Nickell and Graham Parker. I would like to begin by asking you about this vex question of the costing of opposition policies and indeed all parties' policies at a general election. As you know, it is my personal view, and has been for about 20 years, that if we can get something up and running of this type—and a number of countries do this, not just the Dutch—this would be of some benefit to public discourse during a general election. Do you have sympathy with the Government's argument that the costing of other parties' policies could undermine the perception of your impartiality and independence?

Robert Chote: I can understand people having that sort of concern. I do not think, in the experience of, for example, the Dutch agency, that has been a particular problem for them. I did this obviously for quite some time and my predecessors at the Institute for Fiscal Studies. If you are doing the work properly and on the basis of good rigorous analysis then I do not see there is any reason why that should be a barrier to it.

Q2 Chair: Any party is going to want to ask you to cost something as its firm policies, the things that will make it reflect in the best possible light for the purposes of fiscal policy, while at the same time probably have a set of wider aspirations or general or less concrete commitments that they would hope will attract the interest of those who might benefit from them but which, nonetheless, they would be reluctant to find the cost that had been totted up. How do you think you should address that conundrum?

Robert Chote: I think the important thing to do is to set the same criteria for being willing to look at the costing of a policy for an opposition party that we do for existing Government policies that appear in the policy tables of the *Red Book*. In particular, you need to have the policy spelt out in enough detail that you are able to, with some

confidence, say what the impact is going to be in terms of its amount and also the timing at which it would take place. That would probably necessitate some discussion with the parties concerned about exactly what the policy is, what the timetable is and what the mechanics of it would be. As I say, you do that anyway when we are looking at policies that appear in Government *Red Books* or the Autumn Statement document.

Q3 Chair: Just to be clear, it would be your intention to look at a full list of statements in the public domain and then to go to the party or parties and go through these and just say, “This is uncostable because I do not know X, Y and Z. This is uncostable because I do not know A, B and C. So is this a firm pledge or not?”

Robert Chote: I would put the onus the other way. I would say to the parties, “What policies do you want to come to us with that you believe you can set down firmly enough that you would like us to kite-mark the costing of this policy?” Then I think the public and everybody else should reach the judgments on what one might describe as the more poetical elements of the manifesto it makes.

Chair: What judgment should they make about that?

Robert Chote: Sorry?

Chair: What is that poetical judgment?

Robert Chote: I think the very fact that they—

Chair: That it is all froth and hot air; is that it?

Robert Chote: The very fact that they have not come to us with a concrete policy, I think it is for the public to draw conclusions about that rather than us.

Chair: I am asking you what conclusions they should draw.

Robert Chote: For example, I remember, with my previous hat on, looking at commitments from every party to hit the child poverty target in the run up to the last election. The conclusion I drew from that is that everybody was willing the end and no one was willing the means.

Chair: I think it would be helpful if you could set out on a piece of paper how you think you would go about this role in a little more detail and send it to the Committee. Would you be agreeable to doing that?

Robert Chote: Yes, that would be fine.

Q4 Mr McFadden: Robert, I want to ask you about the shape of the recovery that is beginning. Could you possibly put this in some kind of historical perspective for us? We have had a couple of quarters of good growth but, in terms of the depth of the recession, the length of the slump and the speed out of it, where does where we stand today compare with previous recessions?

Robert Chote: I think the depth of the recession, while it was certainly a very deep recession, was not enormously out of line with historical experience. The surprise has been the weakness of the recovery. That is what has been striking, not so much the peak to

trough fall in GDP but the fact that we have had a long period in which the recovery has not been very strong at all.

Q5 Mr McFadden: In terms of the shape of this, in the report, for example, you predict a re-leveraging of the household sector in terms of debt, rising from around 140% of income today to 160% in 2018. What is driving the recovery?

Robert Chote: That is being driven by the housing market. Basically, you are having a rise in household debt to income because you are having more people buying houses with mortgages and that is showing up in debt. Similarly, you are getting a much bigger increase in the debt to income ratio than in the net asset position or in the asset position, both of which basically have more assets and more debt alongside it. It is being driven very much by the housing market rather than a particular story about what consumers are doing off the back of that.

Q6 Mr McFadden: Is that rising housing market resulting in a greater propensity on the public's part to spend more? If people are moving house they often spend more on white goods and other expenditure associated with moving house. In other words, is this a sort of classic British recovery?

Robert Chote: If you look at the surprise we have had in the data since the budget then the main contributors to the fact that the growth has been stronger than we anticipated are consumer spending, private consumption and the housing market. Net trade and business investment continue to disappoint. On the consumer spending side, it does seem to be that it is people dipping into savings or taking more debt rather than an increase in income. As we know, real incomes remain very weak. Looking at that element, you can see that that is what appears to be driving the most recent news.

Q7 Mr McFadden: You have said that some of things may cause risk to the sustainability of recovery over the medium term. What did you mean by that?

Robert Chote: The key point is it need not. It can be a natural consequence of the state of policy and the revival in the housing market you have that you see this rise in debt relative to household incomes. That need not be a problem for the reason that the net asset position is not changing very much. You can argue there are also some risks, potentially, out of that if the assets do not end up being worth what the people anticipated they would be at the time they bought them.

Q8 Mr McFadden: You said a minute ago that net trade and business investment continue to disappoint. I think that was the phrase you used. Should be worried about this? There has been a lot of comment in recent months about this being a recovery driven by the property market; that it is resulting in rising debt for people; that this is the way Britain always recovers; that the march of the makers that the Chancellor referred to has been taking a back seat. What your report says and what a lot of commentary about the recovery says appears to be of that ilk. Why should people worry about that kind of shape of recovery if it is producing good growth figures and will eventually feed through to a rise in living standards?

Robert Chote: If you take the example of business investment, one way of looking through that and a prism for being worried about it is that it is partly a manifestation of the major

puzzle that is confronting us and all economic forecasters at the moment, which is what is going on with productivity. That is, even though GDP growth was stronger than we anticipated over the first three-quarters of this year, total hours have risen by even more. Once again, productivity has disappointed. One of the reasons why we looked at this in detail in our forecast evaluation report earlier in the year is why the long-awaited investment recovery has not happened. In past recoveries you would expect to see robust investment rising as a share of GDP at this stage.

One reason why that has not happened is that firms' expectations of profitability have not been particularly high. That can be linked to the fact that there is a weak productivity. One reason to be worried about those sorts of things is it is taking you back to this puzzle of weak productivity growth and, in the absence of stronger productivity growth, you do not get the growth in real incomes and the growth in living standards that most people would think of in a recovery in that context.

Q9 Mr McFadden: Just a final question on the shape thing. Does a property-driven, consumption-driven recovery versus an investment, trade-driven recovery have any particular impact on the fiscal position?

Robert Chote: One of the reasons why the budget deficit fell in the first two years of this Parliament pretty much as we had anticipated back in June 2010, even though real GDP growth was much weaker, is that the weakness showed up in those elements of nominal cash spending in the economy that are least well taxed. The weakness was not in labour income and in consumer spending, both of which are taxed relatively highly, but in business profits, which are taxed at a lower rate than labour income, and business investment. The higher business investment is it hits your tax receipts in the short term because of the use of capital allowance. Ironically, what you might think of as a virtuous recovery consisting of lots of business investment would not be terribly good for public finances in the short term.

Q10 Mr McFadden: The kind of recovery that we are seeing, so far at least, is better for the fiscal position than the kind of recovery that most politicians say that they want to see, which is around manufacturing, trade and exports.

Robert Chote: As I say, the fact that the weakness has shown up in the corporate sector, corporate income and corporate spending, rather than in household income and household spending, helps explain why the deficit was not worse in those first two years. If you take a much longer view, maybe you think higher investment is going to lead to more productivity, more innovation and more potential in the future and so, in the longer-term view, the argument could flip round.

Q11 Jesse Norman: Mr Chote, you say, "We forecast that the saving ratio will decline gradually from just above 5.5% in 2013 to just under 4.5% in 2018." Why is that?

Robert Chote: Basically, you have a relatively weak process of incomes recovering. Once again, we are coming back in part to the productivity puzzle. We are still waiting for productivity growth to pick up and the expectation would be that that would lead to earnings growth. If you look in terms of real earnings, for example, we do not get the 2% a year real growth in wages and salaries that people would be used to on past historical

experience for a couple of years still. We have consumption rising faster than that; therefore, leading to a relatively modest fall in the saving ratio. It should be borne in mind there are other things going on within the saving ratio that means it is not quite as straightforward a picture as that, but that is broadly it.

Jesse Norman: But you are blowing an alarm on this? You do not regard this as problematic?

Robert Chote: We do not have a view of what the optimal level of the saving ratio is. In considerable part, it is looking at a relatively weak picture for income growth.

Q12 Jesse Norman: You do not have a house view as to what would be a good savings ratio? It could be 10% or it could be 1% and you would not have a view on it?

Robert Chote: No, we do not have a particular figure. There is a tendency sometimes to view the savings ratio as an index of moral fibre. I would not go with that.

Jesse Norman: Or to expect it to rebuild during the process of recovery from recession, which it appears not to be doing.

Robert Chote: Historically, is that—

Steve Nickell: It is higher than it was before the start of the recession.

Jesse Norman: To say it is not negative, that is not the strongest possible endorsement I have ever heard.

Robert Chote: Sorry?

Jesse Norman: It is not the strongest endorsement I have heard.

Steve Nickell: No, but before the recession it was lower than it is now. Of course, during the recession it rose to a high-ish level and it is coming down slightly.

Q13 Jesse Norman: Are you surprised, Mr Chote, that households appear to have decided to reduce savings when their debt remains so high?

Robert Chote: In terms of the most recent data—

Jesse Norman: Yes. Why haven't they repaid debt? Why are they reducing their savings?

Robert Chote: People may be making their decisions on the basis of their expectations of future incomes. If there is greater optimism around about that, that could be having an impact there. The other question is whether those data remain looking as they do into the future. You will have noticed from successive ones of these that not only do the forecasts for the saving ratio move around quite a lot, but so do the estimates of its path in the past.

Q14 Jesse Norman: On your analysis people are spending it on stuff rather than saving it and they are doing that because their investment horizons have been altered by very loose monetary policy or other external factors that are pushing down the returns to savings?

Robert Chote: The other possibility is that people are more confident about their future incomes perhaps and that might be leading them to save more rather than necessarily on returns.

Steve Nickell: Don't forget there is a surge in the purchase of houses by first-time buyers. Since they have been building up deposits and maybe now they do not need quite as much deposits as they thought they were going to need, in that process, of course, they will be taking these deposits and taking out bigger loans as well and then buying houses. There are two parts to this savings process. One is the question of raising consumption. If consumption is growing faster than incomes obviously you have to be running down your savings. The other part is what is going on in the housing market; first-time buyers spending their deposits and savings falling in that mode as well. There are two mechanisms currently pushing down on savings.

Q15 Jesse Norman: You do not feel there could be an asset effect where people are feeling that their other assets have been pumped up and, therefore, they do not need to save separately?

Steve Nickell: That is also a possibility. The way that might affect consumption is, of course, if the price of the house rises you have more equity in the house; so you have more collateral; so you are able to spend and, as you say, you have more of a cushion once your house is more valuable.

Q16 Jesse Norman: Mr Chote, you give two sentences to the savings ratio in a book of 160-odd pages. Do you not think that is underrating it a bit for something that is quite important?

Robert Chote: We have given considerably more space to it and explained why it does not send as simple a picture as it does in previous EFOs. Rather than repeat ourselves in an already-long document, we have tried to point out what in particular has changed since last time. You will recall in previous reports we have discussed, for example, the contribution that pension saving makes here, which is counted towards that but not visible and it is something that people are making active savings around; so just highlighting some of the uncertainties about the interpretation of that number.

Jesse Norman: That is very helpful, thank you.

Q17 Chair: Just on the savings ratio, most people agree that at some stage people do have to rebuild their savings more than they have been doing so far. I don't think there is any disagreement about that, were you not coming out with a view about where you think the savings ratio should be in response to Jesse Norman's questions. Do you think that that is compatible with your long-run growth forecast, which is of a return to trend growth?

Robert Chote: I don't see why it should not be incompatible with that.

Chair: When you are rebuilding savings you would expect low-trend growth as people retrench.

Robert Chote: In terms of the recovery of trend, we are particularly thinking, again, about the productivity story and the fact that we have had a period in which trend growth has

been relatively weak. Not for reasons to do with the saving ratio; more to do with the functioning of the banking system and its ability to get the process of innovation and productivity back on track.

Chair: Your answer to the question is all tucked up in the productivity puzzle?

Robert Chote: I think that is the key puzzle for us, yes.

Chair: Which is closely related to the output puzzle?

Robert Chote: Yes, it is.

Q18 Mark Garnier: Can I carry on with this household balance sheet question? In response to one of Mr Norman's earlier questions you said that there is not an OBR house view on what the net household savings ratio should be, but do you have any view on what the household gross debt to income ratio should be?

Robert Chote: No.

Mark Garnier: Not at all?

Robert Chote: If you have an increasing housing market, you have more transactions, more expensive houses, you will see debt to income ratio rising as a consequence of that. You will not necessarily be seeing a big change in the household net assets, which we have not.

Steve Nickell: A balance sheet has liabilities and assets. You can't describe a balance sheet by describing liabilities only.

Q19 Mark Garnier: No, you can't but it has implications on cash flow. Any liability has an implication on cash flow because they have to service that debt. The reason I ask the question was, if you were to go back to the 1980s, during the so-called Lawson boom, the increase of this gross debt to income ratio went from 70% to 80%. That increase drove the Lawson boom of the 1980s and that was just a 12% increase in the leverage of a household. If you go back to the decade that some of us refer to as the Brown Bubble but, in deference to some of my colleagues from the Labour Party, the decade before the financial crisis, in 1997 that same measure was standing at about 100%. It went up to 170%. That is a colossal increase. That is a 70% increase in the household's leverage in terms of debt to income ratio and in nominal terms that was £1.46 trillion worth of household debt, which is clearly a lot bigger than the national debt at the same time.

As a gilt might be predicted to grow in size, obviously we have seen the stagnation of the absolute terms of the nominal terms of household debt. As household income has risen as more people come into work, obviously that household gross debt to income ratio has dropped to 145%, I think, which is rather encouraging, but now you seem to be saying it is absolutely fine that households are now revving themselves up again in order to try and stimulate the housing market.

Steve Nickell: I don't think we are describing it as fine or not fine. It is in fact the inevitable consequence of the fact that people desire to own their own houses and the price of these houses has risen hugely in the last 15 years.

Q20 Mark Garnier: One of the problems, though, with the lead up to the financial crisis was we saw an increase in the number of interest-only mortgages. Are you suggesting that interest-only mortgages should continue to be the case or are we going backwards? I know only 40% of the £1.2 trillion stock of mortgage is interest-only at the moment and mortgage companies are now moving to repayment mortgages. You are suggesting in your report that it is going to go from about 140% back to 160% by 2019. Is that not going to stress households, particularly at a time of rising interest rates?

Steve Nickell: The rise in interest rates will stress households. The fact that a household takes on a mortgage and the mortgage has to be bigger than the households who were taking on mortgages 20 years ago, in some sense you could think of new mortgages replacing old mortgages and the new mortgages are going to be bigger. That is the driving force behind the rise in debt. The fundamental issue is how cautious everyone is being. Historically, people and the lenders in the UK have been reasonably cautious, which may surprise some people but is, nevertheless, true. As a consequence, the level of repossessions, as we know, has been exceptionally low relative to the depth of the recession compared with, say, the early 1990s and the level of losses that lenders have made in the UK mortgage market have been absolutely tiny.

You could say, "Well, yes, but there is more forbearance and interest rates are low and so on and when interest rates shoot up there will be a problem". I think it is perfectly true to say that there will be some households who will be stretched when interest rates rise, but I think we have been through this argument before. All the evidence suggests that what gets households into trouble and what leads to repossessions and so on is change in the financial circumstances of the household, either because of unemployment or because of sickness and so on, not basically because of rises in interest rates.

Q21 Mark Garnier: But there is a strange dynamic going on. For hundreds of years we operated in a gently-rising level of household debt in terms of the debt to gross income ratio. It trundles up fairly gently and, as I say, we find ourselves in quite a boom in the 1980s and a lot of that can be ascribed to just the increase in leverage; creating more money in the system, which helps that boom along. That was just a 10% or 12% increase in this debt to income ratio. Now we are looking at these movements as being quite significant. We get a 70% increase in the debt to income ratio during a 10-year period. That is absolutely unprecedented.

Steve Nickell: It is, yes.

Mark Garnier: I keep banging on about this and we have had this conversation before and I will keep on going on about it every time we meet until such time as I get satisfaction that somebody is looking at this without saying, "Well, it is absolutely fine. We just need a new paradigm". This does not strike me as being a new paradigm. This strikes me as being something that is building quite a lot of instability into the system and, to a certain extent, what troubles me about this is that we are now at a stage in our

economy where our economy requires an increase in the leveraging of households in order to get any sort of economic growth rate.

We are now not requiring businesses to do more. We are not requiring manufacturing output to be greater or exports to be greater or productivity to be greater. What we are now expecting is something that is much more fundamental and basic and that is, in order to get any sort of economic growth rate—and as we know household consumption represents 60% of the economy—are we now in a position where we have to have an increase in gearing, an increase in the leverage of households, in order to secure any sort of economic growth rate and, if that is the case, is that a good thing?

Robert Chote: No.

Steve Nickell: We do not need to. If we have productivity growth growing at its historical rate, we can easily have growth without a booming housing market. It just so happens, however, that when everyone's incomes are growing, given the desire for people to own houses and given our inability to build any houses, the inevitable consequence of that is the price of houses keeps going on up relative to incomes. If we sustain the level of owner occupation and mortgages that we have had in the last 10 or 15 years, when that happens you will find debt going up as well, but the rise in debt is not a necessarily condition once you have productivity growth and real wages growing. That alone will be quite enough to drive growth in the economy.

Q22 Mark Garnier: I think there will be more questions on the housing market a little bit later, but I just want to ask one last question on this debt to the housing market. Given where we are now, that we seem to be looking for levels of certainly above 140% if not up to 170% in terms of the debt to income ratio, what does that say to you about the value of the housing stock? Is it the right price? Is it too high and is it sustainable, given this level of debt? Come on, you are the economist.

Steve Nickell: The value of the housing stock is the value of the houses. Are you asking me if house prices are too high in some sense?

Mark Garnier: Are they sustainable? I suppose that is a better phrase to use.

Steve Nickell: Can they be sustained?

Mark Garnier: Yes.

Steve Nickell: Leaving aside the possible instability that might be caused if all the foreigners sold up and moved on, I think that in a world going back to normal, where real incomes are rising and household numbers are growing faster than the house building, there is a fundamental flaw under house prices and, unless we start building houses at a rate that outpaces the growth in the number of households, that flaw will be sustained.

Q23 Mr Newmark: I just want to stay a little bit more on house prices and what has been driving things up. I will probably go back to Robert since he has not spoken for a while. I am not sure Graham wants to get into this. The Funding for Lending Scheme and the Help to Buy Scheme has been good. It has enabled people to perhaps start to get on the housing ladder or think about getting on the housing ladder. It has pushed up construction.

All those things are good, but it is not necessarily always a virtuous circle because, while the good things are that people have been able to start getting on the housing ladder and construction is now doing much better than it has done for a number of years, house price inflation ultimately means that it suddenly becomes out of reach.

A lot of the talk here is of a housing bubble and so on and I just want to touch on your forecasts. When answering me try and differentiate, if you can do, between what is going on in London and the south-east and the rest of Planet United Kingdom. You have adjusted your forecasts, after all these good things have happened, of house price inflation from 1.6% to 5.2% for 2014 and from 3.3% to 7.2% in 2015. You now expect house prices to be 10% higher in 2017-18 than in your March 2013 forecast. I am sure I have already answered this, but why is this? Why has there been this sudden leap? Is it just simply through Government change in policy that has driven this boom or is there something else going on?

Robert Chote: If you take the 10% figure, which compiles all of those growth rates together, one point to bear in mind is that house prices are already 3.6% higher than we anticipated they would be back in March. That is the outturn data taking you almost 40% of the way there. In terms of policy effects and so on—and it is coming back to Steve’s point—there are a variety of factors that are increasing demand, but we have very inelastic supply. You would indeed need to have a very big increase in house building to make enough of a difference to the stock to be making a great deal of difference on the price side. I think this is a natural reflection of—

Q24 Mr Newmark: When you are saying “increasing stock”, a big argument we hear in the Chamber is there was a huge lack of housing stock for social housing. A lot of the social housing did not grow as fast as perhaps we would have liked to have seen in 13 years of the last Government. Do you think the Government is doing enough to try and stimulate the growth in social housing stock or is it just all private-sector housing stock that is creating this boom?

Robert Chote: It is beyond our remit to talk about the merits of the policy, but I think we just come back to the point that we do not have the housing stock rising in line with the number of households. You mentioned the point about a bubble to begin with. There is an issue here about whether house prices are rising and houses are expensive in some people’s view for fundamental reasons, that we have more demand and relatively inelastic supply, rather than what you might think of a classic bubble, which is, leaving those fundamentals aside, people see prices rising and want to exploit the future rise in prices that they expect. That is one reason why I do not think we would use the “bubble” language. You would use more the language that is saying there are a variety of policy and other related reasons why demand for them is going up and the supply is not.

Q25 Mr Newmark: When people start speculating on housing, as we have seen historically, and they buy second and third houses they do not live in you get a quasi-tulip mania where people are buying stuff for the sake of buying stuff not to live in and that creates a problem. Anyway, why does projected house price inflation fall from 7.2% in 2015 to 4.8% in 2016 and further thereafter?

Robert Chote: That is basically because we have a neutral stylised assumption that over the long term house prices rise in line with average nominal earnings in the economy.

There is no particular magic other than looking more particularly at the short-term indicators for the first couple of years and then assuming that the—

Mr Newmark: It is nothing to do with tailing off of the Funding for Lending Scheme? The reason why I say that is because the OBR has pointed out that it did not include the recent eligibility and changes to the Funding for Lending Scheme in its forecast of house price changes. Do you expect the removal of FLS to dampen house price growth projections materially or do you have that in a separate intellectual bucket?

Robert Chote: Obviously the announcement on the FLS came late in the process. There was not the change in bank funding costs that gave you an instant answer to that question, so we have said we will come back to that at the time of the budget. On the basis of the initial take, there did not seem to be a change in the funding conditions that would lead you straight to a forecast change of that sort.

Q26 Mr Newmark: Going back to this geographic imbalance, the current distribution of house prices obviously is geographically uneven. London is obviously much higher; the north-west and north-west low to no growth; and if you go to Northern Ireland and Scotland in some places I think it may even still be declining, although Mr Hosie can probably correct me on that. Do you think that this disparity will continue to persist? Will the delta effectively come in a little bit? How do you see the disparity going forward?

Robert Chote: We do not make a specific set of forecasts for regional house prices. One area where this has obviously shown up is on the fiscal forecast side. If you look at stamp duty land tax, which has been coming in much more strongly than anticipated over the course of this year. You could call it a London effect. You could call it an expensive houses effect, because the expensive houses are predominantly in London, but in that sense it does look as though you have relatively expensive houses rising in price more quickly. There is a lot of fiscal drag built into the structure of stamp duty with the slant effect and so on. That has contributed to that element of—

Mr Newmark: Okay. If you are going through—

Robert Chote: We have effectively made an assumption that some of that stays into the stamp duty forecast in future. There is an implicit increase in either a London or expensive house effect within those numbers.

Graham Parker: But we have not assumed it gets wider after this year.

Mr Newmark: You have not assumed it gets wider?

Graham Parker: No.

Mr Newmark: Do you assume it contracts?

Graham Parker: No, we assume it is roughly the same as it is now.

Mr Newmark: The disparity will remain between London and the rest of the country?

Graham Parker: Yes. We do not start assuming that London prices go down. We assume that everything goes up broadly in line.

Mr Newmark: Okay. But you are forecasting 7.2% growth for 2015. Do you expect London houses to grow faster than that or not then? I am not quite clear where you are coming at. Graham?

Graham Parker: Effectively we are assuming they grow by that. The only reason we would have to make a change in that—

Mr Newmark: But why? That does not make sense.

Graham Parker: We think it is a central assumption. It is very uncertain, obviously.

Robert Chote: As I say, we do not do regional house price forecasts but, in terms of the way in which we have structured the stamp duty forecast, the assumption is that we are not making further additional assumptions and pushing those numbers up in future years on the basis of a further dramatic widening.

Mr Newmark: But it is as though you have said, “Wow, the south-east booms, the rest of the country does not and then we are keeping growth pretty much the same nationally”. Again, intellectually, at least to me, that makes no sense at all.

Robert Chote: You have some people talking about the steam coming out of London, others not. As I say, it is not an area where we have done a detailed regional forecast.

Q27 Mr Newmark: Just generally from a bigger picture then, how important has a strong housing market been in terms of our economic recovery? I know you touched on it a little bit before.

Robert Chote: If you come back and look at the surprise since the budget, consumer spending has been one of them. Housing investment has been another one. One thing it is important to bear in mind is that, rather contrary to the name, housing investment is not just building houses. The transfer of houses is quite a large component. I think we have a chart showing the breakdown of that. Clearly it has been one of the two main sources of the surprise on GDP during the course of this year to date.

Q28 Mr Newmark: When I think of house price recovery it does two things. You are getting a build-up in the whole construction sector with the multiplier effect on that and then, intellectually, it goes to people’s confidence in spending. I think Steve talked on it. People feel richer when their house price goes up and whether they leverage more off their existing asset or they spend more, all that is pushing recovery. Do you see—

Robert Chote: It can also be that, but causality is obviously not entirely in one direction. People can be motivated to buy houses on the basis that they are more confident on the future levels of their income. The issue about whether it is the housing market that drives these things or housing market reflecting the expectations of future incomes is much debated.

Q29 Stewart Hosie: Robert, I would like to ask you about business investment growth mainly, but can I do that by going back a couple of years and just looking at the trends? This is quite important. Budget 2010 told us that the 2011 business investment growth would be 8.1%. Budget 2011 revised that down to 6.7%. The 2011 Autumn Statement

turned negative to minus 0.8% and then the outturn was 2.9%, barely a third of the original 8.1% growth forecast. What was the reason for the fall in business investment growth between the budget of 2010 and the outturn published in 2012 in the Autumn Statement?

Robert Chote: Budget 2012 in the Autumn Statement?

Stewart Hosie: Yes.

Robert Chote: As we did in our forecast evaluation report exercise in the autumn, which you will have seen, we were looking at the extent to which the business investment story is linked to the fact that, as I was pointing out earlier, if you look at where our nominal errors were, they were in profits and in business investment rather than in aggregate wages and salaries and consumer spending. In terms of thinking why it is that business investment has been weaker than we anticipated you would probably want to point to, first of all, uncertainty about future demand.

The second possibility is that the weakness of profitability means that there is a lack of internal finance for those firms that are reliant on internal finance and also weak productivity implies and the weakness of profits implies weak expected profitability and, therefore, firms thinking, “Is it worth me undertaking an investment programme on that basis?” If we were to look at the three reasons why you have had, over the period since the June 2010, weaker outturns than we anticipated, those are probably the ones that you would point at.

More recently, if you look at page 71 what is striking is that, since the budget, the ONS has changed the methodology for estimating business investment and we now have a picture that is much more volatile with a steeper fall and a lower average rate of business investment since the recession. We have a business investment deflator, the measure of inflation in that sector, which is now very volatile by historic standards and by the standards of other statistical series for that in other countries.

I would be wary in terms of looking at those numbers. We may come back to you with another line that is not in the same place as either of those two.

Q30 Stewart Hosie: Indeed, but let us just look at that volatility first then because Budget 2011 did exactly the same for 2012. It started at 8.9%, reduced to 0.7% and with an outturn of 2.6%. Presumably the outturn being less than a third of the original forecast is down to the same sorts of reasons and the same volatility?

Robert Chote: Yes, absolutely. As I say, look at page 71. If you are doing a growth rate, whether you are doing it from the bottom of those zigzags or the top will give you a very different picture and obviously we are taking the latest outturn data as the number to kick off from.

Q31 Stewart Hosie: I appreciate that, but the second-last set of data, which was the Budget 2012 stuff that started at plus 6.4% for 2013 and it went to minus 5.5% in the Autumn Statement of 2013, is extraordinary. It has gone from not slightly less positive or slightly less negative. It has gone from plus 6.4% to minus 5.5%. How on earth was that explained? What was the reaction—

Robert Chote: If you have quarterly movements of the order of 10% that is less extraordinary than you would like it to be.

Stewart Hosie: Fine, but if we are forecasting at the start an annual investment increase of 6.4% and we end up with a projected outturn at minus 5.5%, how did we start off with plus 6.4% in the first place?

Robert Chote: Because I presume you were starting at one of the relative low points of those oscillations. If you have a series that bounces up and down by 10% from quarter to quarter and it is heavily revised then the growth rates you project forward are going to be similarly volatile.

Q32 Stewart Hosie: If they are going to be similarly volatile, then the 6.1% growth that you forecast in the budget this year for 2014 or the 5.1% you forecast in the Autumn Statement for 2014 are as likely to end up being minus 5% as they are plus 5% or plus 10%.

Robert Chote: If you compare where the two lines are in terms of the outturn data between now and the budget, you can see how much of that has moved and from quarter to quarter how much it is moving. I would be the last person to say, “Oh yes, I can now be confident that you are going to see business investment of X change”. We obviously have to forecast those things to the best of our ability, but business investment is an extremely volatile series and it is very heavily revised. I think one has to accept that rather than assume it is going to change any time soon, much as we would love it to.

Q33 Stewart Hosie: Given that business investment is an important driver of GDP growth and everything this Government and the Chancellor do is based on new rolling forecasts, you are effectively saying we cannot trust the business growth forecasts at all until we get outturn figures.

Robert Chote: Whether you trust it when you get the outturn figures is the other issue. Your medium view and comparing, for example, the share of GDP spent on that over that sort of horizon, which is not an easy thing to predict either, that is probably a better indicator of whether you have a sensible forecast and a sensible path for looking at the quarter-on-quarter changes from the outturn data, just simply because the outturn data are so volatile.

If you are looking at the path that we have for business investment over the next five years, you basically have a pick-up, the long-awaited pick-up that we are still awaiting, but that then looks, in context of previous recoveries, as though you have a rise to levels that do not ridiculous out of lines with previous recessions. Everybody who is trying to do a forecast at the moment is having to look at these numbers and those are the numbers we have. We could all wish for clearer ones that did not move, but they are not there.

Q34 Stewart Hosie: Of course, but let us just try and get clear on this. You are saying that the numbers that we have now do not look out of place with the kind of numbers you would have seen in the past but, with the greatest of respect, the OBR and others have been saying precisely the same thing on business investment and the contribution from exports and some of the other aspects that build GDP in 2010, 2011, 2012 and 2013 and they have been marked down, including with the outturn figures, year on year on year on year. I

suppose my question for you is, how can we be any more confident that the figures you have given this year, which are driving all the Government (inaudible 16:47:45 on PTV), are any better or can be trusted any more than the figures we have seen revised up and then significantly down over the last four years?

Robert Chote: There are good reasons to believe that at some point business investment is going to pick up on the basis of having described the factors that have helped to impede it in the past. There are reasons for some of those to be less of a constraint in the future. That said, if you look at the way in which these data move then you would be foolish to say you can have particular confidence in the path of this thing from quarter to quarter, from year to year, staying as it was in the latest set of data.

Chair: The argument is you will be right about business investment one day?

Robert Chote: One day and probably then wrong the next. It is the clock. The clock is—

Q35 Andrea Leadsom: I would like to ask you a bit about your non-British forecast, so the Eurozone and then emerging markets. Specifically, you have revised upwards your GDP figures for 2013 for the Eurozone from an impressive minus 0.4% to an impressive minus 0.3% or minus 0.5% to minus 0.4%. It is all semantics.

Robert Chote: I think that is what is referred to as statistically insignificant in the trade.

Andrea Leadsom: Yes, precisely. So not going anywhere fast. But you have specifically highlighted one of the key risks, that “euro area economies and banking systems have yet to complete the adjustment towards sustainable demand and competitiveness. While policy has managed the process more effectively this year, further damaging instability remains possible.” Can you explain what you mean by that and particularly which countries you are talking about there? What is the most likely source of the damaging instability?

Robert Chote: Taking a step back, if you are trying to explain why things have picked up as they have done over the last year or so, the absence of as many nasty stories and nasty adjustments coming there is a plausible contributory explanation to that. I do not think we have any particular scenarios or economies in mind other than to note that in the past you have had fresh bouts of instability if the markets take a particular view of the sustainability of a reform programme in a particular country, banking systems and so on. It is not as though we have a particular story or a particular incident that we are being coy about there. It is merely observing in the past that this has been one of the things that has knocked the growth prospects off course in the past and it would be foolish to recognise that could not happen again.

Q36 Andrea Leadsom: Then is it true to say that you are not assessing the likely occurrence of instability in the Eurozone; you are merely observing that there has not been any lately but there might be some more in the future?

Robert Chote: There has not been recently but this has bitten us in the past. Looking at the central forecast is basically looking at people like the IMF and the OECD, obviously, who are surveying all these economies more frequently, but pointing out that the central forecast is that, a central forecast. There are risks and uncertainties around it and we have seen that this is an area where risks can be considered.

Q37 Andrea Leadsom: Just to be clear, you have not assessed, for example, the likelihood of the French economy going into deep recession or the German economy booming while the Italian economy does not? You have not looked at any of the relative strengths and weaknesses of different Eurozone economies?

Robert Chote: Not specifically. If you were thinking about risks and instability it is less out of those France growing a little stronger or France growing a little weaker issues. It is more disruptions that create concerns in financial markets, which create concerns that have implications for bank funding costs, which could then affect the UK.

Q38 Andrea Leadsom: Have you done any specific analysis of the Eurozone banking system and what might be needed to complete the banking union or what the level of impairments might mean for the robustness of the emerging European banking union?

Robert Chote: No, we have not. Given the resources we have, there are other people spending a lot of time looking at that and obviously we are looking at what the FSA are saying on things like that.

Andrea Leadsom: You are just looking at what others are saying there?

Robert Chote: Yes.

Q39 Andrea Leadsom: With regard to other emerging markets, there is obviously your analysis and there has been a lot of analysis in the newspapers and from the Bank of England talking about slowing down emerging economies. To what extent would you say it is possible that there will be significant shocks within emerging market economies next year and have you factored in any of that to your forecast or what impact do you think it might have on your forecast?

Robert Chote: Again, I think we have looked over people like the IMF, who are covering a much larger range of countries, and that is certainly reflected in the central forecast in some slowdown there. If you were looking at how this could be more volatile and more dramatic, then one thing you obviously have seen is the potential for expectation of the relatively loose global monetary conditions, the tightening in the Fed, the changing in the Fed's monetary policy and how that can have consequences for capital flows that can be quite disruptive to emerging market economies and thus have broader spill over effects.

Q40 Andrea Leadsom: What prospects do you foresee for an export-led economic recovery in the UK through exports to emerging economies? Have you factored in the prospects for export-led growth?

Robert Chote: If you look at it overall in terms of the net trade contribution, which is not just emerging economies, basically we have very little addition to GDP growth from net trade over the course of the five years of the recovery.

Andrea Leadsom: You have been fairly pessimistic then about the prospects but—

Robert Chote: I think you can differentiate. There is a short-term and a medium-term story there. We have had weaker data on exports recently and that has led us to be more

cautious in the near term about that. There has been some rewriting of history again in terms of the statistics. I think last time we were here we would probably have been talking about the fact that one of the puzzles was that UK market share had deteriorated by more than one would have anticipated given what had been going on with sterling and laying quite a lot of that at the door of financial services exports, which seemed to have been considerably weaker. The data has now been rewritten on that. The financial services export data has been revised up. That does not appear to be so much of a story. The market share figures do not look at puzzling as they did. Looking further out into the medium term, it is the lowering of global growth and global trade forecasts generally that has led us to take a more cautious view of the contributions that net exports can be making in the future. If you look at our aggregate GDP forecasts, we have nudged down 2015, 2016 and 2017 by 0.1 points each again. Not a large number obviously, but it is basically that judgment on the weakness of UK exports markets over that horizon that has led us to do that.

Q41 Andrea Leadsom: The prospects for economic growth are not predicated on any sense of booming export share, let alone export growth in real terms?

Robert Chote: We continue to assume that our market share falls, which is partly a function of the growth of the emerging markets and that is a sort of arithmetic effect. But, no, we basically do not have any significant contribution to GDP growth over the forecast from net trade.

Andrea Leadsom: Depressing.

Q42 Mr Ruffley: Mr Chote, I am sure you share my interest in the Treasury paper, the *Analysis of the dynamic effects of corporate tax reductions*. It is not as dry a subject as people think. This computable general equilibrium model throws up in the Treasury paper some interesting benefits for the UK economy and I am just going to paraphrase them quickly. One is that the tax reductions will increase investment between 2.5% and 4.5% in the long term, increase GDP by 0.6% and 0.8% in the long term and lower corporation tax will increase the demand for labour, which in turn raises wages and, therefore, increasing the share going to labour; equating, in the paper's view, to between £405 and £515 per household. The further and final virtuous benefit that these reductions will lead to is that profits, wages and consumption all add to higher tax revenues and the paper concludes that the cost of the tax reduction in revenue foregone falls when you take into account all these virtuous effects. The cost of the policy of tax reductions falls between 45% and 60% in the long term. Is this a model that you had any input in putting together?

Robert Chote: No, the HMRC and Treasury have been working on that. We have seen it, obviously. They showed us the paper.

Mr Ruffley: Why did the Treasury produce it and why did they not ask for your input? You are a very important, objective independent body. It seems a bit odd.

Robert Chote: You would have to ask them why they—

Mr Ruffley: No, why do you think you were not involved? This is quite a serious bit of work. It is potentially transformative, some people are arguing, and there are some very

startling effects, which I have just rehearsed. I just wondered why the OBR were not involved in this.

Robert Chote: Obviously the work they are doing in that area we read with interest and we will look and see how it informs our own. You have outlined a number of the interesting effects there, one of which is the reduction in corporation tax reduces the cost of capital, encourages business investment with a potential knock-on effect on GDP. That is in the forecast. We make adjustments for that effect when we have included corporation tax measures in the past. We have pushed up business investment by, I think, roughly the same proportion, 3% or so, as this paper would suggest.

The paper also points out that you need to look at the impact of profit shifting. Again, our forecasts have made an adjustment for profit shifting, which reduces the direct static cost of the measures. The area where I think this analysis suggests more impact than we would include is the fact that it does more to boost consumer spending than it does to boost investment.

I think the rationale of corporation tax in effect being incident on labour rather than incident on capital is a fairly—certainly work at IFS we did was in that area and I do not think that is something with which people have a great deal of quarrel, but in terms of the aggregate effect on GDP rather than those distinct profit-shifting cost of capital and business investment effects, we look at measures together and make a holistic judgment about what impact that has on demand and supply in each set of forecasts.

If you were to do that for each and every measure you then have a horrible job of disentangling the overlapping effects from each of those, whereas what we do is to look at the first and second round effects of each measure and then to stand back and say, “Do we want to make an additional adjustment to the economic forecast on the basis of that?” HMRC make the point obviously well in their paper that the CGE model is not a forecasting model. It is a model designed for particular purposes. There is no monetary policy in that model. There is no spare capacity in the sorts of things that we would think about in terms of coming up with a view of the full implications of these and other policies on the forecasts, but it is important to bear in mind that this paper is not a comparison between the way we treat these things and an alternative way. Quite a lot of the stuff that they are highlighting as potential effects are things that we take into account when we are doing our forecast anyway.

Q43 Mr Ruffley: That is interesting. Subject to those carve-outs, those exemptions, have you factored in all the work in this paper in coming to your forecast? Were you shown this at an early stage?

Robert Chote: I would not say that we factored the work into the paper. When these policies come along, we look at those sorts of costs of capital. We are talking specifically here about the CC, which is the issue they have addressed here, that we look at that cost of capital effect, we look at the profit-shifting effect and we look more broadly at the economic impact. This is an exercise that they have imagined that the whole cut in CT takes place in one go and have run that though a model, comparing it to a world in which nothing was happening to CT at all, which is obviously not the world we are having to deal with, where policy changes from fiscal event to fiscal event and you are taking it into

account bit by bit. But as far as we can tell, the overall adjustment they imply on business investment is not a million miles away from what you would get if you added up all the adjustments we have made as these measures have gone along.

Graham Parker: They are going rather further ahead than we do in our forecast period.

Robert Chote: Yes.

Graham Parker: You would not see all those effects in our forecast.

Mr Ruffley: They are talking about the long term, which is further than the time horizon you are forecasting.

Graham Parker: We will not have all that. Particularly because the CT rate cuts are staged, you will not have all that effect by the end of our forecast.

Robert Chote: As you see, if you look at the proportion of the static cost of the measure recouped, it is that it is falling until the five-year horizon and then most of these effects, presumably from the efficiency of removing distortions in the tax system, is building up over a much longer time horizon, over which we are not forecasting anyway.

Mr Ruffley: This paper and the model contained therein, the OBR has not been asked to certify?

Robert Chote: No.

Q44 Mr Ruffley: Do you think there is any scope for the Government broadening it out beyond CT, the dynamic effects of other tax cuts?

Robert Chote: They certainly could do. I am not an expert on CGE models. I think this is one of those measures that it is relatively straightforward to do this for, which may be one of the reasons why they have chosen this one to do. They have not taken account, I think, in this paper the changes that were made on the investment allowances, for example, which go in the opposite direction and might be rather harder to model. I am sure they could use it for other things. I think, as I say, not speaking as a technical expert in this area, that CT, up or down, is one of those things that is relatively straightforward to model in this approach. Is that right, Steve?

Steve Nickell: Yes, but they can do more or less anything, in the sense that these models have been developed over the last 30-odd years to deal with tax changes of more or less any kind—VAT, income tax and so on and so forth—and my guess is that the reason why they produced this particular one was that if you add up what has happened to the tax system over the last five years, the change in corporation tax is one of the biggest events.

Robert Chote: It is less likely to be vulnerable to the fact that the results you get out of these models depend on the many judgments that are implicit in them. They are a rather black box structure; it is hard to see what is driving some of it. As you say, with a very big change in whatever it is, 28 or 20, you have something where—

Q45 Mr Ruffley: When did the Treasury or HMRC share this work with you? Did it inform your forecasts explicitly?

Robert Chote: We did not have a new policy in this area to look at specifically, so if there had been an additional announcement of a CT change up or down, then obviously we would have had to focus in particular on what that was doing.

Mr Ruffley: No, I understand it was not—

Robert Chote: But looking back, clearly if you—

Mr Ruffley: Has it led you to think again about the effect of the previous announcements on CT?

Robert Chote: If you did, obviously it would suggest that if you thought that we had underestimated the impact—

Mr Ruffley: That is what I am asking.

Robert Chote: —of the CT cuts on investment and GDP, then our errors in those things would have been even larger than they have been already.

Mr Ruffley: Mr Parker, were you going to say anything?

Graham Parker: No.

Q46 Mr Ruffley: This piece of work has not changed your view, either your past forecast or future forecast?

Robert Chote: No. As I say, we will address the insights in here. We will draw on when we see any future change in policy in this sort of area, but as I say, it has not helped. For example, if we had looked at this in the context of our forecast evaluation report, we did not say at the time, “Oh, this is the other way round” as Mr Hosie would prefer. We did not have an unexpected boom in business investments that we needed to find an explanation for and this would have suggested that maybe we had underestimated the impact of the cuts in CT, so it is not in that direction.

Q47 Mr Ruffley: I just have one final question for Professor Nickell. The CG model is used, as I understand it, by the Congressional Budget Office in the States and has been for a while. Is it, so far as you can work out, similar to the CG model that HMRC have used in this paper?

Steve Nickell: I am sure it is pretty similar, because most of them have quite similar structures: you have production side, a consumption side, which is based on consumers having particular preferences and producers having particular technologies. In broad outline, most CG models are the same or similar. The parametric detail may differ, but I would imagine that the Congressional Budget Office and the HMRC CG models are pretty similar.

Q48 Chair: Bearing in mind you are the independent OBR, does it give you any cause for concern that a black box structure is being constructed in an important part of your forecast?

Robert Chote: No, because we are making the forecast on the basis of our judgment, not on the basis of that particular model. As I say, as we were discussing, in the end we incorporate quite a lot of the things that show up here, but the CG—

Q49 Chair: You will ignore it for the purposes of your forecast?

Robert Chote: No. We cover many of the same effects, but the CG model is not a forecasting model, it is an evaluation model, and that is it, so I think we cover much of the same territory.

Q50 Mr Love: Can I turn to the vexed question of living standards and real incomes? In the *Autumn Statement*, the Government states, “Total real household income has grown by 3.9% since the crisis”. Can you tell us how they get that figure and what “total real household income” defines?

Robert Chote: I do not know which definition. I presume that is real household disposable income over a particular period, but I do not know exactly which one.

Steve Nickell: It sounds like it.

Robert Chote: It sounds like it. We do not write those sections of the report or any of those sections. I suspect it is real household disposable income since 2008.

Q51 Mr Love: I am rather surprised. You have taken me a little bit aback by not having considered this more carefully, because the real question I wanted to ask—and there has been some controversy over this over the weekend with the IFS commenting on the whole issue of living standards—is whether total real household income was the best determinant of living standards?

Steve Nickell: No. First of all, you have to divide by the number of people. The total disposal income can go up because each person has more disposable income or that each person has the same or even less disposal income, but there are more people. It is much better to take total disposable household income and then divide it by the number of people or the number of households.

Q52 Mr Love: I take that point. The IFS went just a little bit further when they were asked about this matter. They said that they did not think total real household income was not something with which to measure living standards. Would you agree there is a disconnect, not just a disconnect in terms of per capita, but a disconnect—

Steve Nickell: Yes, there is—

Mr Love: —in that it does not get to the essence of what living standards are?

Steve Nickell: —because there are various themes that appear in household disposable income. For example, if you are in a company pension fund and your company pension fund contributes money towards filling a black hole in that pension fund, that money contribution counts towards your disposal income, it is part of your disposal income, but it is not the sort of thing that you and I would think of as being readily available to spend. Of course it is a contribution to your wellbeing, because it means your pension is more secure

than it otherwise would be and can ultimately be paid, but in terms of what the average person thinks of as disposal income, it is not part of it. It has to be said, however, that this amount is not that large relative to the total of disposal income.

Q53 Mr Love: Let me ask you about average real household income. It has been suggested that that might be a more appropriate determinant. The claim from the *Autumn Statement* was that total real household income had gone up by 3.9% since the crisis, presumably 2008. What has happened to average real household income and is that a more appropriate determinant of where we are in terms of living standards? I do not know whether—

Robert Chote: It depends what you mean by “average” I guess.

Steve Nickell: Is this the IFS measure?

Robert Chote: Is this “medium” they are talking about the HBAI, Households Below Average Income?

Mr Love: I am taking from the IFS. I do not have a definition of it. I thought that you would have a definition of it.

Robert Chote: It is probably from Households Below Average Income, which would be equivalised household income.

Graham Parker: Not the National Accounts.

Robert Chote: Not the National Accounts measure.

Q54 Mr Love: What does that tell us? What I am trying to get to is what people would understand by living standards or real incomes. Would that get—

Robert Chote: Certainly when I was at the IFS, we would look at the Households Below Average Income, which is drawn from an annual survey, and you can get equivalised income data from that. We would compare that to what was going on in the National Accounts measures, and often that would differ quite significantly. It is unfortunately some years since I pored over those reports when they were being written every year, but I believe they still produce *Poverty and Inequality in the UK* once a year based on the HBAI numbers, which compares the measure you get from each of those things, but I am afraid it is some time since I knew exactly how that was moving relative to the National Accounts measure.

But certainly in terms of the analysis that we used to do—and I am sure the IFS still does—about the income distribution, about what is happening in each percentile of the income distribution, then it would be the HBAI numbers that you would normally go to for that.

Q55 Mr Love: Let me ask a simpler question: the IFS, when they were asked about this whole issue of living standards and real incomes, they prayed in aid of survey evidence that had been produced and not more recently, but between 2008 and I think 2012, saying that

that showed quite clearly that living standards had declined. Mr Nickell, would you disagree with that?

Steve Nickell: No. Almost whichever way you look at it, you only have to look at average earnings and wages and salaries, all those data tell us that the levels have been falling, so it is inconceivable that real household incomes have not been falling over that period.

Q56 Mr Love: They only have survey evidence until 2011. I think I have a quote here somewhere from your own Office of Budget Responsibility, “It will be several years before household spending power returns to pre-recession levels”. You would all agree with that?

Robert Chote: Yes.

Steve Nickell: Yes.

Graham Parker: Yes.

Q57 Mr Love: The question then becomes since 2008, when the crisis began, has there been a fall in real living standards year upon year and when do you expect that is likely to change?

Robert Chote: If you look at the simplest view, taking earnings, when are we going to get back to the situation in which earnings growth is outpacing inflation by the sort of 2% or so that you would expect to have been the case normally, then we are not seeing that until 2015 for that sort of normal pace of real income growth. We do have the discussion that one way of looking at this is the consumption wage showing the weakness on page 76, but in terms of the survey information you are talking about, I suspect again we are back to Households Below Average Income, because that lags by a year or so. I presume that is the numbers that come out from DWP in April-ish normally, so I expect that is the last.

Q58 Mr Love: Let me just ask you, there has been some discussion about whether or not wages will overtake inflation this coming financial year. I tell a lie: in this year that we are in at the present time. What is the OBR view of that?

Robert Chote: I think in terms of real earnings, it is pretty flat next year and then basically it gets back to something more like the clear real earnings growth in 2015.

Mr Love: 2015 will be the—

Robert Chote: I think pretty much it is a small—

Steve Nickell: Yes. In 2014, I think real earnings grow fractionally, but it is not until 2015 that you get any serious growth.

Mr Love: But that could go either way. When you say a fraction, it could be on either side of the line, but the next year you are expecting real income growth?

Steve Nickell: No, 2015 real incomes to grow significantly.

Robert Chote: The sort of things that people have been used to on average over a relatively long period in the past, that is not until 2015.

Mr Love: Would I be right to say that your view is that since the crisis in 2008, living standards—as defined by whichever is the most appropriate reflection of people’s economic wellbeing—have fallen in each year up until this 2015 effect takes hold?

Steve Nickell: I do not know in about every year, but certainly we are lower now than we were then.

Q59 Mr Love: When would you predict—I do not know whether you have figures for this—that living standards will return to pre-recession levels?

Steve Nickell: We have a measure in the thing called the real consumption wage, which just basically means real wages, and that looks as if it gets back to 2008 levels by 2016.

Mr Love: 2015 and 2016 we will see real incomes moving ahead and that will overcome the decline from 2008 onwards?

Steve Nickell: Yes.

Mr Love: Thank you very much.

Q60 John Thurso: Robert, can I come to you first and just pick up quickly on something you gave in answer I think to Andrea, when you were talking—sorry, no, it was Steve Nickell I think who gave the answer. It was regarding revision of figures to financial services and things like that. It the question of the revision of figures. We had an interesting exchange with some members of the Monetary Policy Committee regarding the quality of figures and so forth. Do you share the view that the ONS needs to improve its game with more resources and better figures? How much of a problem is it for you?

Robert Chote: As consumers of economic statistics, it would always be nice if the producers of those statistics had more resources to do their job with. On the other hand, for forecasters to complain about data revisions, it is like sailors complaining about the sea. That is what we have to float on, I am afraid.

Q61 John Thurso: On the other hand, there is an underlying extremely serious point—

Robert Chote: No, there is.

John Thurso: —which is if other countries are producing better data and therefore are able to make better judgments, while indeed you might like all the bells and whistles, but if you do have the core product at a level at which you can make your best judgments, then that is a matter we need to look at.

Robert Chote: Absolutely. I think the points we were discussing earlier, the number of people looking at the investment data, and that is doubtless ONS’ best estimate of what that is showing at the time being, but given the way in that these things have moved around, given the path of the investment deflator, you clearly have to not worry, but to look at the possibility that that is going to change the picture in the future. But you always have to have in mind the fact that we are dealing with the very early drafts of history here. The 1990s recession is still being rewritten significantly 20 years after the event.

Q62 John Thurso: I know. The question I am asking is, is there a need to give more resources to the ONS to do the level that is necessary, not any bells and whistles, or is your view that they have the sufficient resource?

Robert Chote: More resources well-used would be better. Whether what they are doing with their existing resources is the most optimal, it is not for me to judge how ONS is run, but in terms of if there were ways of—

John Thurso: Is that a yes or a no? I am sort of mildly lost in all of that.

Robert Chote: More money, well-spent, would produce better and more reliable statistics to help us and we would happily consume them.

Q63 John Thurso: Let me move on. You have—perhaps, Graham, if I could come to you on this one—made quite a lot of comments around the structural deficit and said it is worse, broadly it is worse than was previously thought, and therefore will take longer to deal with. What has led you to this conclusion? What are the key elements within that?

Robert Chote: I think the key distinction I make is you look at a headline we have revised down the deficit, the headline public sector net borrowing in each year going forward in the forecast. Our judgment is that that improvement is primarily cyclical rather than structural. It reflects the fact that we believe that the surprisingly high GDP growth over this year is eating into spare capacity, rather than suggesting that at one level of the economy there is more growth potential, and similarly that the structural deficit is smaller than we had anticipated. The other changes to what is left, the structural deficit, are relatively modest year by year, so I would not read too much into that difference. The key point is that the deficit is lower, but we are judging that the structural deficit is not significantly lower than we thought in March.

Q64 John Thurso: That is the question I was asking you. The whole point of this is what the Government is doing over the period of this Parliament, and now possibly into the next, to eradicate the structural deficit. That was the goal that was set and you are now basically saying, put simply, that it is more difficult to do that and will take longer. I am broadly asking you what the key points within that are.

Robert Chote: I do not think we are saying that it is taking longer. The size of the structural deficit, the hole that the Government has to fill in we do not think is any noticeably larger or smaller than we thought back in March.

John Thurso: I have misunderstood this.

Robert Chote: The bit that the economy is refilling is filling in more quickly.

John Thurso: I have misunderstood what the central forecast means for the structural deficit, okay.

Robert Chote: If you take the mandate measure, the one that the Government is focusing on, the structural cyclically-adjusted balance, we have changed that by 0.1% of GDP in 2017 relative to March, compared to a much larger change in the total deficit, because that

is basically the economy being more active, filling in the spare capacity and generating more revenue.

Q65 John Thurso: But it goes to the fact that the improvement in the economy, all the concerns you have expressed, are around consumer-led rather than investment and productivity-led. That is broadly where that is?

Robert Chote: Yes. If you look at the positive news, why would you not conclude that a significant portion of that was telling you about growth potential rather than cyclical change; the fact that even though real GDP growth has been stronger than we expected, productivity growth has been weaker, unemployment has continued to fall relatively rapidly and the labour market on the quantity side has been performing again better than we anticipated. Business surveys are suggesting relatively small amounts of spare capacity, if anything, suggesting even less spare capacity than our central forecast, and other major forecasters like the OECD and the IMF again would have measures of potential GDP going out a couple of years no larger than ours.

Q66 John Thurso: That brings me back to then the question of the productivity puzzle. I had a very interesting exchange with Charlie Bean and Dr Broadbent when the Monetary Policy Committee were before us, and basically put to them the proposition that their key judgment that they had made was that inflation will not follow through based on the fact that productivity will pick up. To a certain extent, you seem to be taking a slightly different view, in that you have cautioned policy-makers. I think what you said is, “Policy measures cannot continually improve the terms of trade, taxes cannot be cut indefinitely and workers can only work so many more hours in a day. Productivity growth is the only sustainable source of real income growth in the long term”. It seems to me that you are making a slightly different core judgment, which is that productivity has been impaired and may not come back in the way that the Bank of England are basically judging that it will. Have I again misunderstood?

Robert Chote: I think almost everybody is assuming that some part of the weakness in productivity relative to the pre-crisis trend or the trend, for example, implied in the March 2008 budget—which you could say is a similar way of reaching that—is likely lost for good and that therefore the path of future potential is lower than that was, but the big uncertainty of course is how big that effect is. I think you would find a range of views, for example, on the Monetary Policy Committee about that, one of the reasons why, with the forward guidance policy, the phrase they use about, “Exploring the potential for productivity”, it is basically teasing out there whether there is a relatively big hit to spare capacity or a relatively small one. We have been—

Q67 John Thurso: I have one last question of substance, but just to check up on that, what you are saying is you do not have a difference of opinion with the Bank of England and you are just as much making the same gamble as they are?

Robert Chote: The bank does not publish an estimate of the output gap or of potential GDP, so you cannot compare it. What I am saying is if you look at the speeches of people on the Monetary Policy Committee, there is clearly a range of views there, but common to all of them is the notion that you have probably seen us moving off the path that you

would get from just extrapolating the pre-crisis trend, but there is huge uncertainty as to about where the new path is.

Q68 John Thurso: Last question, please, if I may, is in relation to you have mentioned in some of the stuff here tax cuts and what might or might not be done. Maybe this is one for Graham, with his previous Treasury experience. Has anybody done any work on what might happen if one reduced VAT back to 17.5% and what that would do? Would you simply lose the income, £2.6 billion or whatever it is, or is there some of that that would be mitigated by growth?

Graham Parker: We have not done any work on that. We would not unless there was a policy proposal put to us.

John Thurso: Nobody has the policy at the moment, yes.

Graham Parker: We have not done it, but I would expect that if there was a VAT cut, there would be some effect on household consumption.

Q69 John Thurso: Let me ask you not necessarily as a member of this panel, but just as an individual, given that—

Robert Chote: Nice try. Just a random member of the public with no career to worry about, yes, fine.

John Thurso: You do not take the Clapham omnibus, do you, by any chance? But we have the experience in 2008 or 2009 when VAT was reduced, and we have the contra-experience of the first increase of 2.5% in 2010 and the second one in 2011. Can we extrapolate from that or is there any information that one might be able to extrapolate as to the likely effect of a return to 17.5% as to what it would cost the Exchequer or whether it would be neutral or whether it would help growth?

Robert Chote: I am sure people have done lots of work on that. While I was still at the IFS, I think we—dimly remembering—concluded that you ended up with people buying 1% more stuff 1% more cheaply when it was coming down. It depends a lot on the degree that it is passed through to the prices that people are paying. I am sure there is work that people have done there that you could draw on.

Q70 John Thurso: Sorry, I just want to get this straight, Chairman. Of the 2.5% drop, one of those per cents would be mitigated by the effects of growth. Is that roughly what you said?

Robert Chote: No, it is not what I said.

John Thurso: Good. I thought I had misunderstood. What do you say?

Robert Chote: As I say, I do not whether you have the IFS before you and you can ask them the analysis—

John Thurso: Sorry, I am trying to do this at great speed, I know, but—

Robert Chote: Yes. The question is how much of that is passed through and what the people's response is. That can depend on things like, for example, is the measure expected to be permanent; is it expected to be temporary? That can have a big impact. If you pose to somebody that if you did this and you were to persuade people it was permanent, what sort of a response you would get; it is not something I have my fingers on.

John Thurso: You gave the answer. I will ask the IFS tomorrow, thank you very much.

Q71 Chair: The trouble with forecasts from Government bodies is that people tend to exaggerate their importance, isn't that right, and attach far too much significance to them, and particularly to changes in them? You would agree with that, would you not?

Robert Chote: I think so. We are trying to emphasise the uncertainty at all times.

Q72 Chair: Part of your job is to downplay their reliability, isn't it?

Robert Chote: That is one of the reasons we did sensitivity and other analysis, to show people what would happen if things turned out differently.

Q73 Chair: The creation of the OBR has not succeeded in changing the quality of public debate in that respect, has it, so far? People treat your forecasts pretty much as they treated Treasury forecasts.

Robert Chote: I would not say that is true, having been a consumer of them in the past with other hats on. I think there is a greater recognition. We are in a position where we are able to be more candid and transparent with people about why forecasts have changed from one time to another. It is easier for us to say, "Look, we have changed our view because we have changed our judgments or the facts have changed". We are under much less pressure to engage what I used to call conviction forecasting, and I think some people do appreciate that.

Chair: Aspirational forecasting.

Robert Chote: Yes.

Q74 Chair: Have you considered not calling it a forecast, but calling it a projection?

Robert Chote: No. We have to say we are doing the best forecast that we can on the basis of the data we have. We normally draw a distinction when we are doing longer-term projections, so our 50-year analysis and the Fiscal Sustainability Report, we do refer to that as projections. It is based on more stylised assumptions about what is going to go on. This is a forecast in the sense that we are putting out a very detailed picture of the determinants on the economic side and of the bottom-up fiscal forecast, so I do not think we should shy away from that. We should just explain to people what uncertainties lie around forecasts and what health warnings should be attached to all of them.

Q75 Chair: That was a set of questions about one important issue, which is how much weight we should attach to the output of any forecasts, so I am not casting aspersions on the OBR.

Robert Chote: Absolutely.

Chair: There are a number of helpful points you have made there.

The other is on your independence. Can you confirm, as you have in the past to the Committee, that you have not come under any undue pressure to alter this forecast in any way or interference of any type and that you have had the co-operation you wanted and you would have expected from the Treasury and, where appropriate, other Government bodies?

Robert Chote: Yes, I can confirm that.

Chair: Good. Thank you very much indeed for coming to see us this afternoon.

Robert Chote: Thank you very much.