



Treasury Committee

Oral evidence: [Summer Budget 2015](#), HC 315

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Members present: Andrew Tyrie (Chair); Mr Steve Baker, Bill Esterson, Mark Garnier, Helen Goodman, Stephen Hammond, George Kerevan, John Mann, Chris Philp, Mr Jacob Rees-Mogg, Wes Streeting

Questions 1-148

Examination of Witnesses

Witnesses: **Professor Phillip Booth**, Editorial & Programme Director, Institute of Economic Affairs, **Jonathan Portes**, Director, National Institute of Economic and Social Research, and **Michael Saunders**, Chief UK Economist, Citi, gave evidence.

Q1 Chair: Welcome and thank you very much for coming to give evidence to us this afternoon. As you probably have seen from the agenda this afternoon, we are pretty pressed for time and you might feel short-changed in the exchanges, or even cut off, in which case please write down further thoughts that you may have so that we can use them in evidence if you would like them to be in the public domain.

I would like to begin with a question to Michael Saunders about the symmetry of monetary policy and whether you think we are indifferent to deflation of 1% or inflation of 5%. We are after all at zero, 2 away. It is a question I asked the Bank yesterday and frankly they did not answer it very directly. I wonder whether you could do a better job.

Michael Saunders: No, I don't think they should be indifferent. I think they should fear deflation much more than an overshoot in inflation. I think that is because the tools for getting out of deflation are probably less effective. If inflation is too high, we know how to deal with it. We have done it plenty of times in the past. If you whack up interest rates far enough and long enough, inflation will come down. On the other side, what you are seeing around the world, a number of countries with lowflation or deflation hitting the zero band on policy rates and finding it hard to go much further, using QE, and the effectiveness of these tools to break out of lowflation so far has been much weaker. So to me that is an argument for policy to be asymmetric or for inflation targets to be a little bit higher.

Chair: Very interesting comments. I am not going to explore them further because we are pressed for time.

Q2 Steve Baker: The MPC's Martin Weale said that the risk of holding rates low for a long time is minimal but that of raising them soon is large. Professor Booth, what is your view?

Professor Booth: I don't agree with that. If he is talking about the current time, I think the risk of continuing to hold rates down is to give the impression that rates will remain low, basically whatever; that will lead businesses and households, I think, to increase their borrowing on the expectation that that will continue to happen, and borrow to finance projects, purchases and so on, which are not necessarily sustainable should rates then adjust. I think the risk of raising rates at the current time, given the likely trajectory of inflation, is quite minimal. Surely seven years after the crash the economy has begun to normalise. Insofar as we have a problem at all it would appear to be productivity problem and not an aggregate demand problem, as it might be termed. Also to some extent commercial interest rates have become rather decoupled from central-bank interest rates so the risk of the central bank sending a signal currently by beginning to raise rates is, I think, insignificant.

Q3 Steve Baker: To save time, I will just say this. You and I both know that I belong to the school of thought that thinks that holding rates low for a long time also risks capital misallocations. Do you think that is something that the Bank of England should spend more time thinking about?

Professor Booth: I do. The BIS have thought about these issues and that is what I was implying, that if you hold rates too low for too long, and also signal the expectation that they will be held low for a long period of time, then that will lead businesses to borrow to finance projects that in the long-term are unsustainable. Yes.

Q4 Steve Baker: Leading to a worse problem later?

Professor Booth: Yes.

Q5 Steve Baker: Does anybody else wish to add to that particular perspective? Is the risk of holding—

Michael Saunders: I take the opposite view right now. I think that right now there is no great rush to raise rates. Sure, rates will probably rise over the next year or two but right now inflation is zero; wage growth is picking up but is not dangerously high. So I do not see an urgent problem to be dealt with. The risk of raising rates early is that sterling might rise very sharply and that would hit our export sector and import disinflationary pressures. After all, the target is 2% inflation and in that sense an early rate hike might well make it higher.

Q6 Steve Baker: But you do not worry about mispriced credit leading businesses into making bad decisions?

Michael Saunders: Right now, no. I think the economy is growing very nicely; business investment is quite strong. I do not see great evidence, apart from some bubbling areas of the housing market, that the economy is over-investing in a way that you should worry about.

Q7 Steve Baker: We are short of time so I will move quickly. The IEA has published at least one book that described the idea of the euro as a pan-European currency as utopian and bound to fail. I have in mind Hayek's *Denationalization of Money*. Do you think was a reasonable summary, looking back with the benefit of hindsight?

Professor Booth: Not entirely. I am rather more pro-euro probably than many members of this Committee as a matter of principle. The idea of decoupling currencies from nation states is something I find quite attractive and you may do as well. However, it was structurally flawed. I think some of these structural flaws were predictable in advance but I don't think anybody predicted quite how serious they were. The biggest structural flaw is the fact that the ECB essentially takes on credit risk of all member countries no matter how credit-worthy they are through its monetary policy operations and however strict the no bail-out clauses are, which I think are very important for a pan-national currency, they are not operational in practice because of the way monetary policy operations are followed. That is the problem that needs to be resolved should there be reform of the euro.

Q8 Steve Baker: Jonathan Portes, I think you have supported the euro in the past. How do you reflect on the euro now?

Jonathan Portes: Just for the record—I am not sure what you mean by that—I was a civil servant up until January of 2011 so obviously I made no public statements up to that point except insofar as I was doing so as a civil servant. I broadly agree with what Philip said. The way that the euro has been implemented and the way in particular that eurozone policymakers have taken decisions over the past five years have been deeply damaging in some respects to some European economies clearly. Is the idea that it makes sense for more than one country to share a currency always wrong? No. We could spend all day discussing the structural flaws in the euro—

Chair: Well, we are not going to.

Jonathan Portes: —and we won't. I will merely say that I do not agree with everything Philip said but broadly the point is that it was not in principle a completely mad idea but there were a number of serious structural flaws and the way that policymakers have responded has made those apparent and possibly made them worse.

Chair: I want to tell colleagues there is a chance of a vote on the ten-minute rule Bill. If I can find three colleagues to assist me to carry on, I am intending not to vote on it so that we can keep the session going. How many colleagues are not intending to vote? One, two, three. All right. I'm fine. We can carry on. That is good news.

Q9 Wes Streeting: I want to ask you about the issues of the path for wages and also unemployment and where you see the trends going. The Bank's "Inflation Report" said that

the uncertainty around the path of wages is considerable. I am interested in your view about how you see wages panning out in the foreseeable future. Secondly, the overall headline figures on unemployment are up today. I am interested in what you think the trend is likely to be.

Jonathan Portes: I'll take that first. Obviously one should not take too much from one month's figures but I think there are some indications that we may have reached the limit of significant further reductions in unemployment and significant further increases in the employment rate. So that has two sides to it. In some ways it is bad news. The good performance of the UK economy in creating jobs has been the single most important success story over the last few years so the fact that is coming to an end is bad in itself and also of course bad for growth going forward. The upside one might hope would be that it would lead to the wage growth coming back to something much more like what we would describe as normality, which is significant real wage growth, year on year. Again there is some sign of that in the figures but the Bank is right; that is both what the Bank assumes, the ODR assumes and what we assume will happen but there is considerable uncertainty about it. We will have to see what happens.

Chair: Any other questions, Wes?

Wes Streeting No, unless there are differing views, in which case I am going to have to read the transcript and go and vote. So if you do have conflicting views, I will be interested to read them.

Q10 Mark Garnier: A number of factors in this budget affect the housing market. We have the 1% reduction in social rent, the £1 million inheritance on main homes, the buy-to-let interest rates, allowances have gone down to the basic rate, the mortgage market review and the influence of pension assets coming out. Have you had a chance to work out what all this stuff is going to do to the housing market?

Professor Booth: Well, we are not forecasters; we leave witchcraft to the national institutes but conceptually this is a pretty important question and it goes to the heart of this budget. This budget was not an economist's budget, I can tell you. All the examples you have chosen might have gone down very well politically but they make no sense as far as the economics are concerned. Increasing the inheritance tax threshold but only for housing assets does not make sense. On restricting the extent to which you can offset financing costs against profits from buy-to-let, financing costs are a business cost and they should be offsettable against profit from buy-to-let. Restricting rents on social housing so they will fall further below market rents also does not make sense and may well lead to a reduction in social house building as well, which is not desirable. There has been a movement towards subject subsidies, which I think is by and large right. If you want to fix the housing market you do not do it simply—well, you do not do it at all—by pumping more demand into a market with fixed supply; you liberalise supply.

Q11 Mark Garnier: On that business-cost thing, you have private individuals paying potentially 45p in the pound tax whereas businesses are now going to be paying 18p in the pound tax. So it does create quite a big differential.

Professor Booth: You have to borrow to finance, like you do with any other business, and then whoever is providing the funding pays tax at whatever their rate happens to be.

Q12 Mark Garnier: Yes, but a business borrowing would be getting the credit, if you like, at 18% whereas a private individual is potentially at 45%. That creates an anomaly between private individuals acting as a business and a business acting as a business.

Professor Booth: It depends who owns the instruments that are funding the lending. If those instruments are held by households they will be taxed on the returns—

Mark Garnier: Oh, I see.

Professor Booth: —the interest that is being paid, at their tax rate. So we have symmetry in the system at the moment. We tax debt in one way and we tax profits in a different way. There are some rather uncomfortable interactions of that system and I think it should be radically reformed but just to choose one aspect of the system, limiting the tax relief to some extent on one particular type of business, does not make any sense at all to me.

Q13 Mark Garnier: No, fair enough. Jonathan Portes, you are in witchcraft: what do you think it is going to do to the housing market?

Jonathan Portes: I agree almost entirely with Philip; you do not solve the serious structural problem of the lack of supply in the UK housing market by messing around with demand mostly in ways that will tend to increase demand. Taking it all together, I doubt this will make our problems significantly worse, although I could be wrong—I think they will probably make them marginally worse and they will not do anything to make them better. The real test is whether the other things that the Chancellor has announced on planning and supply have a meaningful positive impact. We live in perpetual hope on this, of course. The previous Government tried to do things on planning and supply that did not work. The Coalition Government in 2010 said it was going to do lots of things on planning and supply, which equally failed to deliver. Will it work this time round? Again, we live in hope. I should mention this. The social rented sector measure: I have rarely seen the OBR be quite as rude about a policy measure as they were about this one where they said not only would it reduce the number of houses built but that if, as you probably should, you counted housing associations as part of the wider public sector, it would increase public borrowing at the same time.

Professor Booth: Slightly worse than that, they suggested that because of these measures and solely because of these measures and the requirements on housing associations to sell off part of their stock, the ONS might require them to put housing associations in the public sector.

Q14 Mark Garnier: That is quite an interesting point.

Both of you have mentioned that this is dealing with the wrong end of the equation, dealing with the demand rather than supply. On the basis that supply is not forthcoming at the moment to the extent that it should be, is property fairly priced? The reason I ask that is because if you look back over these long trends historically it is still about 35% overvalued

on an average-price to average-earnings basis. Having said that, the low interest rates change that. But a lot of dynamics have happened over a number of years, including a huge inventory in the buy-to-let taken out of the owner occupier market, and a number of other things. Having said that though, even at this higher level, house builders are not building houses. So what is going on in the housing market? Why does there seem to be a limited amount of supply, given the fact that in the most basic economic terms it has to be worth building at the moment, doesn't it? Jonathan Portes. Then we might get Michael Saunders off the bench on that one.

Jonathan Portes: When it comes to predicting house prices or saying what is fair I tend to share Philip's view that it is slightly akin to witchcraft. As you said, we have limited understanding—given that we are now in this very low interest rate environment—of the extent to which these historical relationships hold good.

Why are house builders not building? It does appear to be a combination. There are some perverse incentives that seem to arise from the structure of the housebuilding market for land banking, sitting on land with planning permission. It is not, frankly, my subject area so I am not sure I could say much more on that but I think there probably is something happening there.

Mark Garnier: Michael Saunders; do you just want to finish off on that and then we will move on?

Michael Saunders: I don't think the budget measures will do much to boost or slow housing demand either way. At the moment demand for housing looks like it is fairly strong. The home ownership rate is the lowest for decades. Surveys suggest that a very high share of people thinks it is good time to buy a house; mortgage rates are super low. That is one of those conditions, I expect house prices will go on rising and I agree with you, the issue here is the restriction on supply. What I hear from companies is that planning law is a major part of this.

Chair: All right. We are going to move on.

Q15 Stephen Hammond: Can we get to some of the heart of the budget measures then, please, and the overall macroeconomic effects? The first thing clearly is that the pace of deficit reduction was pushed back a year effectively; it will be a year longer before we get to surplus. Can I ask you three points on that? First, that pace: does pushing that back surprise you? Do you think that the balance between reduction in spending and tax increases is the right balance and if it is, what do you expect that to do for growth? Also, given that the first year of surplus has been pushed back a year, are you changing any of your growth forecasts as a result of that? Finally, can I ask you to comment on the concept of an expansionary fiscal contraction?

Chair: Apart from that you have nothing to bite on.

Professor Booth: If I answer those from the bottom up, then Jonathan will certainly find something to disagree with me about on this set of questions.

I think there is very little evidence in most times—especially when monetary policy can bite—that reducing a budget deficit will lead to a contraction of the general economy over a

period of, say, six to 18 months. It might do over a period of, say, nought to six months. There are several reasons for that. One very important reason for the UK, which does not necessarily apply to the eurozone, is if you are very open to capital movements and you have a floating exchange rate, the budget deficit and the overall net borrowing position of the economy affects the exchange rate and if you raise the budget deficit, as long as you do not raise it so much that it disturbs confidence, then it will tend to raise the real exchange rate and that will have an impact on the private sector of the economy. So Jonathan and I take very different views about that.

Jonathan Portes: I disagree with almost none of that.

Professor Booth: Okay.

With regard to the other questions, I think they have now really become an irrelevance. Nothing surprises me in terms of postponing the time at which the budget will be balanced and I don't think it really matters all that much anymore. Whether the budget deficit is 2% or 1.8% in 2017, 2018, or whatever it might be, is really irrelevant to the big picture of the enormous fiscal headwinds that we are going to face over the next 30 years. So I am relatively relaxed about that. I think it is fairly irrelevant as far as growth is concerned and then as far as the spending tax balance is concerned, my big concern there is the balance between cutting one type of spending and cutting other types of spending. The protection of the biggest proportion of the welfare budget, so these very damaging things have been done to child tax credit systems, which will reduce work incentives, is my biggest concern. This has been a problem since 2010: triple lock put on pensions; pensioner benefits protected; means tested benefits to pensioners protected and people of working age being treated in an entirely different way. That of course also makes the fiscal headwinds over the next generation much worse as well as making it more difficult to deal with the current fiscal situation.

Jonathan Portes: I agree with a very large part of what Philip has just said. Expansionary fiscal contraction: the notion that fiscal contraction would be anything other than sharply contractionary in 2010 was obvious nonsense at the time and so it proved. The notion, however, that—as Philip said—now that we are much nearer normalisation of economic conditions in general and interest rates might be expected to rise over the course of the Parliament and monetary policy to regain traction, the notion then that fiscal policy one way or the other would have a much lower impact on the economy, I think, is as Philip said, absolutely right. So the pushing back of the surplus target, which we regard as sensible from a macroeconomic perspective will lead us, other things being equal, to adjust our growth prospects, or growth forecast, up slightly, but it will not have a huge impact in the way that fiscal policy did several years ago.

Q16 Stephen Hammond: The definition of slightly?

Jonathan Portes: We would be assuming, now that we are much closer to normalisation, that the fiscal multiplier will be that much more towards the sort of normal value we would expect in a small open economy for exactly the reason that Philip stated around monetary exchange rate policy of perhaps 0.3 and again that that effect would only last for—again as Philip said—six to 12 months rather than being very prolonged. So the relaxation in fiscal policy represented by this budget will have a positive impact on growth

relative to our previous forecast, but it will not be transformative; it will not change the numbers by a huge amount. So that is the first point on growth and expansionary fiscal consolidation.

On the surplus target, I think the implication of that is that from a macroeconomic perspective targeting the projected path of fiscal policy over the next Parliament does not look to us to be a significant negative impact on growth. From a macroeconomic perspective it appears to be reasonable. I would make one point, though. In the last Parliament the fiscal framework within which targets were embedded meant that when things went wrong, the Chancellor was able basically to ditch his target, ditch the secondary target, and readjust policy, allow the automatic stabilisers to work and all the rest of that. That is not provided for in this fiscal target. This fiscal target says that unless growth goes below 1% then the target is a surplus by 2019/2020. So let us imagine what would happen if growth were not the 2.5% that we, the Bank, the OBR and everyone else, is forecasting in our central forecast. Suppose growth was about 1.25%. Under that situation the Chancellor in principle would still be fully committed to the surplus target. Now you only have to look at the back of an envelope to realise that that growth shortfall would lead to a £35 billion or so hole in receipts. Right? There would be a cumulative growth shortfall of about 5% so receipts fall by 5%; £35 billion shortfall; £35 billion more in spending cuts. What the Chancellor's charter of budget responsibility says is that if that is what happens, if growth is 1.25% for the next four years—and that could happen; anything could happen—then we will still hit the surplus and to do that we will make £35 billion-worth of extra spending cuts. That is simply not going to happen. We know it is not. The Government will not do that. We know that by their previous record. It would be economic madness. They will not do it; quite rightly. So in that sense the surplus target is simply not credible. The Government do not intend under those circumstances to hit it. So there is a big question mark it seems to me about what it means. If growth proceeds along the lines set out in the forecast, it is not unreasonable, but the way it is set out in terms of the framework, simply does not make sense. It will not happen and I think that is something you should be pressing the Chancellor on. I could talk about the balance between tax and spending cuts but I think Andrew wants me to shut up now.

Q17 Chair: Well, don't think I want you to shut up but before I bring in Helen Goodman I would like to just go back over some of the territory that we covered in the last Parliament.

You argued for a fundamental change in policy in 2011 and in 2012 in pretty lurid tones. You quoted Macbeth. Do you want me to give you the quote? "I am in blood, stepp'd in so far that, should I wade no more, returning were as tedious as go o'er."

Jonathan Portes: That's right.

Chair: You came out with something like that and then explained that what you meant was that the Government seems to have decided that since it had gone so deep into the wrong policy it was going to carry on with that wrong policy. Do you think the Government did fundamentally change policy?

Jonathan Portes: There was clearly a very significant change of policy, effectively admitted by the Government quite recently in some of the revelations that came out; the argument between Danny Alexander on the one side and other people within the

Government about this. There was clearly a significant change of policy. It was not the fundamental change of policy that I would have wanted but there was a very significant slackening off in fiscal consolidation after about—

Q18 Chair: Stabilisers kicked in. What else was there?

Jonathan Portes: The stabiliser kicked in and there was a significant structural shortfall in tax revenues, which the Government under its plans should have been obliged to make up but they chose not to.

Chair: That was the stabilisers.

Jonathan Portes: No, it was not the stabilisers then. There were two things going on. There was a structural shortfall. That is what the OBR said.

Chair: You are calling it a structural shortfall on the basis of OBR reports. Nobody really knows whether it is structural or not.

Jonathan Portes: That is true. But whether you measure fiscal consolidation according to the headline deficit or according to the best estimates of the structural deficit that we have, any way you look at it there was a significant slackening off on fiscal consolidation. Does that represent a significant policy change? It depends on what your counterfactual is and what the baseline is and we could argue about that. In economic terms there was clearly a significant reduction in the pace of this consolidation and in my view that was one of the factors, not the only factor, but one of the factors that contributed to the reversal of economic fortunes.

Q19 Chair: Your view is that the Government did surreptitiously change course and it listened to some degree to arguments from people such as you but did not like to admit it and that as a result the pickup that we now have and the relatively strong performance can be attributed to that significant change of course.

Jonathan Portes: Only in part. Others things went on as well. The eurozone was in a dreadful state in 2010, 2012 and then went back into at least stasis from 2012 to 2014. That was a relative improvement for us. Obviously the oil prices helped as well. So I would not attach all the weakness in 2010 to 2012 to mistaken policy; nor was all the bounce-back the result of the change in policy, but it was one of the factors that contributed to what we saw.

Chair: I will leave listeners outside this room to—

Professor Booth: Could I make a very brief point on the fiscal rule issue?

Chair: It had better be very brief because Helen Goodman wants to come in on this point.

Professor Booth: I think in the handbook of possible fiscal rules the Government is choosing a very, very, very bad one. I think it was 78 economists that wrote to *The Guardian* criticising the Government and I wrote an article criticising them because they used all the wrong arguments. One of them then responded using similar arguments to

Jonathan's and he is absolutely spot-on in his critique of the fiscal rule that has been chosen.

Chair: Helen wants to come in on exactly this point.

Q20 Helen Goodman: Thank you. I was a little bit surprised that Mr Portes had such thoroughgoing criticisms of the new fiscal rule but you did not seem to be saying that you thought the long-term impact would be deflationary. Could you just explain that apparent dissonance?

Jonathan Portes: It is for the reason that Philip set out, which is that there is a degree of consensus that has grown up over the past 20 years in advanced developed economies that short-term macroeconomic fluctuations are where possible best dealt with by monetary policy. The big criticism that I and others made—the argument that Philip was just alluding to—was that in the circumstances of 2010 to 2012 where we were in uncharted territory for monetary policy and for a number of other things and monetary policy was clearly ineffective in some respects, fiscal policy was much more important in addressing short-term macroeconomic fluctuations. As we now return to something closer to normality, the reasons to believe that fiscal policy is either the right tool to manage demand or that it has as big an impact given what monetary policy can do, are much weaker. That is not to say that a sharply deflationary fiscal policy will not hit demand—it will—but monetary policy is much better able to respond than it was five years ago and over the next few years in a small open economy like the UK, our model and the general approach of macroeconomists would suggest that you should not worry that much about fiscal policy, from a macro perspective. There are lots of other issues, again which Philip alluded to, although we probably disagree on what the answer is, about the balance between taxes and spending, what you spend the money on and all the rest of it, but those are not about the macroeconomic impacts of fiscal policy.

Q21 Helen Goodman: Turning to Professor Booth, if we look back over the last 60 years I think we had surpluses in seven out of those 60 years but we had growth below the Chancellor's 1% in 11 out of the last 65 years. So what we would have had, had we had this rule over the last 60 to 65 years is an almost exact reversal of the position that he is proposing. Do you think, if we had had this rule, we would have had such high growth since the Second World War?

Professor Booth: Such high economic growth or such high growth in the debt?

Helen Goodman: Such high economic growth.

Professor Booth: I think for the reasons that Jonathan set out, if we had started with this rule in 1945 we would have quickly dispensed with it because it is an unworkable rule. When there are unforecast changes in tax receipts or government spending the suggestion here is even if these changes are not structural that there would have to be cuts in planned spending or increases in taxation, which—

Helen Goodman: It is just too clunky. Is that what you are saying?

Professor Booth: It is too clunky, yes. So to have a structural debt break or something of the type that Switzerland has, I think that would be perfectly sensible. So in Switzerland, I think I am right in saying—

Helen Goodman: They target the debt ratio.

Professor Booth: They target the debt, yes, and if you go over the debt ratio then you have to reverse it the following year unless the cause is random fluctuations as opposed to structural changes. So that has both the rigour of reversing deviations from the rule in future years as well as being a more sensible rule to start with.

Q22 Helen Goodman: Okay, I understand. Mr Saunders, are you with the 79 or are you with Mr Portes and Professor Booth?

Michael Saunders: I think the fiscal rule is not very well phrased. I think the cyclical adjustments should be there and done properly and I think that the rule also fails to distinguish between current and capital spending. One of the things I preferred about the previous version of the rule was that the fiscal target was in terms of current balance whereas with this rule any government that is constrained by it, if it takes the rule seriously, would probably be tempted to cut capital spending and I think in the past that has been done and has often been the wrong thing to do.

Q23 Chair: To the panel, very quickly, all three of you. Has there ever been a fiscal rule from the government, any government since the war, that, with the advantage of hindsight has filled you with confidence and to which as a result you think we should turn now?

Professor Booth: Not really. Kwasi Kwarteng persuaded me that the Swiss one worked as well as any.

Chair: In the UK; of the UK's rules

Professor Booth: No. And I should say that with any other rule my great worry is that governments, as this Government has done, massage up current tax receipts at the expense of future tax receipts, reclassify social security liabilities and this type of thing, in order to reduce the explicit debt. This has happened in Hungary for example.

Q24 Chair: I would like very much to hear more but I do not have time now. Has this made borrowing any cheaper, Mr Saunders? That would be a good measure.

Michael Saunders: It has not made borrowing cheaper, no. Has there been a fiscal rule that has been successful? No. I would say it has always been a question of under what circumstances do governments either try to manipulate the figures or abandon the rule, so you just have to be ready to do so.

Chair: That is a clear answer. If you can do something even more briefly, Mr Portes, that will help.

Jonathan Portes: There is no perfect rule but on the whole I would give the rule in the last Parliament maybe 2 out of 3, partly because of what we have just discussed. Although it had to ditch the second half of the rule, the first half of the rule worked in its interest. It was able to change policy in a reasonably sensible manner. So combined with the OBR, which is very important—the institutional aspects are very important, to have that independent check—I would give them 2 out of 3 for the last Parliament.

Chair: I am going to bring in Jacob. This is about ring-fencing and hypothecation, very quickly. Then there is time to bring in the colleagues who slipped off to vote.

Q25 Jacob Rees-Mogg: You will obviously know about this from the budget, that more public expenditure is ring-fenced; now defence and counter-terrorism is included along with health, schools, overseas aid, pension benefits and child benefits. Is it efficient from an economic perspective for the Government to be tying its hands in this way? I don't mind who answers first.

Chair: As long as you answer quickly.

Jacob Rees-Mogg: Is there anybody who thinks it is efficient? So you all think it is inefficient to a greater or lesser extent?

Michael Saunders: I do because what tends to happen is things that are just within or just without either get benefited or squeezed in a way that is quite arbitrary.

Jonathan Portes: It is fairly inefficient but I think that sometimes the dangers are overstated. For example, even without the ring-fence, the level of health spending projected for the next Parliament is the bare minimum that any government would have had to do for perfectly good and sensible political reasons anyway, and that is the biggest one. I don't think it is a brilliant idea but it may make somewhat less difference than some people think it does.

Professor Booth: My problem is that it is really an attempt by governments, or a particular political party, to get what public-choice economists describe as expressive applause from particular interest groups that feel strongly about a particular issue. So that is how the pensioner benefits ended up being ring-fenced. The health service was ring-fenced, although I agree with Jonathan that it probably would not have made any difference, in order to neutralise it as a political issue. The aid budget was ring-fenced in order to completely castrate the development charities in the 2010 general election in terms of their political campaigning. Now I think the defence budget has been ring-fenced for a similar reason. So I think it is almost wholly done for bad reasons.

Q26 Jacob Rees-Mogg: Do you think doing it for these bad reasons then, prevents a proper discussion on where public expenditure should go because if you have half the public expenditure ring-fenced, any cuts have to come from the other half and there is no point in even talking about the ring-fenced bit?

Professor Booth: Absolutely. The Government is stuck up a blind alley when it comes to discussion of the welfare budget because a huge proportion of it, even that part of it that goes to relatively well-off people, if those people are older, is ring-fenced and not just

ring-fenced but also pledged and planned to increase faster than public spending, the price level and indeed wage growth in general.

Q27 Jacob Rees-Mogg: Do you think these problems are fully understood by the public? Or are they seen, still, as good things to do electorally?

Professor Booth: Well they are certainly seen as good things to do electorally otherwise they would not be done because I think they are done for purely political, not economic, reasons.

Q28 Jacob Rees-Mogg: Any other views on that? Or shall we move on? The other side of the coin, which is now not only do you have half the public expenditure ring-fenced but you have the taxation to pay for all the public expenditure about to be legislated for to prevent it going up. Do you think this is equally ill-advised?

Jonathan Portes: Yes, I think it is. I see no particular case for legislating—there may be a case for reducing taxes but for legislating to tie your hands to reduce taxes, there are circumstances in which it makes sense for governments to tie their hands—for example in defence of the Bank of England or whatever. The case for legislating to reduce freedom over future tax rates seems to me to be far, far less clear and I think the result is that since the Government did feel it needed to put up taxes, you end up, as under the previous Government, with stealth taxes; taxes that nobody, certainly not me, understands. Philip was trying to explain to me before the meeting how the dividend-tax increase works and I don't think he entirely succeeded, I am afraid. But that is the sort of illustration of what governments do when they cannot raise the main tax rate.

Q29 Jacob Rees-Mogg: So spending ring-fencing is a bad idea; tax ring-fencing is a bad idea. The Treasury for centuries—

Professor Booth: There are exceptions, I think, on tax ring-fencing and that is to prevent tax increases that would not be transparent. Things like the Rooker-Wise amendment to index-linked tax thresholds, that is a good idea.

Jacob Rees-Mogg: Do you agree with that?

Jonathan Portes: Yes, I agree with that.

Professor Booth: The very last thing we need to do is legislate to not increase taxes that are about as transparent as they come, the basic rate of income tax for example.

Q30 Jacob Rees-Mogg: All right. So the final bit on all of this is something the Treasury has praised for centuries but has been brought back in the budget and that is hypothecation of taxes. Does any of you think hypothecation is a good idea?

Jonathan Portes: You don't want to have two thirds or even one third of your budget on either side hypothecated. I think there are cases when from a political economy

perspective there is a case for hypothecation. For example, we got ourselves into a terrible mess on national insurance by effectively removing the hypothecation principle.

Q31 Chair: We will move on, but I think we have the answer, which is not much and your view is not at all, is it, Mr Saunders?

Michael Saunders: Yes.

Chair: And your view is—

Professor Booth: I agree hypothecation is appropriate in certain circumstances, potentially with road taxes and also national insurance.

Chair: Very limited then?

Professor Booth: Well, for a particular purpose also, where it is possible to have alternative private provision so that hypothecation almost becomes like a price and people can opt out of the Government's services, as they did with pensions and national insurance rebates, and have their own alternative private provision. Then the whole idea of hypothecation, I think, becomes rather more sensible.

Q32 Jacob Rees-Mogg: Do you think that applies to vehicle excise?

Professor Booth: It could well do, depending on what the Government's plans might be regarding potential privatisation of the road network.

Q33 Bill Esterson: Going back to the fiscal rule, what would be the impact on households and on businesses in terms of borrowing and savings?

Jonathan Portes: Obviously from a macroeconomic perspective things have to add up. A fiscal surplus for one side means that everybody else must definitionally be in deficit. Of course, that adjustment could happen through the current account, to the extent that it would be a good thing, or it could happen through households and/or companies borrowing more.

To go back to what I said earlier, again one of the reasons why accelerated fiscal consolidation in the 2010 to 2012 period was a mistake, and in my view was a predictable mistake *ex ante*, was because it was clear that households and companies had no desire to borrow more and, therefore, we were exacerbating things by reducing the amount the Government were borrowing. The Government were doing the sensible thing of picking up the slack by borrowing. The case for Government to be doing that over the next few years, because we are coming back closer to normal times, is much weaker. For example, we see that companies are indeed now investing considerably more. I am considerably less worried about that sort of overall national accounts problem than I would have been four or five years ago.

Bill Esterson: In so-called normal times, not a problem.

Jonathan Portes: Much less of a problem, yes.

Bill Esterson: Much less of a problem, yes. Professor Booth, any different comments?

Professor Booth: Nothing further to add. Perhaps for the record I could register my disagreement with Jonathan about the interpretation of events between 2010 and 2013 but there is no need to rake over that. I don't disagree with what he has just said.

Q34 Bill Esterson: I will move on to young people. What is going to be the longer-term economic effect, quite apart from the effect on young people themselves, of having young people who have not been able to get into the labour market?

Jonathan Portes: We have quite a lot of evidence that early labour market experiences matter quite a lot. In other words, the relatively high level of youth unemployment and low wages of people who did get into employment over the last few years is likely to have a permanent negative impact on quite a large number of people. On the plus side, it will not be as bad as it was in the early 1980s when youth unemployment was far higher than it has been over the past few years.

Q35 Bill Esterson: I am also interested in the impact on the economy, the longer-term effect on the economy of having people who have not had that experience early on.

Jonathan Portes: The historical evidence would suggest that there will be a negative impact; these lasting negative impacts on people's employment probability, wages and so on will go on for some time. But of course the fact that it happened before, that it happened after the early 1980s recession, does not mean it has to happen now. There are policy actions that Government can take in terms of helping people retrain, making sure that people who had a bad time in their early 20s have a much better time in the labour market in their mid-20s. There are plenty of things we can do to avoid those long-term negative impacts.

Michael Saunders: I think this is getting us on to one of the big issues in the Budget, which is the shift between tax credits and pay. The UK, through a series of tax and benefit reforms over the last 15 years, ended up with a system that when the recession hit proved very effective at getting people back into work. We had less of a spike in unemployment and a quicker drop in unemployment than after previous cycles and after other countries. That was mirrored in the big expansion of people employed in relatively low-paid sectors. Some people worry about the side effect of that, which is the productivity puzzle, but I think we should be quite grateful for the fact that we ended up with much less of a hangover of long-term unemployment, and all the hysteresis effects that come from that, than we had in previous cycles, and tax credits was a part of that. I think they have helped to raise workforce participation and also, by topping up the incomes of the low-paid, probably helped to cap pay and thereby encourage labour demand. That has been all part of the story for the growth of people in low-paid sectors.

I do worry as to whether the simultaneous withdrawal of tax credits and what is now in effect a much higher minimum wage for the over 25s reduces both the supply of labour and the demand for labour in a way that, if a future downturn hits, the outcome in terms of jobs may not be as good as this last one has been.

Q36 George Kerevan: Mr Saunders, the current account deficit is a large number; we seem to be surviving well despite that. Can you think of any plausible circumstances, not theoretical circumstances but plausible, within five years in the UK where the current account deficit might impact negatively on Government policy?

Michael Saunders: At the moment, the reason why the current account deficit is not a big problem is because it is not a classic story of the UK importing lots amidst a debt-fuelled consumer boom, which has been the story many times in the past. It is chiefly because the UK has very large external assets and foreign investors have very large amounts invested in the UK. The yield on our overseas assets is really low, chiefly as a side effect of the super low interest rates and sluggish growth in the euro area. So we are not earning as much on our overseas assets as foreign investors investing in the UK earn. That yield differential also attracts lots of capital into the UK, which more than funds the current account deficit that is caused by that yield differential. That may well continue for a while.

Circumstances under which that could cause a problem would be if foreign investors start to worry about the UK's commitment to economic stability in general, because after all we do have to fund that current account deficit. I would say the question of EU membership is a very important thing. What I find talking to investors around the world is that is probably their number one concern about the UK. But if that happened, if greater risks were to grow, then the adjustment would be that the pound would fall, I suspect. I do not know how directly it would affect Government policy and in a sense the exchange rate would be the shock absorber.

Q37 George Kerevan: Do you think that the loss of foreign capital earnings will reverse if interest rates start to rise?

Michael Saunders: If interest rates start to rise in the UK, the mathematical effect of that would probably be to make the current account deficit worse because foreign investors would earn more on their deposits in the UK. The only way the current account deficit within this framework would correct significantly would be euro area growth is strong enough to push up the return on our external assets. That may well be some time away.

Q38 John Mann: Mr Saunders, you talked of deflation and your concern in relation to that. Is there any particular country that we should be studying in order to look at this issue and some of the complexities in dealing with any potential deflation, in your view?

Michael Saunders: Switzerland, Sweden and New Zealand are all countries that have faced significant currency appreciation. In the case of Sweden and New Zealand it was after relatively early interest rate hikes, which then squeezed their export sectors and have produced a persistent lowflation or deflation.

Q39 John Mann: That is very helpful. Mr Portes, you have blogged about immigration. Is what in essence you are saying that we have the wrong kind of migrants coming here?

Jonathan Portes: No, I was not making a negative point about immigration. I was merely observing, as Michael quite rightly said, that the effect of the changes to the tax credit and the national minimum wage will be to reduce the relative labour supply of people with children, most people already in the UK labour market, and reduce relative labour demand for those people from UK companies. At the same time I noted that this will not affect labour supply for people under 25, particularly those who might be attracted here from eastern Europe, and indeed people over 25 without children, which make up a significant proportion of people who come here from eastern Europe. This may rather paradoxically actually increase the relative attractiveness of migrants for UK employers and the UK labour market to migrants while reducing it for British families currently resident with children. It was merely an observation. I am not saying anything about the wider impacts of migration from the European Union, which on the whole I regard as being broadly positive.

Q40 John Mann: Have you not missed this issue of 30 hours free childcare? In fact, isn't it more likely to be migrants with children, attracted by free childcare if in work, who are more likely to come here than under 25s?

Jonathan Portes: Most migrants who come here don't have children when they come and all the evidence we have suggests that the primary motivation for migrants from eastern Europe to come here is the headline wage rate; first of all, the fact that our labour market creates a lot of jobs and, secondly, that minimum wages here are pretty high relative to anywhere in eastern Europe, which of course will be even more the case now, and we speak English. There is very little evidence that they really understand things like the tax credit system, let alone the system for the provision of childcare. Of course, once they have been here a year or two then they learn how we work and then they start claiming tax credits and no doubt they will take advantage of the childcare and all the rest of it. So they will end up in the system but that is not the reason they come in the first place.

Professor Booth: Could I strike a dissenting note on deflation, as it has come up a couple of times?

Chair: Very quickly, and then I think we are going to have to close.

Professor Booth: When thinking about deflation, you should distinguish between a temporary fall in prices or temporary very low inflation as a result of a fall in some prices, which is what we are experiencing at the moment in the UK. We are not experiencing deflation as such. Even when you do experience this continuous decline in prices, which some people worry about, you can also distinguish between one that is expected and understood and embedded within people's expectations and decision-making and sudden shock deflations. I think Japan's problems are far greater, more structural than simply the problem of deflation it has had over the last few years. I think deflation is something of a red herring in the debate about Japan.

Chair: We have covered a large number of areas there in a short space of time and no doubt only some of them, nothing like as deeply as we would like. So if you have further thoughts you would like to add, please put them on paper and let the Committee see them in due course. Thank you very much for coming to give evidence. It was extremely interesting. We are going to move straight on to the next session.

Examination of Witnesses

Witnesses: **Paul Johnson**, Director, Institute for Fiscal Studies, and **Carl Emmerson**, Deputy Director, Institute for Fiscal Studies, gave evidence.

Q41 Chair: Thank you very much for coming to give evidence this afternoon. Can I begin with a question to you, Mr Johnson? You have seen the announcement on the proposal to give a statutory base to the Office of Tax Simplification. You work in the field of trying to think through what should be done to the tax system on a daily basis. What do you think the structure of that body needs to look like in order to make it effective, and in particular in order to give it enough independence for its views to carry credibility?

Paul Johnson: The OTS over the last few years, as you know, has been a relatively small organisation that has sat very much within the Treasury, reporting to the Chancellor, working on an often widely defined set of issues but often coming to very narrowly defined sets of recommendations, to which no one has a responsibility to respond explicitly. I think something that involves a clear responsibility on perhaps the Chancellor or the Treasury to respond to recommendations would be helpful. A situation in which the OTS is reporting directly to a committee of Parliament would also be helpful, and a close working relationship and understanding within HMRC of what OTS is doing, the feedback that it is getting from its extensive consultations and the reasons for its conclusions. The more independent that you make an organisation like the OTS, the more difficult it becomes for it to be impacting on the day-to-day policy, both making and administration. I think one of the difficulties that it has faced is that a lot of the complexity in the tax system is deep policy complexity. There is administrative complexity where you can make changes that tidy things up around the edges, but the OTS has inevitably over the last few years strayed into areas that potentially make quite a big difference to the structure of the tax system, whether you are talking about the taxation of employee benefits or whether you are talking about the integration of tax and National Insurance contributions. A lot of the complexity is created by those deep policy decisions and it is inevitably difficult for a small organisation to change those, but I think it would be helpful if it had a platform for explaining why the complexity that people observe is driven by the overall policy and, therefore, allow it to force Government, as it were, to respond to that.

Q42 Chair: For that it needs some independence. Its leadership needs some independence.

Paul Johnson: I think that independence and particularly the responsibility on this Committee or another committee and the Chancellor to respond—

Chair: Accountability in some form here is what you are saying?

Paul Johnson: —to those recommendations, yes, indeed.

Chair: Okay, that is very helpful.

Q43 Chris Philp: I would like to ask about the achievability of the welfare savings. In the past, the IFS have questioned the Government's ability to achieve savings in the welfare budget. Would you agree that the £12 billion of welfare savings set out for the coming period are pretty clearly itemised and will, therefore, be achieved following the Budget last week?

Paul Johnson: Clearly, savings are achievable if you cut the generosity of benefits and that is what is being proposed and that is clearly achievable. I think there are two riders to that. One is that benefit spending can rise even when you are making those cuts, and we saw that very clearly over the last Parliament. There were cuts to the generosity of housing benefit but housing benefit spending rose because rents rose and earnings fell. You are always at the mercy of what is happening in the rest of the economy.

One other thing I would say is that the £1.4 billion I think it is that is scored as a saving on housing benefit is not a saving on housing benefit. Essentially, it is a cut in the support to housing associations and local government. It is not a cut in the generosity of housing benefit. I think it is rather odd that it was scored in that way.

Q44 Chris Philp: Okay. I think the IFS has been recently quoted as saying that 13 million families will be £260 a year worse off due to the effects of benefit changes, so across that 13 million average. Does that analysis account for the effect of the proposed national living wage? Have you done analysis that looks at the combined effect of the reduction in benefits joined together with the very significant effective increases in the minimum wage?

Carl Emmerson: The 13 million families is simply the number of families in the UK receiving working age benefits that the Government has subjected to the four-year freeze. There are 13 million people who will lose from that measure. The Government has scored that as saving about £4 billion, which works out at £260 a year on average. That is how we worked out that number. It is just the losses from one particular measure on the scorecard. If you are talking about how much families will lose from all of the welfare cuts, then clearly the Government has scored that at £12 billion, so it is a much bigger number. If you want to think about the gains from the higher minimum wage, the OBR estimates that £4 billion extra in employment income will be generated from the higher minimum wage, so there will be some compensation for some of those families that lost. It is important to remember that, first, the minimum wage has to be paid for somehow. That is not just free money appearing in the economy. There will be fewer hours worked or there will be higher prices or lower returns for shareholders; somewhere the money has to come for these people. You also have to remember that some people will benefit from a higher minimum wage who will not be losing tax credits. The compensation is not perfectly targeted at the group who are losing from welfare cuts and from the benefit cuts and the tax credit cuts.

Q45 Chris Philp: The Treasury has produced figures that suggest that for a typical family with one working full-time person on the minimum wage, when you put all of these changes together for that particular exemplar demographic, so one full-time person on

minimum wage, they will be better off by 2020 when you net all these effects together. Is that an analysis that you accept?

Carl Emmerson: There are certainly examples where families are better off as a result of the package set out in the Budget, even if you just look at the benefit cuts and the minimum wage increases. They tend to be families who are working a lot of hours at the minimum wage, so they benefit a lot from the minimum wage increase and they do not qualify for much in tax credits anyway. If you look at other families where the hours are lower and perhaps they are earning more per hour, they will not benefit as much from the minimum wage increase, if at all, yet they can still lose a lot in tax credits.

Q46 Chris Philp: That is a very interesting point that you have made there. I think what you are suggesting—and I think this is something I would agree with—is that the combined effect of the tax credit reduction and the increase in minimum wage might actually serve to encourage people to move more towards full-time working as compared to part-time working because there are much stronger incentives now to work full-time rather than part-time and that might well be beneficial for the economy.

Carl Emmerson: For those who are receiving a higher minimum wage they may well want to work more hours per week if those hours are on offer from their employer. I mentioned before that somehow a minimum wage increase has to be paid for. Of course, there are a set of people who are out of work for whom the returns to working now may be lower because they will not be able to get as much in the way of tax credits if they are to work.

Q47 Chris Philp: Yes. I think that is an important point, Mr Chairman. I think that the net effect of all of this may well be to push people more towards full-time work than part-time work and that is worth bearing carefully in mind. In terms of the perceived fairness of the changes, which some people have commented on, the distributional analysis produced by the Treasury is quite instructive and it compares the proportion of spending received by the various quintiles in 2017-2018 as compared to 2010-2011. What is very interesting is that even after all of these changes we have heard about, the bottom two quintiles essentially receive the same proportion of spending, 24% and 26% respectively, and pay pretty much the same share of tax, 6% and 8% respectively, as they did five years ago, which would suggest to me that these changes do not have a redistributive effect and do not penalise people on low incomes. The distribution of both spending and taxation is essentially unchanged over that 2010 to 2018 period. Do you accept those Treasury figures that the distributions, both for spending and tax, have not changed and there is not, therefore, any unfair penalisation of people on low incomes?

Carl Emmerson: In terms of the distribution of spending, I think what it is showing is that the Government has been cutting, say, benefits targeted towards the middle of the income distribution harder than it has been cutting benefits that are targeted towards the bottom. Therefore, the share going to the bottom has not declined as a result of that. If you look at all of the tax and benefit changes that have been implemented since January 2010, which is roughly when we started the fiscal consolidation and dealing with the deficit, and you look at the loss from tax rises and benefit cuts by decile of the income distribution, what you see is that it is the people at the bottom who on average have lost the most, followed by people at the very, very top who have lost the most. It can be people on very, very high

incomes who have been hard hit by the tax rises, essentially, that have taken place and particularly the direct tax increases and the reductions in generosity of the pension tax regime, but it is working age families in the bottom half of the income distribution who have also lost a lot as their benefits have been cut back.

Chris Philp: You are quite right about the top quintile. Their share of taxation has increased from 49% to 52%. Your comments are not reflected in these figures lower down the income spectrum. I think that was everything, Mr Chairman.

Chair: That is all you want to ask?

Chris Philp: Well, the other question I wanted to ask was a hangover from the previous one on a different topic entirely.

Chair: No, I think we will stick with welfare just for the time being.

Q48 Bill Esterson: Do you think that the welfare changes in the Budget are going to help people into work without other measures?

Paul Johnson: As ever with welfare changes, you are trading things off. The particular changes to the tax credit system will have different effects. If you are currently a family with just a single earner, then it reduces to some extent work incentives because the work allowance has been reduced in the universal credit system, so the point at which you start to have your benefit withdrawn comes in earlier. But if you already have another earner in the family, because you lose the benefit more quickly that increases your incentive to move into work. As ever, there are trade-offs. Different people are affected somewhat differently, but for lone parents and those without a working partner, this will have some reduction on the incentive to move into work. It makes relatively little difference to the incentive to work a little bit more or less.

Q49 Bill Esterson: Sure. What did you make of what Michael Saunders told us in the last session in relation to young people and the longer term impact?

Paul Johnson: I did not catch what he said, I am sorry.

Bill Esterson: He was saying that he has concerns about the combination of tax credit cuts and the rest of the welfare changes on their ability to gain employment both in the short and long term.

Carl Emmerson: I think the concern he had was about if there was another downturn, looking at what happened over the last downturn. When you go into an economic downturn, you might think that the right policy response might be to, if anything, boost tax credits or not cut them in order to keep labour supply high and, if anything, do not increase the minimum wage, if anything reduce it, in order to keep labour demand up. He was saying that the combination that the Government is now going for, which is a higher minimum wage combined with lower tax credits, might be okay in normal times but he was worried about what that might do in a downturn and how Government might need to think about policy if we were to have another recession.

Q50 Bill Esterson: Yes. Is that something we should worry about? That is the question.

Paul Johnson: Yes, in the sense that if the benefit system has less of a clear incentive to move into work in it, then that is an issue. If the minimum wage system is less responsive to the economic circumstances, then that may also be something of an issue. What I am less clear about is how the—well, to some extent it also depends presumably on how median wages change if we are fixing the minimum wage at 60% of the median. We will be to some extent at the mercy of how the distribution of earnings changes over time. Whether this is a big change in terms of the way the labour market works I am not so sure.

Q51 Bill Esterson: Okay. Asking about the impact on disabled people and people with long-term illnesses, what is your view on the changes to employment and support allowance on those people?

Paul Johnson: It will clearly make them worse off to the extent of the cut in the benefit. In a sense, there will be more reason for those people to try to get on to the enhanced level, potentially more of them appealing to get on to the higher level, but I think the main effect will be that it will simply make them worse off by the £20-odd a week that their benefit is being cut by.

Q52 Bill Esterson: Yes, £30. So is it more likely they will end up in work or not, do you think?

Carl Emmerson: I think the lower educated people who perhaps command less of a wage in a labour market, that is the group where claimant rates on disability benefits have not really been falling in recent years. Among higher educated and middle educated people, claimant rates have been falling. It is the lower educated group that has been going up. Maybe among that group you will start to see some people who are a bit ill but deciding at the margin they would rather stay in work than move on to the benefit that is £30-odd a week less generous.

Q53 Bill Esterson: The £12 billion over the whole of the economy has a relatively limited impact. What about the impact on local economies where you have relatively high numbers of people in a particular community who would be adversely affected? What is your assessment of the effect on businesses and on jobs in those areas?

Paul Johnson: I do not think I would like to offer any comment on that. There will be some areas where there are more people affected than others and that might have some effect, but I certainly have no view as to how significant that effect might be.

Q54 Mark Garnier: Carl Emmerson, I just want to go back to these 13 million people that you say will be worse off and be absolutely clear about what you said on this. That 13 million people who are worse off, you are just looking at the reduction in welfare, aren't you? You are not looking at anything else?

Carl Emmerson: Just looking at the benefit freeze for four years, yes.

Q55 Mark Garnier: The benefit freeze, exactly right. It is quite a misleading number for the IFS to have put out because, of course, those 13 million people, as we have heard a bit earlier, would have got the benefit from the rising tax-free personal allowance.

Carl Emmerson: Well, the number is in a presentation where we go through each of the measures in the Budget—

Q56 Mark Garnier: Yes, sure. It is just a very interesting point. By the time you add all these things together, the picture is very different from perhaps what was suggested. Maybe some of those people will be living in social housing and so you would get a reduction in the rents. Are you comfortable with how you were reported given the fact that it is quite a small sliver of a much bigger picture?

Carl Emmerson: The presentation, which goes through all of these measures and describes how many people are affected, what the average loss or gain is, ends with a distributional picture that takes into account all of the points in the model—

Mark Garnier: Sure, I appreciate that.

Carl Emmerson: —and shows how the effect varies across the income distribution. Most of the broadsheet newspapers I looked at reproduced that graph, which is our most comprehensive analysis that we could do.

Q57 Mark Garnier: Yes, I understand that. It is just this 13 million thing is the one that has been picked up on. The other point about this, of course, is that there is an economic effect of what is happening. The idea is that with the increase in the minimum living wage that will create more money in circulation in the economy. As we have heard, it will drive more people into work. Have you taken into account the effect of that, the economic effect of this, or are you simply looking at it from an, if you like, bookkeeping point of view, a mathematical point of view, rather than a qualitative point of view?

Carl Emmerson: We have not taken account of that, although I would point out that the OBR thinks that GDP will be 0.1% smaller as a result of the higher minimum wage.

Mark Garnier: Yes, we have them coming in. We are giving you the chance to have a canter round before.

Carl Emmerson: We do not have that loss that will be experienced across the households in our model.

Q58 Steve Baker: Can I return to this point about the distributional analysis? I was just going back and looking at what you have done compared with what the Chancellor has done. The Government has changed the basis of their distributional analysis, as you will know. They have said that if you look at spending on each decile, then borrowing adds to the

amount received for each decile and is, therefore, an unreasonable thing to do. Do you accept the basis on which the Government has changed its distributional analysis?

Paul Johnson: We can do these analyses in different ways. The way that we have tried to do it is just by looking at those cash changes that immediately impact on the incomes of households and that in a sense is the most straightforward and most intuitive way of looking at it. That is how much they will be—

Q59 Chair: Do you think that the way the Government is now doing it is the right way to do it or not?

Paul Johnson: Well, it is a different way. It tells you something different and it tells you something about the impact of other bits of public spending on—well, not even the impact, the size—

Q60 Chair: But is it of equal value or of less value or of greater value?

Paul Johnson: It is a different way of looking at it. I think it will be useful to show what we did as well. I think what the Government has done—

Q61 Steve Baker: Do you regret that the Government has ceased to publish the previous distributional analysis on a different basis so that we can see a time series on the same basis?

Paul Johnson: I think it is generally a shame when Government stops doing things that are interesting and stops you seeing things across time, yes.

Q62 Steve Baker: Of course, the way we communicate in different ways does communicate something quite different. When I look at your analysis of the impact of tax and benefit changes, it does show a quite different picture and it is, frankly, quite a worrying picture. I just want to return to this point that Mr Philp made. If somebody is on the national living wage, according to the OBR the average gain for a gaining household in the bottom decile looks like about £580, about £550 for the second decile, getting on for £600 for the third decile, and so forth. Does this impact of tax and benefit reforms take into account that analysis of what the national living wage does to people on the lower deciles?

Paul Johnson: No, that analysis does not have the living wage in it. We were not able overnight to model that.

Q63 Steve Baker: One of the things that concerns me is that if people, particularly people in the lowest, the poorest deciles, see this analysis without taking into account the national living wage's impact, then they surely will not have a fair understanding of what the Chancellor is trying to achieve. Isn't that right?

Paul Johnson: I think I would say two things to that. First, as Carl says, the expectation is that the living wage will reduce national income and, therefore, the average loss in that

chart will be bigger, not smaller, if we were taking account of that in terms of its impact on national income. Secondly, the—

Q64 Chair: That is national income as a whole—

Paul Johnson: National income as a whole.

Chair: —but we are talking here about the bottom decile.

Paul Johnson: Yes, with—

Q65 Steve Baker: I am sorry to interrupt, but the point here is that I think all of us, who are all people of noble intent, are concerned that the people with the broadest shoulders should bear the worst burden. I appreciate there are lots of different ways of looking at these analyses. What I am asking you is: should you have taken into account the impact of the national living wage when showing the impact of the tax and benefit reforms on each decile?

Paul Johnson: What our decile chart does is show, as we always have done going back for a very long time, the changes in the tax and benefit system. So to be consistent over time, that is what it has done. Secondly, we were simply not able to model the additional thing overnight in the way that we do that. Thirdly, we did go through in some detail what we would expect the broad effect of that to be. It is clearly having a positive effect on incomes right across the distribution with an average effect on those bottom deciles much less than the loss that they have received from the changes to the benefit system. Yes, there are different ways of looking at this. It would not change the overall picture. It would change the scale of some of those losses down the bottom. It would not change the overall picture in terms of the—

Q66 Steve Baker: I just want to press you on this point because the poorest decile in your impact of tax and benefit reforms between 2015 and April 2019, you show the poorest decile losing £800 a year. Well, the OBR analysis of the average annual gain through the national living wage is almost £600 a year.

Paul Johnson: Among those who gain, if I understand that to be right.

Steve Baker: Among those who gain, that is correct.

Paul Johnson: That will be a relatively small proportion, a very small proportion on a guess, of the bottom decile, so the effect it would have on our chart would be pretty small.

Q67 Steve Baker: Well, would you undertake to do the chart again taking into account the impact to the national living wage? I think what we are all concerned to do is to make sure that the Government's policy is properly understood, aren't we?

Paul Johnson: We are indeed.

Q68 Steve Baker: Yes. The Chancellor has been very clear that we are trying to move from one kind of society to another. I say it with all good intent: would you please undertake to have a look and see if you can get the impact of the national living wage into that chart?

Carl Emmerson: We are going to try to, but I think it is important to remember that the national minimum wage going up is not just a giveaway to households. You cannot just say on average all households are better off from a higher national minimum wage, whereas when you are doing a tax or benefit change we can say, "What is the impact on the public finances and what is the impact on household incomes?" Just as the welfare cuts—

Q69 Chair: So you have to make assumptions?

Carl Emmerson: You have to.

Chair: You have to; that is where you earn your crust.

Carl Emmerson: With the welfare cuts we could say it makes certain households worse off, it strengthens public finances, it reduces the burden on public services.

Paul Johnson: The answer to your question is yes, we will have a shot at this and I am not sure exactly when we will be able to do it by, but my expectation is the pattern you will see will be very similar to what you are seeing there, but just a little less dramatic.

Steve Baker: Okay. We will look forward to seeing it. Thank you very much.

Q70 Chair: When you say you are not sure when you are going to do it by, I think I am going to press you on that. Last time we asked you to do something in a week or so and we were told it was really impossible. How long is it going to take you to do this, Mr Emmerson?

Carl Emmerson: We have arranged to meet at the IFS next Wednesday to discuss exactly what is possible to do in terms of what is practical, in terms of spare resources, and what is technologically feasible, and then we will decide. We have some funding in place for some work that we have to do for this autumn and we want to make sure obviously how it fits in with that. I am afraid it might not be on the sort of timescale that this Committee will be reporting on the Budget.

Chair: I am going to press you again. You exist partly to support committees like this and to assist Parliament. We really do want an answer to this. This is an important question and we want it as soon as possible. Can you have a conversation prior to next Wednesday to find out what timeframe you could do this in and let the Committee know on Monday? I will put into the public domain your reply. Can you do that?

Paul Johnson: Yes.

Q71 Chair: Thank you very much. There is another piece of information I would also like, which is the Government have changed the basis for their analysis and you were

asked a moment ago do you think it would be helpful if we had the Government's previous approach to looking at distributional analysis applied to this Budget, which we no longer have, of course, because the basis has changed. Do you think that is something the Government can or should provide?

Paul Johnson: It certainly can and I think it would be useful to the public debate for it to do so.

Chair: That is very helpful. I think we might ask the Government for that as well. Of course, we have the chance; they are coming to see us next Tuesday.

Q72 Helen Goodman: Back to the incentives point, you provided us with some charts on the effective marginal tax rate before and after the Budget for a lone parent with two young children, and that is very interesting. What I would really like would be if you could roll forward the chart that you did in your pre-Budget briefing, which showed the marginal rate changing over the whole income distribution from nought to I do not know what it goes up to, £100,000 or something. I am sure you know the chart I mean.

Carl Emmerson: That is just the income tax and employee National Insurance schedule. It was changed a little bit by the Budget because they increased the personal allowance and the higher rate threshold, so we can certainly reproduce that. The big picture still remains that the system is overly complicated and is in need of improvement. That does not include tax credits.

Q73 Helen Goodman: Okay. I am sorry, I have not quite grasped that. Do you have one that incorporates as well the tax credits change? Because the thing that really struck me in the OBR was that the Chancellor was increasing the taper rate to 48% but the top rate of tax is 45%. I guess what I am asking for is a slightly extended version of this where we look at the tax credit marginal rates as well.

Paul Johnson: That is where you have to select a particular type of person because, for example, lone parents are different and that is where I think what we have provided is probably the best that you can do, which is the one that we have done for the lone parent. Because if you were to stick that into the chart that goes up to £150,000, you would see a little bit right at the beginning and then everything else will be the same. What you are seeing there effectively is the impact on that particular individual.

The change to the tax credit taper, you are right, does increase the effective marginal rate right at the bottom at the moment for those on tax credits. What we have illustrated in our lone parent example is what this looks like under the universal credit system because, of course, this tax credit change only will apply for the next couple of years until the universal credit is in. Within universal credit the withdrawal rate has not changed. It is the work allowance that has changed, which brings down the point at which you start to take away the income, which is why it has—

Q74 Helen Goodman: Yes, I understand that. I have grasped that, but are you saying then that, for example, on the original combined tax and employers' NICs hardly anybody

was paying more than 60% unless they were at about £80,000, but here we have these lone parents and they are paying over 70%?

Paul Johnson: Yes, so if you were to include the tax credits in that chart that you are pointing to, then for that lone parent type person you would have numbers of 70% or 80% right at the beginning, which would then go down and follow the rest of that.

Q75 Helen Goodman: I guess what I am saying is could we possibly have a couple, two children, the usual array of stereotypical families—

Chair: Perfectly reasonable approach, isn't it?

Paul Johnson: You can produce all sorts of examples of this kind.

Q76 Helen Goodman: I was just thinking that because you have done it before it would just literally be a question of cranking the machine, not doing a whole new piece of analysis, whereas I know that the problem with what Mr Baker has done is that you do not know the overlap between the minimum wage people and the tax credit people and that is a complexity there. We do not really have that complexity when we are looking at the tax credits and the income tax in anything like the same way, do we?

Carl Emmerson: We do. The graph here is not just a lone parent with two children. It is a lone parent who is in the rented sector at the median local housing allowance rate. She has no assets and no other income, so we have had to make a lot of other assumptions because it includes housing benefit as well as tax credits.

Q77 Chair: Still, we like you earning your crust by making these assumptions, so I think Helen is on to a reasonable point. We would like to have a look at that as well.

Carl Emmerson: Possibly paying our crust here.

Chair: We should really be demanding pay by results. We would certainly like Helen's graph or table, however you want to present it, and also Steve Baker's.

Helen Goodman: Just a couple, a lone parent and a family.

Paul Johnson: I should say, as Carl said, you can produce immense numbers of examples here, so if we do this we will have to choose something specific.

Chair: We would like some suggestions on Monday on how you intend to go about this with the end date that we are going to get them, and we are not going to take no for an answer. We would like it certainly before the House resumes in September, please. Now, Wes Streeting has to go, so I will bring him in next.

Q78 Wes Streeting: I wanted to ask around higher education and student finance, two dimensions. The first is around equity and the way in which the Chancellor is proposing to move student grants over to loans. Could you say something about the impact this will have in terms of the debts of the poorer students but also, given what the Government is

considering around the freezing of the repayment threshold, what impact do you think that will have on graduates and which graduates in particular will be most disadvantaged?

Paul Johnson: I can say we will be publishing something on this within the next week because this is a piece of work that is under way. Broadly speaking, yes, the debt of students from poorer families will rise substantially because the grant is being turned into a loan and the result will be that an even higher proportion of them will not ever pay off the full loan from the current 75%. That number will become higher. One result of that, of course, is that because the majority are not in any case paying off the full loan at the moment, the impact after graduation ex post will be zero because they were not paying off the full amount anyway. The fact you are loading more debt on to them does not change the amount they end up paying.

The change to the threshold is quite significant in terms of the amount of repayment that students will end up making and so that will over the lifetime of graduates, particularly middling income graduates, make a significant difference to the amount that they end up paying. It will not have much impact on the very lowest income graduates. They still will not get above that threshold. It will not make much difference to those at the top end because they pay it all back anyway, but for those at the lower middle of the earnings distribution, they will end up paying back more. Of course, the flip side of that is that it does mean that the Government gets back more of the loans that it makes and arguably puts the system on to a more sustainable basis.

Q79 Wes Streeting: That brings me on to the second issue, which is around the RAB and how it is being treated, not just the long-term consequences for the Treasury but also the way it is driving short-term policy decisions. I think the previous Minister, David Willetts, was always keen to say, “Don’t worry about the RAB, it’s not an issue” but it does sound a bit too good to be true that the Chancellor can put a significant amount of extra investment into higher education but there is no long-term cost to the Treasury or at least an insignificant cost. Do you have a view about that?

Paul Johnson: Yes. I do not think it is the RAB that is driving anything here, but the way in which this accounts for public finance is driving things. You move from the grant system to a loan system for maintenance that has a significant short-run impact on the public finances despite the fact that the large majority of that probably will not be paid back given, as I say, it is layering debt on top of debt, some of which was already not being paid, and if it is the case the poorer students now end up earning less than the average among other students, they are less likely than the average to pay that back. I think the short-run accounting impact on the apparent public finances flatters. The long-run effect on the public finances should be much smaller than the short-run effect.

Q80 Wes Streeting: Yes, I think my concern—and feel free to disagree—is two things. One is that we are selling off the student loan book not because it is necessarily the best policy decision but because it has an impact on public sector net debt figures and that is the driver for that policy. Secondly, particularly because of the changes that were made I think around 2014, which was a switch in the rules and the way in which this was given an additional facility from the Treasury through the AME spend and they have agreed that they will cover the costs of 1/30th of extra spending every year, that this is having a greater

impact, therefore, on the BIS budget in the short term and that is what is driving the changes to the repayment thresholds. Do you think that is a fair characterisation of the policy drivers?

Paul Johnson: What is driving the changes to the repayment thresholds I think, at least in part, is the repayment threshold was set whenever it was, back in 2011, when there was an expectation that earnings would grow faster than they have. You could argue that it is resetting things relative to where we think earnings will actually be. You are absolutely right about the selling off of the student loan book in the sense that it appears in the national accounts to have improved things, but in truth in the long run nothing has changed. It is simply a feature of the way that we do the national accounting that it appears to have improved the public finances in the short run. In the long run it has not.

Q81 Jacob Rees-Mogg: I cannot remember whether you had come when I asked a similar question before on the questions of ring fencing and hypothecation. As you know, the areas of ring fencing were extended to include defence, counterterrorism and all the things that were previously there, and the limitations on tax rises is the other side of that. I wonder whether you think that is now out of control.

Paul Johnson: The ring fencing of spending is really a political statement of priorities. The consequence, of course, arithmetically is that if you are ring fencing and, indeed, increasing spending in some areas and you have an overall budget limit, then the consequence for other bits of spending is very significant. Our calculations suggest that the un-ring-fenced bit of public spending will be cut by about a third between 2010 and 2019, but as one of your previous witnesses pointed out, it is hard to believe that spending on health, for example, would have been a lot different under a world in which you did not have that ring fence. But you put the two together and then in a sense you squeeze the rest of departmental spending out at the other end and the consequences are that the shape of public spending, the shape of the state, will be very different in 2020 to what it was in 2010 and certainly from what it was in 2000 with much, much more going on, particularly health and pensions, and much less on most other parts of public spending. I think that is an important political debate, in a sense, about whether that is the right shape and that is a shape that will become more like that going forward under current policy as the population ages. I think there are some very big political as much as economic decisions to be taken through that.

In terms of the tax issues, we have not had an increase in any of the main rates of income tax other than the increase of 50p since 1975, so tying your hands not to do that I suspect makes very little difference to the reality.

Jacob Rees-Mogg: We have on NICs and VAT.

Paul Johnson: We have on VAT and NICs so that is more of a constraint. It feels to me there is a less obvious economic rationale for tying your hands on that than there is on the spending side. The spending side is a clear statement about what Government priorities are. Tying your hands on what you might do to the tax system three years hence, it is less easy to see a reason for that other than a purely political one.

Jacob Rees-Mogg: It does not necessarily mean very much, does it, because it can be reversed when Parliament cannot find—

Paul Johnson: Parliament can reverse anything.

Q82 Jacob Rees-Mogg: A wonderful line from the IFS in 1994 calls hypothecation an absurdity and says that spending will be cut during recessions and increased during booms. Do the IFS stand by that view?

Carl Emmerson: Yes. There are two kinds of hypothecation. One is where the tax is paying for part of spending on something, in which case you can never really know whether that tax is paying for that or something else. If you get tax revenue of £100 from some tax and you are spending £300 on some spending item, it is just smoke and mirrors. Or you can have binding hypothecation where the tax is £100 and the spending is £100, and then you are saying that the optimal tax rate on this thing you are taxing in all periods of time, in all states of the world, will equal the optimal amount of spending on this other thing. Do we really think the optimal amount of taxation on motorists, for example, through VED is exactly equal in every single future year to the optimal amount of spending on roads? I strongly suspect not and, in fact, VED revenues seem to be quite a lot lower than what we spend on roads anyway.

Q83 Jacob Rees-Mogg: Though historically they were higher, weren't they, which was why the hypothecation was given up in the first place?

Carl Emmerson: I do not know the answer to that. The one example where we do have hypothecation that is binding and perhaps is a little bit different would be the BBC with the TV licence where the spending and income are equal. Maybe there are different political arguments for why you do it there as opposed to elsewhere in the tax system and your public spending system.

Q84 George Kerevan: I am interested in looking at your preliminary assessment of the impact of the shift away from the bank levy to a charge on bank profits. Presumably, given that the tax base is going to shift, it will have some impact on who pays and who pays what. I am particularly interested if new banks are brought into the tax, particularly the mutual building societies who are using their profits for capital rebuilding. Have you had a look at that in a preliminary way? What might the impact be?

Paul Johnson: We have not looked at that particularly. I think there are two or three things to say. One is that, as I understand it, the increase in the corporation tax rate happens quite a lot before the full reduction in the bank levy, which is I think promised not to reach its minimum until after the next election, so there is an issue of timing there. Secondly, the bank levy was in a sense well targeted at risk capital. The issue with it was that it was continually raised as behaviour was changed and because it had a particular base, which was worldwide; it hit a small number of banks very hard. The increase in the corporation tax for all banks will spread that significantly more. My understanding is that the share price of banks following the announcement, some went up and some went down, and that is probably telling you quite a lot about who is winning and who is losing from this change. My expectation would be that this would reduce the capacity of some of those banks who have additional tax to do some lending at some point into the future, but quantifying any of that is certainly not within our expertise.

Q85 Chair: Thank you very much for coming to give evidence to us this afternoon. As you can hear, we are very keen to have some more evidence. We are looking forward very much to receiving it and we recognise that we are not making easy requests, but I am sure you understand, given you are a part Government funded body and we are Parliament trying to scrutinise Government, we feel we are making reasonable requests of you, at least to attempt this work.

Paul Johnson: In terms of Government funding, we are arm's length funded through the Research Council for a small portion of our funding to do a particular piece of research. We are otherwise funded by charitable foundations and others, all of which is to do particular research, just to be clear about that.

Q86 Chair: Isn't just about 80% of your funding via Government sources?

Paul Johnson: No.

Chair: I have the figures in front of me from your 2013 website.

Paul Johnson: Well, it may have changed a little. The ESRC is our most important funder but we do not get 80%.

Chair: Isn't that a Government source?

Paul Johnson: It is a Government source but I think they would find it difficult if you were to refer to that as Government funding and, therefore, that we were beholden to Government for certain things.

Chair: I was not making that point. There are lots of things that are funded by the Government but they are independent, like the courts, for example. Anyway, thank you very much for giving evidence and we are looking forward to the evidence we are going to get as a supplement. We will adjourn now and resume at 5 pm.

Sitting suspended.

On resuming—

Examination of Witnesses

Witnesses: **Robert Chote**, Chairman, Office for Budget Responsibility, **Graham Parker CBE**, Member, Budget Responsibility Committee, Office for Budget Responsibility, and **Sir Stephen Nickell**, Member, Budget Responsibility Committee, Office for Budget Responsibility, gave evidence.

Q87 Chair: Thank you very much for coming to give evidence to us this afternoon, the first in front of the new Committee, and we are grateful for it. First of all, Mr Chote, are you surprised that no announcement has been made about your successor?

Robert Chote: I have had no discussions with the Chancellor or anything about this. I think obviously time is running slightly shorter so I hope one would hear something relatively soon.

Chair: Just for the record, tell the public what the timeframe is.

Robert Chote: Well, my term ends in October.

Chair: Beginning of October, isn't it?

Robert Chote: Yes.

Chair: So there is not very much time and if we are to have someone other than a renewal of Robert Chote, we need to find out fairly soon.

Robert Chote: Yes.

Chair: You have nothing to tell us?

Robert Chote: No. No news.

Q88 Chair: Sir Stephen, congratulations on your knighthood.

Sir Stephen Nickell: Thank you very much, Chairman.

Chair: Now you carry the particular responsibility of answering this question, which is: is this uncertainty about the leadership doing any harm?

Sir Stephen Nickell: Our leadership?

Chair: Yes.

Sir Stephen Nickell: Well, speaking personally, I think the answer is no because I have a touching faith that everything will come right in the end.

Chair: That was not the sort of informed and thoughtful reply that we were hoping for.

Robert Chote: You will note he did not say which outcome that applies to.

Q89 Chair: Yes, I did note that as well. Have you had any political interference in your work? You have to be independent.

Robert Chote: No, none whatsoever.

Q90 Chair: You received a lot of information quite late on this occasion for the drawing up of the forecast from the Treasury that you need in order to do that work. How big were the difficulties created by it?

Robert Chote: Yes, I think there was a disappointment in terms of the process here. It was finding out about some things that had implications or would have had implications for the forecast later than would have been ideal and later than the deadlines that had been originally agreed. I am conscious, of course, this was the largest fiscal event in terms of the amount of policy measures that we were having to look at since 2010. They were measures that obviously the Treasury had to deal with, DWP and HMRC, so it was by no means an easy task to get that amount of stuff over the line. However, we did have, for example, three measures that would have affected the inflation forecast, albeit modestly, that were notified to us after the inflation forecast had closed. We did not find out about the announcement that public sector pay bills were to be restrained to 1% a year increases for four years until the day of the Budget and we did not find out or we were not told at all and, therefore, read about it for the first time in the *Red Book* the decision to delay the annuities measure until 2017.

Q91 Chair: Okay. Well, I think the polite thing we can say about all that is that that is sub-optimal, to put it mildly, as a way of doing business. I think rather than pursue this detailed stuff right at the beginning of this hearing, perhaps it would be helpful if the OBR could set it out in a little more detail to this Committee and also give a balanced judgment on the extent to which this has hampered your work or could have hampered your work. It is much more important than if in the event it did not alter the forecast much. That does not tell us very much. What we want to know is whether it could have done and I think we need the Treasury to try to do better.

I have one more set of questions. If we take stock now, the OBR has been around for a whole Parliament pretty much. It is set up with two purposes in mind: one to secure independence of the forecast from political or the appearance of political meddling. My first substantive question to you is to suggest that we are certainly succeeding in keeping it independent.

Robert Chote: Yes, I think that is true in reality. Certainly, we have not felt under political pressure to change our views in any way that we would be concerned about. I think the evidence you have had from, for example, the Kevin Page review and the discussions they have had with our consumers is that people seem to be reassured that whether they agree or not with the substance of the forecast they do not see the tell-tale signs of politically motivated wishful thinking in them.

Chair: The appearance of independence, that message is also getting across?

Robert Chote: I think so, yes, as far as one can tell.

Q92 Chair: Right. There is a second task, isn't there, which is while simultaneously trying to produce the highest possible quality piece of work to try to downgrade the importance of forecasting in the public perception since it is the one thing we are all agreed

on in this room is whatever you produce it is bound to be wrong since it is about the future. We have not had as much success there, have we, in getting that message across?

Robert Chote: I think that is always a challenge to do that. People are obviously keen to get a very clear answer from you on what your expectations are. There is for us a particular dilemma or a trade-off here because we produce an awful lot of quantitative detail of the forecast, which I think, given the nature of the bottom-up fiscal forecast that we produce, is essential for transparency and credibility and legitimacy. However, the danger is if you produce an awful lot of quantitative detail it can give a spurious sense of precision. I think I would rather err on the side of providing all of that information, but there are things that we can—

Q93 Chair: Right. How can we get this message across? Yes, there are some things you can do. How are we going to do it?

Robert Chote: Yes, I think, for example, it has been easier to talk about uncertainty and to illustrate it for the economic forecast than sometimes for the fiscal forecast because the fiscal forecast is made up of so many individual components. You can tell a high-level story about what difference does it make to the forecast if growth is higher or lower or interest rates are higher or lower, but in terms of coming up with ways of shining light on the uncertainty around the revenue and spending forecast, that is harder. One thing I think we would like to do is see whether we can extend the fan chart approach to the revenue forecast. I think it will be harder to do that for the spending forecast.

Q94 Chair: That is not going to score much with wider public opinion, is it, Robert?

Robert Chote: No, and I think that is going to be quite hard to change. One of the things moving into a second Parliament that we can hopefully devote more time to is having built up huge chunky products like this is to think of some ways of presenting some of the core material in a way that is more accessible to, as it were, the casual reader who is not terribly interested in how things have moved from one forecast to the next. We have started doing that with our brief guides and hopefully that is another opportunity, but it is an uphill task, I am the first to admit.

Chair: Perhaps before you go or before you are renewed, and we do not know which it will be at this stage you could draw up a battle plan for this task and let us have a look at it, some ideas on how we can get that message across to a wider group. It would certainly inform opinion.

Robert Chote: Yes.

Q95 John Mann: I am just wondering who these casual readers were, whether we are classified as casual readers.

Robert Chote: You are our most well-informed stakeholders.

John Mann: The better the presentation the easier for us, and in a second I will give you an opportunity to clarify a few facts to assist with that. Just before I come on to my main

question that I want to ask, I just wanted to clarify: is there still a structural deficit and how big is it?

Robert Chote: Yes, there is a structural deficit remaining. Indeed, most of the remaining deficit is structural at this stage. The output gap is pretty small so in terms of thinking about the overall reduction in the deficit from about 10% of national income to the 5% or so, getting halfway or a little bit beyond that, most of the remainder is indeed structural. That is reflected in the fact that it is the fiscal consolidation measures that are relied upon to continue to reduce that looking forward.

Chair: Okay. We are going to come back to the output gap.

Q96 John Mann: No, I was not going to go into that. It is just if you could quantify how big just for the record.

Robert Chote: Well, cyclically adjusted net borrowing for 2014-2015 is 4.1 out of a total of 4.9, so as you can see at least four-fifths.

Chair: We will come back.

John Mann: We will come back to that.

Chair: Sorry, just to be clear, have you further questions on the output gap related to using the—

Q97 John Mann: No, I have not. I will defer to others on that. I just wanted to clarify the overall picture early on. You have in your detailed summary table, the big table of 3.6, employment figures of growth from 31.2 million to 32.1 from now until 2020, so just under the million, but the claimant count remaining pretty much static all the way through, 0.78 to 0.79 million. How many of the new workforce will be migrant labour?

Robert Chote: In terms that we do not forecast employment by country of origin, but if you look at the total change in population over this period, implicit in the forecast is total net inward migration of just over 1 million: 1.02 million. That raises the 16 plus population by 0.93 million, and that is roughly half of a total increase in the 16 plus population of 1.86 million. Net migration is accounting for about 50% of the increase in the 16 plus population over this period. That is not necessarily the answer to the question of how much the additional employment is going to be because we do not forecast it on that basis but that, I think, gives you a useful backdrop.

Q98 John Mann: It does indeed and, in terms of the fiscal outcomes, they would of course be very significantly different without that net migration, and hugely so.

Robert Chote: Yes, one always has to distinguish between, certainly, economic performance and otherwise what happens, for example, to per capita GDP and overall GDP. Generally speaking, the conclusions that we have reached in our fiscal sustainability report that are consistent with other reports from the Congressional Budget Office in the United States, for example, is that, certainly over the 50 year horizon, higher net inward

migration improves the fiscal position simply because net inward migrants are more likely to be of working age than the native population more widely. But that is a broad brush conclusion that drives most of the conclusions we reach in the Fiscal sustainability report.

Q99 John Mann: A lot of people would say, in essence, with the age profile of the population, that if, to maintain the tax revenues we have, we are going to need a constant inward migration. I do not want to go down that line. That, in a sense, is implicit in the projections, by definition. I am interested in the quality of the workforce coming in, because there seems to be a dearth of statistics on those leaving the country. I raised with the Bank of England yesterday the suggestion that a significant number of the Teach First teachers who are, by definition, meant to be particularly good, have emigrated. I now have information in relation to a very worrying and significant proportion of newly qualified doctors in the country who are each year, apparently, emigrating.

We have, potentially, quite a significant number of the highly skilled younger workforce leaving the country, but I cannot get any easy statistics to see what the real trends are. Yet, at the same time, because governments are keen, politically, to demonstrate their robustness on immigration, we are seeing lots of restrictions on non-EU migration in and some people kicking up a lot because of that, some employers and the universities. What statistics do you have to look at to see whether the inward migration and the net migration overall is affecting things such as productivity? Because if there is that trend, that we are getting lots more unskilled people and losing highly skilled people, that obviously has consequences in terms of your projections.

Robert Chote: I will ask Steve if he knows anything about the particular data that are available. The last time we looked at whether we should make an adjustment for, as it were, should we assume that the average net inward migrant was a different sort of worker from the average native individual, was in the Fiscal sustainability report a couple of years ago. As I recall, we reviewed a variety of academic evidence that suggested that there was not a clear answer one way or the other, but making the point, obviously, that there is quite a lot of diversity within the migrant population with different people with different skills, and different groups with different skills. Therefore, we concluded from that that we should continue to assume, essentially, that inward migrants had essentially the same sort of age specific characteristics in terms of productivity and employment. Steve, is there anything you can add to what data is available if do want to probe?

Sir Stephen Nickell: There is a way one would investigate this. What we do have information on is the stock; that is to say the Labour Force Survey tells us about the stock of migrants. In fact, it tells you not only about the stock of all migrants—that is, all foreign-born—it has information on the stock of recent migrants, that is people who have come within the last two years. The Labour Force Survey tells you about their qualifications and other interesting pieces; their age and so on. From that, if you look at this through time, you can get a picture of the quality of the stock of migrants and of the stock of recent migrants and how it has been changing. So, it is possible to do roughly what you want.

Of course, it would be better if we knew about the stock of people who left, but we do not know much about those. But to operate on the stock of people who are here at any one time would enable you to get what you want. By and large, my rule of thumb is that, in

terms of overall qualifications and occupations and so on, the stock of migrants, the stock of foreign-born people, is not that different from the stock of native-born people. If you look at the proportion of immigrants who work in different occupations, you will see that, aside from health professionals, the proportion of migrants in each occupational group is pretty similar. Of course, you get fluctuations, but they are of similar orders of magnitude. Health professionals have much higher levels of foreign-born.

Q100 John Mann: There is an issue, is there not, that affects your forecasting if—it is a big “if”—you do not have sufficient information on, particularly the young, highly skilled workforce. Because if it is the case—there are other policy implications, of course—in an increasingly more mobile “global economy” that we are losing more and more people working over the world who are young and very highly skilled, then if we do not replace them with people of comparable skill levels, we are going to hit a problem fairly quickly but down the line.

The reason for flagging this up is because I cannot find all the statistics anywhere, but also I am getting more and more employers, including, for the first time, public sector employers outside health, saying, “We cannot find the skills we need for the first time”, and they are “niche” skills, but there are lots of them. Therefore, my base question to you, in terms of your remit is, is there a dearth of data in that movement of the labour market that could affect the real economy, particularly over a five year period that we need to have much more knowledge of?

Robert Chote: Steve may correct me if I am wrong. I am not sure. In terms of projecting productivity growth over a five year horizon, I would be surprised if the effect was large enough to materially affect that, given the other uncertainties there are about what productivity growth is going to do over a five year horizon anyway. I suspect from our point of view, the cost-benefit of investing in seeing whether all of that information is available probably would not be material for our forecast but it may well be that it is—it is obviously an important issue and that for others it may be worth investing that time and effort into digging those out. I would not have thought of it being—as I say, given the other uncertainties around productivity growth, this is a relatively small one.

Sir Stephen Nickell: I think that is probably true, yes. It is also true, of course, that, in terms of the young, highly skilled people, we do have a significant advantage, that is to say in terms of postgraduate students. We have many more postgraduate students from abroad studying in Britain for postgraduate degrees than British people studying abroad. In some sense, we have some inbuilt advantage in that regard. Anyway, as Robert said, I think, over the short term—that is, five years—I doubt that these effects are going to show up to any great extent.

Q101 John Mann: One final question, because the net immigration is higher than the Government had said it was going to be, and significantly so. Therefore, there are more people here. Therefore, that affects, in different ways, your projections and the statistics, and all the assumptions that the Treasury is making. Does it concern you that the projections of what the Government anticipate and the actual outcomes have varied a lot recently, in terms of the real economy?

Robert Chote: It was one of the reasons in the March forecast, as you will recall, that we changed the underlying population projections that we use to underpin the forecast. Previously, over the course of the previous Parliament, we had used the Office for National Statistics' low migration variant, partly on the grounds that the Government had a stated objective to get it lower, and partly because we assumed that the global environment would be conducive to that. As it has turned out, as you rightly say, obviously net inward migration has been much higher than those numbers have applied, so that is why we moved from that to what the ONS calls the principal population projection. It has to be said, the ONS projections are not a judgment on current policy; they are based very much on what the recent trends have been. But, for that reason, we did push up the net inward migration assumption and therefore the population assumption in the March forecast, and we have stuck with that for the purposes of this one.

Q102 George Kerevan: Can I take us to that fabled world of output gap? I am interested in it because you are projecting that by 2018 it will be zero, which would have clear implications for wages and other things. How robust are your projections?

Robert Chote: There are few things less robust than an estimate of the output gap, as it is one of those numbers that, even after the event, you do not know whether it was correct or not; it is not an observable variable. In terms of the fact that it goes back to zero, that is essentially a consequence of our assumption that the Bank of England tries in good faith to get inflation to target and to keep it stable, which implies that you basically get demand in the economy in line with its supply capacity and try to keep it there. So, in a sense, it falls out of our assumption that the Bank of England is doing what it claims to be trying to do.

Q103 George Kerevan: It is not really a projection; just, if they get it all right, that is what the numbers would be?

Robert Chote: As I say, we have to condition our forecasts on an assumption of what monetary policy will do, and to make an alternative assumption that the Bank of England is not going to, and to know on which side of its symmetric targets we think it is going to err in the longer term, would clearly be a somewhat heroic judgment. As I say, the difficulty with output gap estimates, in addition to forecasting them, is that you change your mind an awful lot about where you thought the output gap was two, three, four years ago, and so what you may have thought was a structural budget surplus or deficit turns out to be something completely different.

Q104 George Kerevan: I am trying to see if we can get anywhere that actually makes the concept a bit more utilitarian. You have obviously come to a number. The figures you have given from other people show such a wide disparity. How have you come to your number, which you presumably think is better than other people's numbers? How have you got there?

Robert Chote: Essentially, our starting point is to try to estimate what the output gap is today to make an assumption about what we think the growth of potential is in the future, and then we have a conditioning assumption that over time the Bank of England will operate in such a way that the output gap tends to zero. As you say, the first judgment, and

a difficult judgment, is where it is today. As you will see, there are lots of different ways of doing this, but at the end of the day, you have to make a judgment on it. We use a variety of statistical techniques, techniques that are based on the production function, which is essentially what the contributions of the inputs of labour, capital and technological progress are into generating these things. We have basically come up with a conclusion that at the beginning of the year it was a little over 0.5% of potential output, which as you will see from the comparisons of the others is pretty much in the middle of the pack, but a quite widely dispersed pack.

Taking a step back, the fact that you have tentative signs of wage growth picking up but underlying inflationary pressure is more broadly relatively modest, the notion that the gap is probably more likely to be negative than positive and more likely to be small than big helps to start concentrating your mind. You can see the range of estimates is quite a large one. What is consistent across even what you might describe as the supply side optimists, who would say there was a big output gap, is that the potential is way, way below what you would have thought it would be if the pre-crisis trend had continued. That is not unique to us. If you go to the congressional budget office and look at their projections for US potential GDP, again it is way off the pre-crisis buff, although not as far away from it as ours is.

Q105 George Kerevan: So does that take us in the direction of saying that the hard number that you have put down is relatively meaningless but there is still something real that you can interpret from the data in a more qualitative direction?

Robert Chote: Yes. But also this comes back a bit to the Chairman's opening question about the point of forecasting: a forecast is always going to be wrong. Another reason is about transparency and accountability. It is very hard to be sure what the output gap is but I think it is better for us to be transparent and clear with people about what we are assuming it is and how that feeds through into the other assumptions we are making about the forecast than just to say, "It is vague, do not worry about this, we have made a perfectly reasonable judgment" and to be clear about that. So it is one of those cases where providing a precise point, say 0.6, how can you be confident it is 0.6 and not 1.6 or minus 0.6? It is also about accountability and being transparent about the assumptions and how that feeds through as a conviction that we are absolutely certain that is the number, which we are not.

Chair: That is very helpful. I think we will go to Chris Philp on productivity.

Q106 Chris Philp: The productivity challenges the UK faces have been commented on quite widely, including in your report. Can you give some commentary about why you think productivity in the UK lags behind our major competitors?

Sir Stephen Nickell: The level of productivity in the UK was well behind that of the United States in 1950 and had been well behind that in the United States for a considerably longer period but was well ahead of that of France and Germany in 1950. By 1979, France and Germany had overtaken the UK in terms of productivity but was behind the United States. From 1980 to prior to the current downturn in 2007, productivity

performance in the UK was rather good. We improved our level of productivity relative to France, Germany and the United States throughout that period. So in that sense it has not all been doom and gloom. Nevertheless the level of productivity in the United States, France and Germany is on an output per hour basis, market output, GDP, it is the same. It is 10%, 20% higher.

Why that is is that by and large people think that in the case of France and Germany this is about capital and skills but in the case of the United States is not about capital and skills that much. It is more to do with the fact that one way or another they are better at organising the capital and skills they have to produce more output. That is the general consensus.

Q107 Chris Philp: In terms of the change in productivity since, say, 2008, we suffered at 2.6% reduction in 2009/10 and since then it has essentially been flat. Now, you would expect that happen in the early stages of a recovery as more workers are taken on at marginal levels of productivity, but once you get say two or three years beyond the recovery you would expect an uptake. Why do you think we have failed to see a growth in productivity say in the last two or three years?

Sir Stephen Nickell: As you may know, since you obviously know a bit about it, you read about something called the Productivity Puzzle, which is why has UK productivity not grown as rapidly as you would expect it to have grown, say as it grew after the early 80s recession, after the early 90s recession, etc. My best guess as to the answer to that question is that the credit crunch and the financial recession in the UK was particularly severe and that has impeded the allocation of resources in the economy—basically a lot of productivity growth is about the reallocation of resources from activities that are not very productive to activities that are more productive.

There is a lot of evidence to suggest that the credit crunch has impeded this natural flow and that as and when the credit crunch fades away this situation will improve. That is my best guess and that, to some extent, underlies our forecast, because in our forecast productivity growth does get back not to its average level over the past 100 years but it gets back to somewhere close to that and somewhere back to normal.

That, I think, is to some extent an act of faith. If you go back to our forecast four years ago, we thought the impact of the credit crunch would be over by 2014 and we were wrong. It is not and productivity in the first quarter of this year, there was a little productivity growth but not very much. As it happens, for the first time in many years today's data on employment has shown that that there has been a fall in employment in the last three months, or at least the three months to May. Under the assumption, which we believe, that the GDP growth fall in the first quarter of this year is temporary, the implication of this fall in employment would be that productivity growth would be rising relatively fast. So maybe this is the turnaround but we have been here before and I have given you my best analysis of what I think is going on. This field in particular is very uncertain.

Q108 Chris Philp: Yes, you described it as an act of faith, which is interesting. You mentioned resource allocation as being critical to driving productivity growth in your view. Presumably you are referring partly to capital and partly to human resources?

Sir Stephen Nickell: Yes.

Q109 Chris Philp: Perhaps you are suggesting there has not been as much churn in both areas so withdraw capital from unproductive businesses, giving it to productive ones and the same for people as well. Is there anything you feel the Government should be doing to encourage that Schumpeter-style reallocation of resources that might boost productivity?

Sir Stephen Nickell: Obviously anything that can be done to mitigate the effects of the credit crunch, but that is very difficult for a government. There is no lever that you can pull that says, "Pull this lever and credit will become more freely available". There have been policies on the credit side to try and relax credit. First we find that went into house building but then they have tried to change it to try and restrict it to corporate lending. There are many other forces at work on the banking industry, as you know. There are immense pressures of regulation and contracting of balance sheets and so on, all of which are moving in the opposite direction to the one one might wish to go in.

Q110 Chris Philp: The figures we have here seem to suggest that net lending to non-financial businesses seems to be, even today, pretty flat. That is to say there is no net new lending, which is disturbing given we are now seven years beyond the credit crunch. What do you think of the implications fiscally if we fail to get productivity growth back on to track as you were suggesting, if that act of faith is not merited and if instead we continue to say, roughly speaking, 0.4% productivity growth we have seen as an average over the last five years?

Robert Chote: If you look back at the economic and fiscal outlook we produced in, I think, December of last year, it was explicitly looking at high and low productivity variance. Clearly one important area is we assume that earnings growth, sustainable earnings growth is crucially dependent on a return to sustainable productivity growth and that, in turn, matters for consumption and matters for both income tax and taxes on tax revenue from what people spend as well. So that is absolutely crucial in a headline sense.

In addition, another concern is that if you continue to have weak productivity growth, if that is telling you that you have weak trend productivity growth, and that is not simply the fact that productivity growth remains depressed while still having a long way to rebound to a better performing normal then that implies that the potential growth rate of the economy is weaker and that you are therefore likely to fall even further behind the path that the economy could be following prior to the crisis. The bigger the hit to potential GDP the more of any given budget deficit is structural rather than cyclical and the more it requires policy measures to remove it rather than simply relying on recovery and activity.

Q111 Chris Philp: Looking at your scenarios it seems to make about a 2, 2.5% difference to the deficit if you go on the 0.4 productivity forecast rather than the other.

Robert Chote: Yes, it depends. You can pick any scenario. We looked there at what happens if productivity growth stays as it has been in the recent past versus what if you see the sort of surge you saw post 1980s, I think, or in the 1980s. There is a whole variety of other variants you could take.

Q112 Chris Philp: My final question goes back to Sir Stephen's comments about resource allocation and thinking particularly about bank loans, which, as I mentioned, have not really been very constructive in terms of non-financial company lending. Do you think that the significant increases in tier 1 capital over the last four to five years, combined with a failure to churn the loan portfolio, that is to say call in poor loans and make better new ones, may have contributed to the productivity malaise that we are describing? Might the Bank of England, therefore, have a look at that as the regulator?

Sir Stephen Nickell: The fundamental point within the banking system is that the banks lost a lot of money and for one reason or another they started contracting their balance sheets. It is that balance sheet contraction that is partly regulation driven and partly driven by the fact that when you have had big losses you want to contract.

Q113 Chair: The stuff on the balance sheet was not of much value anyway.

Sir Stephen Nickell: Well, yes, but nevertheless there probably was some. There are loans that they would have made then, sensible loans they would have made then that they are probably not making now. You want the banks to go out and lend and do good things but you want them to be safe and you want them to have lots of capital and so on. There is a tension there.

Robert Chote: You made the point that there is the zombie firm argument and there is the expanding firm; I think the view we have tended to take is that it is the lack of access to working capital, to funds for potentially vibrant—

Chair: Very good. We are going to go straight into this territory now.

Q114 Steve Baker: It is like you read my mind. I feel like we are tantalisingly close to the right answer but not quite there. In the inflation report that we looked at yesterday, it says, for example, "Forbearance and a low level of bank rate could have allowed businesses to face persistently lower demand. Businesses that face persistently lower demands remain operational". In other words, businesses that are producing the wrong stuff in the boom and should have gone bust have not because—they go on—"This may have impaired the reallocation of resources to newer or more dynamic companies with the potential to achieve it" and so on. Is it not the case it is not the credit crunch that has caused this subsequent long-term failure to reallocate capital, it is actually the policy response to the credit crunch? Sorry, you have shrugged, but "yes" is the answer, is it not?

Sir Stephen Nickell: I have no idea whether it is the policy response because I do not know what the perfect policy response would be.

Q115 Steve Baker: No. I think Ben Broadbent, if memory serves me correctly, would use this zombie term. Are we not going on now for years, allowing firms to continue in this artificial environment that is a deliberate policy choice, that is interest rates on the floor since March 2009? Are we not approaching a point where the policy response intended

to minimise pain is actually giving us a prolonged, chronic experience of pain because productivity is not increasing, because resources have not been reallocated and, as a result, real wages are not rising and ordinary people are suffering? If I am wrong in that analysis, where am I wrong?

Robert Chote: If I recall what Ben was saying, obviously low interest rates are one explanation for why some firms that would have gone have not gone otherwise; obviously the relatively subdued rate of wage growth, the reluctance of banks to basically pull the plug and to see those losses. I do not think that is necessarily the whole part of the story. Again, back to Steve's point of not knowing what the optimal policy response is, having jacked up interest rates with broader confidence effects may have encouraged greater productivity in some cases but could have had worse effects elsewhere so it is hard to know, as I said, what the optimal—

Steve Baker: I am not going to go too much further down this particular path—

Sir Stephen Nickell: We are simply not really responsible for monetary policy. I feel somewhat uncomfortable sitting here saying that monetary policy has been wrong.

Q116 Steve Baker: Yes. I am just conscious we all have a duty to the public to try to work out what is going on and how to make the best of it, and I am trying to drill into that. We have talked about zombie firms. I think we have now got on to talking about the policy response to the crisis has prevented the reallocation of capital necessary to produce the productivity to give us the wage growth. It feels like we are nursing up to the point that we are able to look at these output gap figures, which show an enormous trough, particularly if you look at the unemployment augmented output gap measure, an enormous trough that has been felt very presently in people's lives.

If I could just come on to the output gap and drill into a couple of things there, when we talked about these numbers, how material are they to your forecasts, these fractions of a percent difference in your estimate of the output gap?

Robert Chote: In terms of the fiscal forecast, what we essentially need to get to is a view on by how much is nominal GDP and its components in terms of the things that drive the tax basis in particular going to be over a five-year period? How much is labour income going to grow? How much are profits going to grow? How much is consumption going to grow? How much is investment going to grow? All of those things matter crucially to the fiscal forecast, and the mix of them matters at least as much as the overall magnitude.

Coming back to the point that Mr Kerevan made, in reaching a view on how much the real economy is going to grow over that period, we start with a view of how much spare capacity there is and by how much the underlying supply potential of the economy will grow over the five-year period, both of which are of course highly uncertain numbers. It is a tough job to come up with an estimate of that, but I think it is better to come up with a transparent one than just to say, "For a sense of judgment, we are assuming that there could be growth of X over the following five years". In that sense it is material even though it is difficult, and anybody doing this would be the first to admit that the numbers are highly uncertain.

Q117 Steve Baker: Yes. I have great sympathy because I have managed various aerospace and software engineering businesses, and attempting to estimate the potential output of those businesses would have been possible but quite hard, so the idea that you can do it for the whole economy strikes me as rather incredible.

Robert Chote: As you know, running a business, you have to come up with some sort of view about what you think the demand for your product is likely to be at—

Q118 Steve Baker: No. It is not so much the demand; it is your potential output, and they are different things, are they not?

Robert Chote: Yes.

Q119 Steve Baker: With that in mind, this credibility of having some sort of figure, when I look at the numbers on page 32, charts 3.2 and 3.3, which are these measures of the output gap, what I see is, of the seven measures on there, five of them at the moment seem to converging on the figure that is broadly your estimate of 0.6%. Does that give you a greater degree of confidence, or is it not important that these measures have converged?

Robert Chote: It helps explain why we have come to the eventual judgment that we have, that 0.6% is probably a decent number to go to, but, as I say, you only have to look at the chart on page 34 showing the range of estimates to see that—obviously different people use different techniques to estimate this—in terms of the estimates of the output gap today, they vary enormously. It is a particular challenge at a time at which you think potential GDP has fallen a long way from the path that it would have been on previously, but the Chairman will remember Kenneth Clarke had a panel of independent advisers in 1996 who came up with views of the output gap at the time, and I think that the difference between the top and bottom one was six percentage points of potential GDP. The fact that there are a wide range of estimates is not particular to this current circumstance.

Q120 Steve Baker: We had a prolonged credit boom. Off the top of my head I do not remember what the chart of M4 outstanding looks like, but it tripled in an accelerating curve between 1997 and 2010 before stagnating. We are in a categorically different monetary environment now if you look at M4 outstanding. Is it possible that during such a prolonged credit boom, firms just came to produce output that was only affordable to people because we were in that enormous credit boom, and that now that we are in a categorically different economic environment, the firms have just wasted capacity, they have just allocated productive resources to purposes that are never going to be fulfilled, and that, therefore, the output gap is a pretty meaningless number because firms wasted capital rather than simply having productive capacity that will come on stream later, because later we will not be the credit boom we were in ten years ago, that the capital has just been wasted? Is that something that you consider when you look at output gap?

Sir Stephen Nickell: Yes. We usually reject it. I have heard this type of argument a lot. What are these goods that people did not want?

Q121 Steve Baker: I will give you an example. A friend of mine who shares my broad outlook on economics ran a firm that produced meat and fish, and it supplies a lot of the restaurants in London. What he discovered was that during the bust phase some of the more exotic species of fish, like line-caught tuna from the Bahamas or whatever it might be, the Maldives or whatever it was, but people particularly have a fashion for particularly expensive fish from particularly rare islands, whatever it may be, it was particularly expensive, and they just ceased to buy it once we were into the bust phase. He found he had whole lines of supply that were simply no longer necessary.

Sir Stephen Nickell: Luckily not made in the UK. That is indeed a very tiny, tiny—

Steve Baker: You asked for an example.

Sir Stephen Nickell: No, you have given me an example, but my general view is that the broad brush of what people consume they are still consuming, and by and large the notion that somehow or other we were producing a lot of fripperies I do not think holds water.

Q122 Steve Baker: This is precisely the point then, because in here we are concerned about an output gap of 0.6%, which I think, Robert, you used the word “crucial”, crucial to the forecast that you are producing. It must surely be possible that 0.6% of output was going on what you have just described as fripperies, in which case fripperies and producing the wrong fripperies is material to all the forecast you produced, is it not, even by your own—

Sir Stephen Nickell: Yes, but you can change from producing. We have had ten years to change from producing. The people who produced the fripperies could now be producing something useful.

Q123 Steve Baker: Except that the bank rate is so low that it is preventing zombie firms from folding and reallocating capital.

Sir Stephen Nickell: Yes, but I do not know. I would have to see some numbers that were meaty and really—sorry, fishy as well as meaty.

Q124 Chair: You have not knocked down the point yet, really. You are just saying, “I am not sure I have seen the numbers to support it”.

Sir Stephen Nickell: Yes, but I have seen plenty of numbers that do not support this in the sense that the major industries in Britain are producing roughly what they used to produce. Haircuts have not changed very much. The big industries and retail—go down the shops, go down Tesco—are much the same, and so on and so forth. The car plants are producing much the same.

Q125 Steve Baker: That is an interesting point because I wonder whether anybody ever goes through and looks at the different—we went through a phase from talking about Mondeo man to discovering that the 3 Series was outselling the Mondeo. That would be a

consequence of cheap credit making 3 Series BMWs more affordable than Mondeos, yet you are looking at coarse aggregates that are hiding these sorts of differences.

Sir Stephen Nickell: I suppose so. Luckily, I do not think we make either Mondeos or 3 Series BMWs in Britain.

Chair: We have had a good canter around this subject, and if you have anything substantial to use to knock down the rather interesting set of points that Steve Baker has made, we would be interested to see it.

Steve Baker: I certainly would, because I think it goes to the heart of the economic paradigm that we are stuck in that is at the moment not helpful.

Q126 Helen Goodman: Hello. I want to go to a different part of the economy where there maybe are not so many fripperies and ask you about the impact of raising the national minimum wage, or the national living wage as the Chancellor would like to rebrand it. I have been looking at your section at the back, section B, and I have come to the conclusion I do not understand it, because you have a chart, chart B1, which shows the change in the income distribution under the current regime and under the new regime. It is pretty much as one would expect: you have a spike, and then you have some people further up the income distribution impacted. You say in the text 3 million people get a direct effect and another 3 million people get a second round effect. Obviously there will be some discussion about differentials and what is going to happen to differentials. Then, three pages on, chart B3, “Average annual gains to gaining households in 2020”, and you say in paragraph B30, “Around half the cash gains in household income may accrue to the top half of the household income distribution”. That is what the chart shows.

At first blush, these two things would appear to be in conflict. I would like you to explain to me why they are not and why it is that at least half the gain from this quite significant change in policy is going to the top half of the income distribution.

Robert Chote: One issue is that at chart B1 you are looking at the distribution of individual earnings. The distributional impact is typically looked at in terms of households. Quite a lot of individual beneficiaries of the higher minimum wage, be it people who were below and coming up to it or people who were above it and move slightly further above it, are second earners in households that are higher up the income distribution.

Helen Goodman: Sure. No, I understand that. Yes.

Robert Chote: The other issue in terms of even within the gainers, the chart here is also talking about the increases in hours perhaps being greater or higher up of those who gain. The people are working more hours, so if you increase the amount they get per hour, it benefits the people who are working more hours more than it benefits the people who are working less hours. That is not a full distributional analysis of the outcome. It is basically highlighting that “working more hours” number.

Coming back to the overall distribution effect, it is basically because you look at distribution typically on a household basis and the wage effect typically on an individual basis.

Q127 Helen Goodman: Is it also because chart B1 is using the hourly rate and chart B3 is looking at annual? There is the individual household point and there is the time difference too.

Robert Chote: Yes. If you are working more hours, you gain more of the hourly—

Q128 Helen Goodman: Nonetheless, it is quite striking. Chart B3 is not what one would intuit. You have worked it out and I am sure what you say is right, but it is not intuitively obvious I think.

Sir Stephen Nickell: It is well known. It has been known for ages that the proportion of people in receipt of minimum wage who live in poor households is very small. It used to be about 14%.

Helen Goodman: Yes. Really?

Sir Stephen Nickell: Yes. In other words, minimum wage as a method of relieving poverty is completely hopeless because most people on the minimum wage do not live in poor households.

Q129 Helen Goodman: You have obviously taken the conversation exactly where I wanted you to take it since, as you know, we have had some discussion about why the change to the tax credits is not compensated by the minimum wage, and you have explained very nicely why that is. Thank you very much.

You have also looked at other impacts: impacts on GDP, impacts on the price level. Really, they are all quite small. You have done a sensitivity analysis. Could you just say something about how confident you are about these really rather small effects? Are the uncertainties almost as large as the changes, or not?

Robert Chote: Yes. There are considerable uncertainties both in terms of the economic impacts and in terms of the net fiscal impact. The basic judgment we made on the basis of the chart B1 analysis, before there is any adjustment in jobs and hours, is that you add about £4 billion to the national wage bill, but then you basically see a 0.4% reduction in total hours, so about 4 million hours a week down. There is clearly uncertainty around that proportion. It is based on a judgment about the elasticity of demand for labour, which is drawn from academic evidence of which there is a relatively wide range from which you can pluck, and if you pick a different number from 0.4% you would get a different answer to that.

There is then an uncertainty about to what extent that reduction in overall hours shows up as a reduction in jobs and a reduction in hours for people who are still working. We have assumed 50/50. You could take a view that maybe more of it is jobs, less of it is hours, so there is an uncertainty around it there.

Helen Goodman: Yes.

Robert Chote: Then, in the fiscal numbers, you end up with a very small number, partly because it is a combination of gains minus losses, and, as you know, if you have a small number that is the difference between two larger ones, if you make a small error in the larger numbers, you can get a big difference in the small one.

Q130 Helen Goodman: Yes. On the fiscal side, one thing that I am not clear about either is the Chancellor has two policies: he has a policy to control public sector pay and he has a policy to raise the minimum wage. I wonder whether you have looked at how easy it is going to be for him to stick to his 1% when he is increasing the minimum wage in this way. Have you had time to do an analysis?

Robert Chote: As we discussed at the outset, we did not find out about the 1% pay award—

Helen Goodman: No, I realise.

Robert Chote: —or, rather, pay bill limit until the day of the budget.

Q131 Helen Goodman: I will come back to that issue about not getting the information, but will you be able to have a look at this? It struck me that these two policy objectives were not wholly consistent when I was listening to the Chancellor.

Robert Chote: Yes. It is an interesting and important issue. The potential consequences of the 1% pay awards in terms of retention and recruitment in the public sector are important issues, but they are not necessarily hugely pertinent to the forecasts that we produce for the purposes that we do it. If we had known about the 1% awards, the main difference it would have been made for our forecasts is it would have changed your view about what would happen to general Government employment, but because you are basically constraining the total wage bill, essentially, by what the Chancellor has allocated for departmental expenditure limits, it does not have a knock-on effect through the rest of the forecast, so there may be other forecasting bodies for whom those sorts of questions are more directly pertinent to the work that they do.

Q132 Helen Goodman: On the public sector pay, do you have any sense of the extent to which departments will gain the limits by—we have here some quite amusing evidence where Nick Macpherson is complaining about the difficulty of keeping bright young people, which I think is a discussion that has been going on certainly for 35 years.

Chair: That is his public spending really.

Helen Goodman: Then what arises is the question as to whether or not departments just get around this by paying people bonuses or changing the structure of the pay and all of that. Do you have any—

Robert Chote: We have not looked into it, as I say, because it came up too late for it to be involved. I do not think we would have looked specifically at that. We do pay some attention to drift.

Graham Parker: We have to for the public sector pensions forecasts.

Helen Goodman: Yes.

Graham Parker: That is the only real thing in connection with this that we have to forecast, because we just take total DEL limits and so on and would not look too much at the detail of DEL. It does affect public sector pensions. Once we get the spending review—

Q133 Helen Goodman: Yes. What is the rate of drift at the moment, roughly?

Graham Parker: It is between 1% and 2%, I think. Even when there was the freeze, still average pay per head was going up by something like that order of magnitude.

Q134 Helen Goodman: Of course. Late information. To my mind, two issues arise here. One is: can you do your work properly if you get the information late? Obviously you find it very difficult. I do not know if you want to expand on that or on what you said to the Chairman—

Chair: Robert is going to send us a note on that.

Robert Chote: The point is that we produce the forecast on the basis of the information that we have been given at the time that we have been given it, and it is important for the integrity of the process to say if there are other things. At the end of the day, it is not for me to say the Government cannot announce things or decide things in the week before the budget just because it makes my forecast look out of date.

Helen Goodman: No, of course not.

Chair: This is quite a detailed, technical error, and I think, rather than go into that detail now, what would be helpful is to have it written down. If you are able to get this to us before close of play Monday, that would be even better.

Q135 Helen Goodman: It does raise a second question, though, and this is how good the current budget-making process is if decisions are being taken very late. Once upon a time, when we lived in a world of old technology, all decisions had to be taken four days before the budget speech was made in order to get the red book printed, and some decisions were taken weeks before because they were sending out to HMRC officers around the country what they were going to do with the indirect taxes. Do you have any impression that we have a very late decision-making process now and that sometimes it is not just that you are not in a position to assess the interactions between the different measures, but perhaps there might be some people in the Treasury who are also similarly unsighted of all those interactions?

Robert Chote: A couple of things. The days of old technology, some policies were inserted in budget documents pretty late in the process and probably at the printers in Vauxhall, so it has not always been that old technology was conducive to earlier decision-making. We had a period under the last Government in which—in addition to us being created and I think a very helpful process of us setting out deadlines by which we needed to be told things in order to get them into the forecast—everybody knew that we would be

setting out in the foreword to the document what those were afterwards. You also had the quad process as well, so substantive decisions had to be discussed and cleared in that environment, which provided an additional discipline.

This is the first budget of a new, single-party Government, but it is also a very, very big one. This has an awful lot of measures in it and an awful lot of them are DWP measures. It would be a very complicated package to deliver on time by the standards of the sorts of things that we have seen in the past. I raise this issue partly in the hope not to say that this was a particularly egregiously bad example, but to say there may be reasons why this one was a particularly difficult one to get the decisions finalised in time, but let us hope that that is not a pattern that is maintained in smaller fiscal events going forward, and I hope the Committee will be supportive in urging that to be the case.

Helen Goodman: Thank you.

Q136 Chair: We have ended up going into some detail on this, and I think it will assist us to see it all written down.

I just want to clarify one point about the classification of public versus private sector, which you touch on in your report. You pointed out that owing to Government policy, including the 1% cut in social sector rents, the ONS may reclassify housing associations as public sector, which will be quite a big change to the numbers. Did you warn the Treasury that the ONS might do that?

Robert Chote: It occurred to us; I am sure it has occurred to them. It was conscious of the fact that the ONS approaches these classification decisions focused quite heavily on the degree of control that is exercised over the institutions concerned. This is not to say that any of these things are the wrong thing to do, but in terms of the way in which this might be affecting future forecasts, we felt it was an important thing to highlight. I would be astonished if it comes as a surprise to the Treasury.

Chair: I do not have the figures, but you did warn them?

Robert Chote: When they would have seen the draft of the publication, we would have asked them as we went through the process whether they had any information on whether this was likely to be the case.

Q137 Chair: It is good to have all the qualifications, but the answer is yes. The size of this off the top of my head I cannot recall, but it is very large. What does this do to the public sector—

Robert Chote: I think it would roughly mean £60 billion to Government debt.

Q138 Chair: As a proportion of GDP, even there it is quite significant.

Robert Chote: 3%, 4%.

Chair: Yes. Really quite significant in the numbers.

Robert Chote: It would be a level shift and, therefore, not necessarily affecting the trajectory of debt—

Q139 Chair: Have you discussed it with the ONS?

Robert Chote: No, not in detail. They have their own processes. We have not discussed it. No.

Chair: You have not at all?

Robert Chote: No.

Chair: No. That is all I needed to know. Thank you very much.

Q140 Jacob Rees-Mogg: I wanted to slightly change the subject and talk about the banks and the corporation tax surcharge, which you describe as having a very high uncertainty rating because of the bank's potential behavioural response. What do you think the banks are going to do?

Robert Chote: Graham can expand on this. One prior uncertainty for behaviour—this is an uncertainty that applies to our forecast for corporation tax receipts and our forecast for corporation tax receipts from banks specifically—is that obviously they have made quite a lot of losses in the past, which they are then able to set off against future profit. One uncertainty around this is what the actual path of profitability is when banks are going to sluice out those losses from the system and then be in a position to start paying tax again. That creates an additional uncertainty in this costing as well as in the forecast on the—

Graham Parker: I think the surcharge is before losses.

Q141 Jacob Rees-Mogg: Did they not lose some of their ability to carry losses forward?

Robert Chote: There was a limit, yes.

Graham Parker: Yes. Yes, but they are still there. That just means they use them over a longer period. Again, it is primarily the profit. There have been lots of downs mostly in banking profits for tax purposes, so it is primarily the experience of the last few years, what has happened there, and what is going to happen to their profits in future.

Q142 Jacob Rees-Mogg: By a “behavioural response”, you mean tax planning?

Graham Parker: Yes.

Jacob Rees-Mogg: Good.

Graham Parker: That is part. There may be other things about profits as well, but there is—

Robert Chote: Taxing profits as distinct from a balance sheet might lead you to believe that would have a different effect on investment, for example, than it would do if you were—

Graham Parker: Yes. The uncertainty is coming partly from the modelling aspects, so we are trying to estimate the profits, and partly from the behaviour.

Q143 Jacob Rees-Mogg: Then in terms of domicile, do you think this makes it more or less likely that banks will want to change domicile, perhaps have more in their pockets outside it?

Graham Parker: I am not sure we looked at that specifically, because obviously the bank levy changes work in the other direction.

Jacob Rees-Mogg: Yes.

Graham Parker: It is quite difficult to see. It will depend on how each of these affects different banks. Again, that would contribute to the uncertainty. That is part of the behaviour we are talking about.

Robert Chote: The pre-measures forecast does not assume that someone was going to leave that the post-measures forecast now assumes will stay, so there is no explicit judgment about it.

Q144 Jacob Rees-Mogg: You did not make any judgment on that when making your forecast? You assumed everyone who is here would stay?

Robert Chote: Yes.

Q145 Jacob Rees-Mogg: Thank you. I also wanted to ask you, which I think you may have sort of answered in the questions we have had earlier, but it is on the question of secular stagnation, and there are some economists who think that we have reached a stage of secular stagnation and that we are never going to grow again properly. I wonder whether this is the view that you take or whether you think this is something that economists come up with every 20 years after there has been a downturn and have done since Malthus was alive, and actually it never quite turned out to be like that.

Robert Chote: Is it cyclical? Is it going to happen or is it cyclical pessimism?

Jacob Rees-Mogg: That is a very good way of translating my question.

Robert Chote: Secular stagnation means different things to different people. There is a variant of it that is being depressed about supply potential, of the “We have had three industrial revolutions and that is your lot” variety. There is then also a view of the fact that we cannot get interest rates low enough to get the economy back to “normal”. Implicit in our forecast, as we discussed earlier, is that we have demand in the economy recovering to its potential. We are not taking an explicit view on that being depressed from that, so it is not implicit in our forecast. Steve, do you want to add anything on the merits of summer’s—

Sir Stephen Nickell: Looking at the supply side, our forecast seems to be returning to some level of productivity growth not too far away from its historic trend, and that automatically means that our forecast incorporates a considerable absence of secular stagnation.

Q146 Jacob Rees-Mogg: You have actively rejected it, rather than your remit is essentially to assume that historic trends continue?

Robert Chote: No. The judgment that we have long taken is that in the absence of a compelling reason to assume that a return to some sort of historical normality just looks like very clearly not the best option to go for, that that is the best longer-term anchor of assumption that we have available to us, but it is not to say that it is a dead certainty by any means.

Q147 Jacob Rees-Mogg: Very few things are, or I would go to the bookmakers more often. A final thing that I have been asking everybody today is on ring-fencing and, therefore, the cuts that have to come in the non-ring-fenced areas of public expenditure. Are you now assuming that the non-ring-fenced areas need faster cuts than they had in the previous Parliament?

Robert Chote: We do not have to reach a view on that. The way in which we do the public expenditure forecast is essentially to take the Government's view of the total envelope available to protected and unprotected departments. Clearly, the envelope is not shrinking by anywhere near as much as it was in March. We have not taken a view beyond 2015/16 as to where the cuts are likely to fall. Statements that have been made about defence that would create some additional protections in that sense, but it is not for us to look at the departmental visions.

Q148 Jacob Rees-Mogg: Do you not have to make some point of judgment on the practicality of squeezing the unring-fenced areas further in view of the forecasts that you have to make, that if everything is ring-fenced but the Government are still saying it is going to balance the books, that obviously cannot happen; therefore, the higher percentage that is ring-fenced, the lesser the cuts on the non-ring-fenced areas become?

Robert Chote: In principle, we could take a view that the Government could not deliver their stated objective for the overall envelope for departmental spending and that we could go for an alternative assumption to that. During the course of the last Parliament, we basically took the approach that up until the point at which in real time the Government are failing to keep within the overall spending envelope that they have given themselves, we would not make that assumption in the future. What we do do is, in the remaining years for which there are detailed departmental plans, we say to what extent we believe those are likely to be over or underspent, and historically they are always underspent, so that is again another reason for not assuming that this is going to be broken open. As I say, from the point of view from our Government policy for our purpose, it is the overall envelope and, with protections, sometimes the definition of a particular thing that is protected can end up being more capacious than you might think at first examination, so there are uncertainties there as well.

Jacob Rees-Mogg: Thank you very much.

Chair: Thank you very much indeed for coming to give evidence to us this afternoon—full of interest, as usual—and we are looking forward to that letter on that detailed point, if possible, in time for our hearing with the Chancellor on Tuesday.

Robert Chote: Tuesday.

Chair: Monday night. Thank you very much indeed.

Robert Chote: Thank you.