



Treasury Committee

Oral evidence: [Budget 2016](#), HC 929

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Members present: Andrew Tyrie (Chair); Mr Steve Baker, Mark Garnier, Helen Goodman, Stephen Hammond, George Kerevan, John Mann, Mr Jacob Rees-Mogg, Rachel Reeves

Questions 1 -114

Examination of Witnesses

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

Q1 Chair: Thank you very much for coming in this morning. There have been a few noises off since we saw you last, particularly in the last few days—but you will have seen a good number of these politico-economic events before. I would like to begin by asking you about your treatment of the fiscal surplus rule. Correct me if I am wrong but, as I understand it, you are attaching a 55% probability to the likelihood of the fiscal surplus rule being met—that is, the rule that there will be a surplus in 2019-20.

As I understand it, that was predicated on the view that the Government was building in a margin for error by putting a surplus of £10 billion into the bottom line. As I understand it—and correct me if I am wrong—on a full-year basis, that figure is now £8.7 billion because we have just lost £1.3 billion per year in PIPs, in the full year. Your probability will have been based on some assumptions, and presumably a model. What is the percentage probability at £8.7 billion?

Robert Chote: The probabilities are essentially based on mechanically applying the average size and distribution of forecast errors in the past. Rather than us saying, “Given our own subjective view of the uncertainties around the central forecast, we think that there is an X% probability,” it is, “If this forecast is as accurate as past official forecasts over the previous 20 years have been, that suggests there will be a 55% chance—to the nearest five percentage points—of there being a surplus,” i.e. that 10 turns out to be a number that is merely greater than zero.

Chair: Of course. I understand this is a relationship between two huge variables of about £750 billion of public expenditure, and £600-and-something billion in tax.

Robert Chote: Exactly—which explains why the fan is as wide as it is when you get out to that distance. If you take away the 1.3—

Chair: That is the 5% either side.

Robert Chote: Yes, that is right. Essentially speaking it would still be 55%, to the nearest five percentage points. 1.3 is not a large number at that sort of a time horizon. Clearly if you were to go down to the nearest probability—which we do not do—to the 0.X%, it would be a lower probability as a consequence of the fact that the 10 is no longer 10 if you take just that chain into account, as you say. That is absolutely right.

Q2 Chair: Although there is a great deal of political activity going on, quite understandably, about the merits or otherwise of cuts and increases in disability, this morning you are arguing to us that this is de minimis for the purposes of the 55% probability that you have attached to delivery of the fiscal surplus rule in 2020.

Robert Chote: Yes, exactly. Given the average forecast errors over a four-year time horizon, a 1.3 difference is not large in the context of the other uncertainties. However, as you say, that is not to understate the importance of the measure and its other ramifications.

Q3 Chair: When you model this—and you say that it is, on a strict basis, derived from forecasting errors across the piece—is that methodology in the public domain?

Robert Chote: Yes. We published a paper on it quite a while ago.

Graham Parker: In 2010.

Robert Chote: When we first adopted that, we produced a working paper on how we reflect uncertainty, which I seem to remember.

Chair: I should have remembered that you published it in 2010, but I noticed that you had trouble remembering it yourself.

Robert Chote: Forgive me for that, Chairman. Not many people would.

Graham Parker: We produced a fan chart of public borrowing since 2010.

Q4 Chair: This Committee would like you to take another look at the methodology that you set out there, and to come back to us with a considered view on whether anything needs to be altered in it; and whether, as a consequence, anything needs to be altered with respect to your 55% probability. At least once per Parliament, we should properly re-vamp this. It may be that you will want to change nothing, but you will need to set out why you are not changing anything.

Robert Chote: Sir, I am certainly very happy to give that methodology a spring clean. In terms of the treatment of the new news that has emerged over the last couple of days, there we will have to treat the PIP change as we treat any other change announced between one fiscal event and the other—which is that we Hoover that up in the next forecast that we do, rather than consistently change it. The Government announces measures between events, from time to time, anyway and we do not update the forecast, partly because other things will have changed at the same time. We will take that into account, along with a re-assessment of the welfare cap, which this also affects.

Q5 Chair: I have what I think is a direct quotation of what you said about corporation tax. You said, “The chancellor remains on track”—this is on track to the £10 billion he aimed for in July and November of last year—“thanks to further measures,” by which you are primarily referring to corporation tax, “that shuffle spending out of the fiscal mandate year and shuffles receipts into it.” I found that phrase very interesting. Could you perhaps elaborate on what you meant by this “shuffling” that was going on?

Robert Chote: Yes. Essentially speaking, on the corporation tax, there was a previous measure announced that said that large companies had to pay their corporation tax three months earlier than was previously the case. That means that in the first year that you do that, a large company is in effect paying five quarters of corporation tax, and then in every subsequent year you are back to paying four of them. This generates a one-off lump of revenue. It is a tax increase where it is neither reversed, nor repeated. That produces a chunk of money that does not affect the long-term revenue position.

Q6 Chair: Is there not an element of artificiality about something that has not appeared before and will not appear again?

Robert Chote: At one level it is not purely an accounting change, in the sense that companies will be handing over money at a different time from when they previously would have been. The fact that this shows up in the numbers in the way that it does is a reflection of the fact that the official figures do not treat corporation tax receipts on an accruals basis, in which case the money would be applied to whichever year the profits were generated on which that tax was assessed, not on when the tax payment was made. If you had accruals treatment of corporation tax, you could not move money in this sort of way—even though you are affecting the time at which the company hands over the cash.

The Government has delayed implementation of this measure, which the Treasury said was, “To give businesses more time to prepare.” The effect of that has been to shift to this £10 billion one-off slug of revenue from 2017-18 and 2018-19, to 2019-20 and 2020-21. The largest single chunk of that is £6 billion in 2019-20.

Q7 Chair: Why did you use the word “shuffle”?

Robert Chote: It was to make the point that you are moving money around within the five-year forecast horizon, in a way that does not affect the ultimate position that you end up with and the long-term health of the public finances. On the capital issue, there was a

plan to do a particular amount of capital spending in that year; some of this is now being moved into the earlier two years. It is the same sort of effect, but moving in the opposite direction. However, again, it is not an accounting fiction. Money is being spent at different times from what it would have been before, but it is something that makes that year look better and does not affect the underlying long-term position.

Q8 Chair: Therefore, although you are describing this as a shuffle, you are not describing it as an accounting wheeze.

Robert Chote: No. The treatment is straightforward. With corporation tax, as I say, it is worth making the point that it is only because we do not do accruals accounting of this that you can do this at all, or that this would show up in this way. However, the contribution that we can make is to be transparent that this is how these numbers have changed. It is for others to reach views on whether or not it is an appropriate thing to do.

Q9 Chair: That brings me to my last substantive question in this area. If you look at the fiscal outlook for revenue, you are accepting, and the Government is relying on, are they not, that there will be a very large increase in revenue over the forecast period? The outturn for 2014-15 was £600 billion. In order to get these numbers to add up by 2019-20, we need that to be £761.4 billion, which is an increase of almost a quarter. That is an extremely large increase in revenue. We have both seen this happen before; we have seen increases in the past of more than 25% over a five-year period, but that is very large.

Robert Chote: Absolutely. We are of course reflecting here both the consequences of a rise in the cash size of the economy, and therefore the cash size of consumer spending, labour income, profits, investments etc.; and then changes to the amount of tax you get per pound of GDP. There are some reasons to expect the latter to go up as well: if you get back to a position in which you have real wage growth, that starts to generate more receipts for you on the income tax side as well. However, the bulk of the cash increase is a reflection of the fact that, over time, the cash size of the economy gets larger. As you rightly point out though—and as we have another fan chart around the receipts numbers—there is a lot of uncertainty both in terms of the impact of the behaviour of the economy, and how much tax you are getting out of any given pound of the economy.

Q10 Chair: On every previous occasion that you have come before us while I have been Chairman of this Committee—and that almost exactly coincides with the whole time you have been in your current job—I have asked the same question at the start of the meeting: have you come under any undue influence or pressure from the Treasury to alter your forecast in any way?

Robert Chote: Not at all.

Q11 Chair: You have in the past though, have you not? We have had an exchange about it, and you brushed it off, saying, “I am quite robust enough to deal with minor mischief of this type.”

Robert Chote: The first point to make is that that was talking about the description of the forecast and not the report, as some people interpreted, which is not what you said—that this was pressure to change the numbers. As I say, in terms of the description, I was relaxed about that and with suggestions of sort. You take them on their merits and not on their provenance. However, the recommendations you make about re-examining the memorandum of understanding and the clarity of who gets what and on what basis are very sensible. Now we are out of the way of the forecasts, we will get under way with that.

Q12 Chair: To put it another way: there is a line between what is acceptable and what is not, which appeared to have been made a little elastic here. We have felt the need to tighten it up by beefing up the MoU. That is what has happened here.

Robert Chote: That is right, and beefing up the MoU and re-visiting it is very sensible.

Q13 Chair: We hope that nothing else comes out of the woodwork that would in any way qualify the unambiguous answer you have given to the question. Among other things, we are here to safeguard your independence. We want you to make sure that you are extremely alert to any attempts and that you come to us if you notice anything.

Robert Chote: Indeed. You will not be surprised to know that the attention you have addressed to this issue already has discouraged quite a lot of that traffic.

Chair: That was part of the purpose, and that is behind this exchange.

Q14 Helen Goodman: I would like to ask some more questions about the fiscal consolidation. There is a number of £3.5 billion savings in 2019-20 in the great big table of all the measures. At what point did the Treasury inform you that they were planning to make those further savings in 2019-20?

Robert Chote: Is that the reduction in departmental expenditure?

Helen Goodman: Yes.

Robert Chote: We have deadlines by which we need to know of changes that would be economy-moving. I forget when the deadline for that was, but we were notified in time, so this was not something that contravened that in any way.

Q15 Helen Goodman: Do you think that if they were absolutely clear about where they were going to find that £3.5 billion they would have set it out, rather than just putting it in as a single number in 2019-20?

Robert Chote: You would have to ask them that. From the perspective of the way in which we forecast DEL spending—which, as you know very well, is the envelope for public services expenditure—we have to do this in an effectively top-down way rather

than building it up from all of the different elements that any given department is going to spend, a departmental total, and then adding those things up.

Obviously, in 2019-20 you do not know the detail of what every department is going to spending on every bit of their activity anyway. Being able to say precisely where it would come from is difficult when the underlying baseline that you are talking about is not precisely laid out as well.

The decision that we took in terms of the way in which we responded in the forecast to that particular policy decision was to say that, on the basis of the Treasury's track record of ensuring that DEL numbers do come in—and almost always underneath the limit on which they finally decide—it was appropriate to put that in. We did make an adjustment to the assumed underspend against the total, because that puts things under a bit more pressure. Therefore, we slightly offset that with a change to our adjustment on the underspend.

The other point to make is that the Government has described this as an efficiency review. It is not our role, beforehand or after the event, to say whether these are efficiency savings or cuts that affect the quality and quantity of public services. From our point of view, we are interested in the net effect on the fiscal target. It is for the NAO and others to judge whether this is getting more bang for your buck, or just less buck.

Q16 Helen Goodman: If somebody was to say to you that they have put this number in because it is the number that they needed in order to hit the fiscal target in 2019-20, what would your comment on that be?

Robert Chote: As in every forecast we do, the policy choices the Government have to make in terms of where it ends up is what it allocates as the total envelope for public services expenditure. Those envelopes were set out through to 2019-20 in the spending review. There was an assumption for 2020-21, and the Government have changed what it is pencilling in for 2019-20 and 2020-21. As you see, we highlight that, the impact that it is having, and the fact that it is having a particular impact in a particular year. However, on the track record, we would not have the evidence to say, “We do not think they will deliver that if that is the policy they stick to,” because that has not been the historical experience.

Q17 Helen Goodman: They have a number of things they are going to have to find in 2019-20. They have that £3.5 billion and they have £2 billion just below it for public service pensions—which, in effect, is going to come off all these different departments, is it not?

Robert Chote: Yes.

Q18 Helen Goodman: Do you know how that will be distributed between departments at the moment? That is not in proportion to how much money you have; that is in proportion to how many people you employ.

Robert Chote: Yes. We have not looked at the distribution by department. As you say, the way in which that thing works is that the Government or GAD have reviewed the

discount rate you would like to apply to future pension contributions. The Government have to then make a decision on that.

The Government have chosen to lower the discount rates that will be applied to future contributions from CPI plus 3.0 to CPI plus 2.8. That means that this shows up as a saving because the line in our forecast for the net public service pension contribution is pension spending minus the contributions. Contributions are bigger, therefore there is a saving.

The decision the Government then have to take is, “That also implies extra costs to the departments employing the people who are in these schemes.” The reason it shows up as a reduction in borrowing on the bottom line is that the Government have chosen not to compensate the departments for the additional costs they will face. You have not had a reduction in net pension spending offset by an increase in DELs; you have the one side but not the other. That is why it feeds through as a contribution to the consolidation.

Q19 Helen Goodman: Following the weekend’s event, we now also have in that year a number for PIP, which is about £1.2 billion per annum. That takes us to total savings—as yet unidentified—in 2019-20 of £6.7 billion.

Robert Chote: That would depend on what other decisions the Government makes in response to not having the PIP revenue. As the Chairman said, they could end up aiming for a slightly smaller surplus in that year, or they could try to stick with the £10 billion—other things being equal.

Helen Goodman: Or they could put taxes up.

Robert Chote: Yes. However, this is now one element of policy that goes into our next forecast, and there will be lots of other elements of policy that go in as well.

Q20 Helen Goodman: The £3.5 billion and the pensions are bound to come from public spending savings, but the £1.2 billion for PIP could come through any one of three routes: tax increases, extra borrowing, or public spending reductions somewhere else.

Robert Chote: That is right, yes.

Graham Parker: Yes.

Sir Stephen Nickell: Yes.

Q21 Helen Goodman: I want to ask you about business rates, because I am slightly puzzled by what is going on with them and the commitment that the Government is making to fully compensate local authorities. The Government have proposed reductions in business rates, particularly for small businesses. This is very welcome. There is consensus that this is a good thing to do. However, business rates were the strand of income that they have said they want to hand over to local authorities to pay for the services local authorities deliver.

I know the phasing of this is not sorted out. Next year there are going to be three local authorities—one of which is Manchester; I cannot remember which the other two were—where they will make this translation. But they have said that the whole translation will be made by 2020.

I am interested in how they can make this saving on the business rates, which will benefit the small businesses by about £1.7 billion—if you look at all the different elements added together—and compensate local authorities fully without that appearing somewhere else in the arithmetic. In the Chamber yesterday afternoon the Secretary of State said on several occasions they could do that, as did Treasury Ministers. How is that possible? Should there not be a line somewhere? I have read your box 4.3 in the OBR. Logically, if they are going to be compensated, that should appear somewhere, should it not?

Graham Parker: We are covering the whole of the public sector here, so it is consolidated.

Helen Goodman: That may be an answer to my question, but I cannot see any connection between my question and your answer.

Graham Parker: The flow from central government to local government does not appear in the overall numbers. We are looking at the whole of the public sector as an entity. If central government give local government more money, what matters is how much local government spends, which is basically unchanged by this measure. We are talking about how much the public sector spends outside of the public sector, so a flow within the public sector does not appear within our numbers.

Helen Goodman: It should appear in the Government's numbers.

Graham Parker: It would appear if we were showing central government numbers, but we are showing general government numbers and public operations.

Q22 Helen Goodman: I thought that the OBR looked at the red book and what the Government is proposing. The Government set out clearly what the DCLG grant is, for example. If the DCLG grant needs to be adjusted because business rates are being handed over—or not, as now seems to be the case—I would have thought you might notice that and comment on it.

Graham Parker: We are looking at the arithmetic for the whole of the public sector. There is enough to look at there without looking at all the flows in between different bits of the public sector. We look at the scorecard. If you look at the Treasury scorecard, it does not appear on there because it does not reflect overall public sector spending.

Robert Chote: The scorecard includes those things that affect public sector net borrowing. A shift of this sort would not would not affect that.

Q23 Helen Goodman: Let me try asking the question in a different way. If the Government is going to fully compensate the local authorities for this £1.7 billion reduction in business rates come 2020, they will have to look for savings elsewhere—in other government departments—will they not?

Robert Chote: Correct me if I am wrong: there is a DEL increase to pay for this, which is one of the things that is in effect funded by the £3.5 billion of reduction. Is that not right?

Graham Parker: It is not on the scorecard.

Robert Chote: It is still in part of the DEL. You have a selection of specifically identified additional DEL spending: smart motorways, cathedrals, etc.

Graham Parker: This extra local government grant is not in the scorecard because it is a within-public-sector thing.

Robert Chote: Yes.

Graham Parker: You may be right, but we do not look at the make-up, as Robert said. We just do a top-down look at DEL. We do not look at the make-up of DEL.

Robert Chote: In the top paragraph of page 7—

Helen Goodman: Of the red book, or of your book?

Robert Chote: Our book, top of page 7, first bullet point: “Cut departmental spending limit by £2.3 billion.” As I mentioned, with our underspend adjustment, that comes out as an effect of £2.8 billion. You have a selection of new spending commitments that include the school day, cathedrals, blah blah blah, and this would be another one of them—even though it does not appear on the scorecard. I am not 100% certain.

Graham Parker: Neither am I.

Robert Chote: That is effectively paid for by a combination of the £3.5 billion of “efficiency savings” and reduction in overseas aid—the cash level of overseas aid in that year. We can certainly go back and check this, but I think the money you are referring to is in that component. We can certainly go back and look at that.

Helen Goodman: I would be extremely grateful. I think every local authority treasurer in the land would be extremely grateful if you would do this, because they have been promised this money but nobody can work out where it is coming from. This is quite important for them.

Robert Chote: We will do what we can. As Graham says, the guiding principle of everything we are doing is to look at its impact on the public sector’s finances in entirety, which means that a lot of flows essentially net out.

Q24 Helen Goodman: Yesterday the new Secretary of State for Work and Pensions repeated several times that the Government is not going to revisit the DWP for welfare savings, or look at reductions in rates, or changes to entitlements to social security benefits. There are no plans to do that. In effect, that increases the ring-fence from DFID, health, education, defence and pensioners to the whole DWP budget. My arithmetic takes that to about £400 billion.

These savings that need to be found—whether we are talking about £5.5 billion, which you thought originally, or £8.5 billion if we included the PIP and business rates, as is my suggestion—have to come from an even smaller part of the public sector. Do you think that it is credible to find

£5 billion to £8 billion worth of savings from a smaller and smaller group of government departments?

Robert Chote: It is not for us to say whether that is credible. It is a matter of arithmetic that the more you protect, the more you have to get money out of the remainder.

You are back to the other issue of: if you have lost this money from PIP, the Government can borrow more, tax more, or could spend the equivalent amount less somewhere else. Whether it has that effect on other areas of spending depends on which of those routes you end up going down. It need not be that this feeds through inexorably to unprotected DEL—RDEL. It could come from somewhere else. We will wait until the audit to find out.

Helen Goodman: It does mean that unprotected DEL is smaller.

Robert Chote: Not necessarily.

Graham Parker: The Secretary of State was talking about social security AME. It does not necessarily have any effect on DEL.

Q25 Chair: The general point that Helen is making is correct, isn't it? The ring-fencing is making life more and more difficult for non-ring-fenced budgets, in an era of fiscal restraint.

Robert Chote: Within any given amount, the more you protect—and there are different definitions of protect—the more the unprotected bits get—

Chair: We have had numerous exchanges on this point and the credibility or otherwise of sustaining that policy over a long period. This Committee has expressed deep concern about it and about the consequences for the remainder—the un-ring-fenced part.

Robert Chote: From our point of view, all we can do is show what the numbers imply. It is for you to draw that conclusion—which you have done.

Chair: We have been drawing that conclusion, and it has been quite unambiguous. It is even more unambiguous now than it was four or five days ago.

Q26 John Mann: Mr Chote, what is the current percentage probability of the Government hitting its surplus target?

Robert Chote: As I say—on the basis of the average size of forecast errors in the past—if you are, roughly speaking, aiming for a £10 billion surplus, 55% to the nearest five percentage points. At a larger number of decimal places it would be somewhat lower as a result of losing the PIP money but essentially still around 55%, because of the level of uncertainty at the four-year horizon.

Q27 Chair: We are going to have a look at the modelling of this again, aren't we?

Robert Chote: Yes.

Q28 John Mann: “Somewhat lower”—how much lower?

Robert Chote: I do not know, given the level of uncertainty at that level. The whole point is to emphasise uncertainty, so giving a very precise answer to precisely how uncertain it is would defeat the object.

Q29 Chair: But you have done that with the 55%.

Robert Chote: Yes, but we do not say that the probability is 54.1%, in which case I could tell you to a different number exactly what it would be on that basis.

Q30 John Mann: Can we conclude that it is less than 55%?

Robert Chote: As I say: to the nearest five percentage points it remains 55%, but you are absolutely right that it is lower. If you have less money there, the number of the probability would be somewhat lower, but not necessarily materially so at that time horizon.

Q31 John Mann: For decision-making, a difference between 55% and 50% is significant in terms of a risk profile.

Robert Chote: The Government have to make their mind up how much wiggle room or margin for error they want to put in at that horizon. They have revealed a preference to have a little more than £10 billion in the last couple of forecasts.

Q32 John Mann: Parliament does when it votes. You are a parliamentary body established by Parliament, but Parliament has not voted yet. You said 55% and I am trying to get a clearer indication of how far that has come down.

Robert Chote: For a number to the nearest 5%, it has not come down because it is still 55%, to the nearest 5%. However, if we presented this to a much greater level of granularity, the number would have come down. The whole point of this is to underline the uncertainties and to give a broad idea of what the accuracy of past forecasts would suggest. We do not know whether this forecast is going to be more or less accurate than the average of the previous 20 years.

Q33 John Mann: How many of your other projections can we take as having a 45% chance of not being met?

Robert Chote: We have provided this percentage number in every forecast that we have done. How many of them were 55%/45%? I cannot remember off the top of my head.

Graham Parker: Probably a lot.

Robert Chote: Quite a lot, in that it has been around that 60%/40%, 55%/45% number for most of the time, because the Government tends to aim a little above hitting the surplus exactly.

Q34 John Mann: Something that heads towards a two-thirds possibility, as against something that is heading towards an evens possibility, is a significant difference in terms of a risk profile for decision makers. Do you intend to give more such statistics in terms of percentage probabilities?

Robert Chote: We have provided this one as a guide. It is for the Government to decide what they believe the appropriate margin for error is. It is for them to decide whether 55% is too high or too low, or what the right number is. It is not for us to say how much they should aim to overdo this. It is to give a best judgment as to what we think the median outcome is, i.e. equally likely either side, and on the basis of the accuracy of past forecasts give some indication—we do not have to but we thought it would be helpful—what confidence you might want to place in it.

Q35 John Mann: It also seemed reasonable to project that, with this £4.4 billion additional hole, those probabilities would be shifting towards 50% now.

Robert Chote: Yes, as we have discussed, they would be lower: if you have effectively now got something that looks more like eight-and-a-bit billion pounds rather than £10 billion, the probability will be lower. However, at that time horizon with the fan chart as wide as it is at that point, it does not make a huge difference to the precise number. But the underlying substantive point is that, if you have a lower surplus, the chances of that turning out to be a surplus are lower.

Q36 John Mann: From looking and calculating the figures in my head, it would seem to me that what Parliament has been asked to vote on today, and with your 55% probability given last week, in fact becomes 50:50 in terms of probability to the nearest 5%. We are now at a 50:50 scenario in terms of the Government meeting its target surplus.

Robert Chote: If you look at page 201—

Graham Parker: We produced a fan chart.

Robert Chote: If you shift that—

Graham Parker: The black dot.

Robert Chote: £1.2 billion in 2019-20 is going to be less than 0.1% of GDP by then. You will be shifting this line by less than 0.1%, and you can see that per cent of GDP is 0% to 2%. You are not moving substantively closer towards or away from the edges of that black—the dark—

Q37 Chair: Your answer to John's question is "no". Is that right? Or "yes"?

Robert Chote: The answer is that the probability of achieving a surplus is lower, but to the nearest five percentage points it remains 55%. However, he is right. It is closer to 50 than it was before yesterday.

Sir Stephen Nickell: But it is closer to 55 than 50, and remains so.

Q38 John Mann: As I read it, you are suggesting that interest rates are going to be cut. Is that built in to your projections?

Robert Chote: At the time we close the forecast, we take the market's expectations of interest rates based on interest swap prices. At the time we the closed this, those were moving closer to 0.25% than 0.5%—where they are now. That was plugged in to the forecast.

Q39 John Mann: Are you projecting that interest rates will be cut?

Robert Chote: We were following our usual process of taking the market's expectations, and that is right. In that sense, we are taking on their expectations that rates are—or were then—more likely to fall than to rise at the next move.

Q40 John Mann: Sir Stephen, you have sat on the Monetary Policy Committee. I cannot recall anyone in the last 10 years suggesting there would be a further cut. The Governor has indicated there will be an increase. He has indicated that very strongly and has done so for the past two or three years. You are projecting a cut, but the evidence from the governor is projecting an increase.

Robert Chote: The banks said in the 2015 inflation report that the committee could also decide to expand the asset purchase facility, or to cut bank rate further towards zero, from its current level of 0.5%.

If you go back a bit, they were guiding against the idea that you would have a further cut in interest rates, I think because of concerns about the profitability of particular banks. We have taken on board the fact that the committee has said, consistent with the inflation report, they may feel it is sensible to cut below that. However, we looked carefully at that to see whether we should essentially apply a floor at 0.5% and ignore the market expectations of it going below; but given that the Bank has clearly signalled in print that it is willing to consider going below 0.5%, it was sensible to do that.

Q41 John Mann: The Chancellor has built in a significant additional tax take in 2019-20 that appears to be rather woolly in its detail. What percentage chance are you giving that that will be met?

Robert Chote: That is the percentage chance that the Government changes policy again, which is well above my pay grade. We have put in their current stated policy, which is to implement this change in corporation tax—which accounts for £6 billion of the

£6.3 billion net tax increase in 2019-20, so you are right. The vast majority of it is down to that.

We have to do the forecast on the basis of current policy. Policy can change, as you can see from the fact that they have moved the £6 billion to somewhere else. It is not impossible that could change, but our job is to show the implications of current policy.

Q42 Chair: Is there any particular reason that, whenever we talk about this shift or shuffle in corporation tax, you seem to break out into a broad grin, or should we completely ignore these human signals?

Graham Parker: Yes.

Robert Chote: Natural joie de vivre—no more than that.

Chair: It breaks out from time to time when we are discussing corporation tax shuffling.

Q43 John Mann: You will understand. Parliament has passed legislation now, so these things are far more significant than they were before—some would say—by definition.

Robert Chote: Because you have a target in that year.

Q44 John Mann: Correct, and with your remit given by Parliament, the woolliness or preciseness of such projections and their likelihood of being met is now a significant concern, where one could have perhaps said five to 10 years ago it was of interest but one should not worry too much because politicians come and go, and there will be changes.

That scenario has now changed. Parliament has changed that through legislation. I am interested in the percentage probability of the Government getting that tax take in 2019-20, in terms of your projections of what the surplus will be.

Robert Chote: There are two issues there. There is the probability that the Government stick to that policy, which is something that you/Parliament have told us not to consider. There is then the probability that, if you go ahead with this, that is exactly the amount of money that is going to come in. Clearly, one cannot be entirely certain what the level of profit is that generates you the £6 billion. I cannot remember—what rating did we put on this?

Sir Stephen Nickell: Medium low.

Graham Parker: Medium low. The real answer is our forecast of corporation tax. There will always be some uncertainty in the forecast of profits. However, given that forecast, there is not much uncertainty in the actual policy. Companies have to pay their quarterly instalment payment, and they just have to pay five of them, not four.

Robert Chote: There are a lot of other money-raising tax measures that have much higher uncertainty than that one, let's put it that way.

Q45 John Mann: Sir Stephen, I will not ask the probability in your assessment of us leaving the European Union, but the surplus is predicated on net migration of 900,000 new people entering the country. You are projecting that unemployment will rise over the five years, so it is a net 900,000 new people entering the country. How are you building into the calculations the possibility that those people may not come? Critically, what would be the impact on the Government surplus target if there was a significant fall in net migration up to 2020?

Sir Stephen Nickell: First of all, we are making our forecast based on current Government policy. Current Government policy is to remain within the EU. Our migration forecast is based on the ONS forecast of migration. With those two things, that is how we make our forecast. What exactly do you want?

Q46 John Mann: In a scenario where there is a significant fall in net inward migration, can the Government surplus target be met?

Sir Stephen Nickell: Interestingly, you do have a scenario where we look at what happens to the public finances were the ONS low migration and the ONS—

Robert Chote: If you go to page 205—

Sir Stephen Nickell: There is a fourth one as well.

Robert Chote: It is not relevant for a policy; it is natural. What you have there is that the central forecast is based on the ONS's principal population projection. The way the ONS tends to do these things is that they assume that net in-migration starts at the rates you have seen in relatively recent years, and then moves over time to what you have seen over a longer average period. You have three variants here. The principal one has it falling to 185,000 by the end of the forecast. There is a lower migration variant, which is at 105,000. There is a higher migration variant that is 280,000 or thereabouts.

Sir Stephen Nickell: The Government hits its target in all three cases.

Robert Chote: Yes, and it makes around £4.5 billion difference in 2019-20, up or down depending on which of those you use.

Chair: Rachel Reeves, try to bring some joie de vivre out of Robert if you can manage it.

Q47 Rachel Reeves: I will do my best, Chair. I am going back to the issue of welfare, so I am not sure that I will succeed.

Mr Chote, on the welfare cap: how much will the Government miss the welfare cap by in the last year of the forecast period?

Robert Chote: Shorthand: the forecast that we have produced ended pre-measures forecast. Even after the PIP measure, assuming it went ahead, you have the welfare cap being breached.

Taking the loss of money from the PIP into account, you breach by about £4 billion in most years. It bobs up and down, but is essentially £4 billion a year.

Q48 Rachel Reeves: Not going ahead with the PIP means that it would be move from £2.7 billion to £4 billion.

Robert Chote: It moves from £2.X billion up to £4 billion.

Q49 Rachel Reeves: Over a five-year period, the Government would be spending something like £20 billion more on welfare than if they had met their welfare cap. Is that right?

Robert Chote: Yes.

Q50 Rachel Reeves: On the forecasting of PIP—and this is regardless of what the Government do in terms of aids and appliances—for the last five OBR forecasts, spending on disability benefits has been revised up. I wanted to ask you about your modelling and why those sorts of revisions keep having to be made in the same direction.

Robert Chote: Essentially speaking, the difficulty with all of these sorts of reform programmes is that to start with you do not have any, or very much, outturn data to go on. You can start with some views of what sort of impact previous policies that have a similar role have, and that gives you some idea. You then get in to the situation of the forecast that we did back in November, where the crucial judgments you make are: how likely is it that somebody applying for PIP gets it, or somebody being transferred from DLA to PIP gets PIP; and how much money are they likely to get? That can vary because there are some more generous payments than less generous ones.

Q51 Rachel Reeves: Are you using DWP assumptions or your own?

Robert Chote: DWP bring us evidence, we quiz them, we take our own views, we reach our own ultimate judgment. In November, the main evidence base we had to go on was an analysis of 900 DLA cases. What has changed in this forecast is that you now have 7,300 actual cases of people transferring under the controlled start. That has shown two things. First, the probability of getting PIP is higher in the 7,300 sample than it was in the 900 sample; and secondly the average amount is higher—100 versus 86, or thereabouts. That is because more people are getting the enhanced mobility, i.e. the more generous version of PIP.

Both the average amount and the probability of qualifying for it are higher than anticipated. We have taken those two things into account, and that is why it has gone up since November.

Q52 Rachel Reeves: We will know the answer in the autumn, but do you think that you have now got the information you need to make a—I do not want to be unfair, because I know you are dealing with uncertainties—

Robert Chote: We have to go on the basis of the evidence that we have at the time. 7,300 is a lot more than 900, but a lot less than the 1.5 million people who are eventually going to make this transition. As more people come through this and more votes come in, it will be clearer where it is coming out. I would certainly not rule out the possibility that this moves again.

Graham Parker: There are other uncertainties as well because of these controlled start people. They have had the initial assessment, but the ones who have not been given PIP can appeal etc. Of the initial results, it is 74% of them—no, a bit lower. We had to estimate how many more are going to get it after the appeal process. For these cases, they have not yet gone through the appeal process.

Q53 Rachel Reeves: Mr Parker, what assumptions are you making about the appeal process?

Graham Parker: We make an assumption about—which, again, is very uncertain—how many of them will be successful.

Q54 Rachel Reeves: What is your assumption?

Graham Parker: I cannot remember. I am sorry.

Robert Chote: It is generally based on what the recent rate has been, unless there is a good reason to depart from that.

Graham Parker: Yes.

Rachel Reeves: That might be based on the 900 people, rather than 700—

Robert Chote: As Graham says, the 7,000 have not gone through yet, so it would be based on that.

Graham Parker: It would be based on that but we would aim off it, because the 900 had a much lower initial success rate. You might expect a higher proportion of them to be successful on appeal. However, now some of the more borderline cases appear to be getting it. It is not necessarily the same as that, but we do look at all this.

Q55 Rachel Reeves: We should not be surprised if we see another upward revision.

Graham Parker: Or downward.

Q56 Rachel Reeves: Or downward?

Graham Parker: It is possible.

Sir Stephen Nickell: I know that from history it does not look likely.

Robert Chote: This is our best judgment of a central forecast at the moment.

Q57 Rachel Reeves: You may make the Chancellor happy yet. The Government have promised to half the disability employment gap over the Parliament. How achievable is that, based on your forecasts, and what assumptions have you made about how many ESA recipients will move into work over the period?

Robert Chote: I do not think we have made an assumption. We can check whether there is an assumption that is implicit in this, but I am not sure that we have—in order to get to the numbers we need to do for this—had to make a judgment on that. I can certainly check.

Q58 Rachel Reeves: You do not use the Government's promise to half the disability employment gap in your forecast about employment.

Robert Chote: We do not use promises of that sort in forecasts generally. It is on the basis of the policies they announce. They may have made that promise on the basis of some evidence that is also incorporated here, but I do not recall that being the case.

Graham Parker: It would be in our participation rate forecast, wouldn't it?

Robert Chote: It could be.

Q59 Rachel Reeves: It would be interesting to know what proportion of disabled people you have implicitly or explicitly in your forecast, by the end of the forecast period—if that is possible.

Robert Chote: The most we would do is have some sense of what the percentage success rates are in the particular judgments. Whether that answers that question, I do not know. We can certainly look at it.

Graham Parker: People get PIP whether they are in work or out of work.

Q60 Rachel Reeves: Yes, but ESA is different.

Graham Parker: Yes.

Q61 Rachel Reeves: The question is what assumptions you made about how many ESA recipients would move into work over the period, and what that means for the disability employment gap.

Robert Chote: On the disability employment gap, I am pretty certain we would not have an estimate on that; but we might be able to help on the first bit.

Q62 Rachel Reeves: Moving on to issues around the changes around ISAs, the estimated cost of the change to ISAs—both raising the allowance and the Lifetime ISA—is around £2 billion over the 2017 to 2021 period. If you broke that down, how much of that £2 billion is from increasing the ISA limit from £15,000 to £20,000, and how much is from the Lifetime ISA?

Graham Parker: I am not sure about the exact figures, but the majority of it by far is the Lifetime ISA.

Q63 Rachel Reeves: Is it 80% or 90%?

Graham Parker: Something like that. It is of that order of magnitude—very much the majority of it.

Q64 Rachel Reeves: Would you be able to come back with the costings? I am particularly interested in the costings of increasing the allowance from £15,000 to £20,000.

Robert Chote: We can check whether that is something that comes out of the numbers we have done.

Q65 Chair: Could you either come back to us with it, or come back to us with what exactly we should demand of the Treasury to secure it? The Treasury will have a number, even if they have not divulged it to you.

Robert Chote: Yes, we can do that.

Q66 Rachel Reeves: The reason I am interested in the cost of raising the allowance from £15,000 to £20,000 is that HMRC numbers show that 8% of savers used their maximum £15,000-odd last year. 29% of savers with incomes between £100,000 and £150,000 used their full allowance, and around half of those with incomes of more than £150,000 saved the maximum—just over £15,000.

It seems to me that raising the limit to £20,000 will largely only benefit those on the highest incomes. I am interested in the cost of a measure that looks like it benefits only a small number of people. I am keen to interrogate that further, if I could have that.

Graham Parker: It is clearly only the people who put the maximum in now.

Q67 Rachel Reeves: Only they will benefit, will they?

Graham Parker: Yes.

Q68 Rachel Reeves: Yes. I am interested in how much a measure would cost that seems to benefit only those on the very highest incomes.

Looking at the savings ratio and savings policy more generally, you are forecasting that the savings ratio will fall further. It is currently at its lowest level since 1963, at 93.5%, but you expect it to fall further between 2015 and 2020. The savings ratio is revised down in every year of the forecast period, compared with November. Can we assume that your verdict is that the measures to boost savings do not seem to be doing very much?

Robert Chote: I would not read too much into the effects of individual measures in what is driving those sorts of movements. A lot of it has to do with the recent outturn data and the broader picture of the flow of funds. We have a larger central household deficit through the forecast. It was roughly 2% of GDP last time. It is up to 3%. That is not particularly driven by recent policy changes. It is about the broader macro make-up.

Sir Stephen Nickell: If you include the pension equity adjustment, the savings ratio goes up over the forecast.

Q69 Rachel Reeves: The savings ratio is falling from 4.2% in 2015 to 3.9% in 2020, and it has been revised down in every year of the forecast period.

Robert Chote: If you go to page 67—

Sir Stephen Nickell: On page 67, it does not seem to be the case. When you say it was revised, do you mean it is lower than we—

Rachel Reeves: It has been revised down.

Sir Stephen Nickell: It is not going down; it has been revised down.

Rachel Reeves: It has been revised down in every year of the forecast period.

Sir Stephen Nickell: Yes.

Rachel Reeves: The Government are spending £2 billion on changes to ISAs in this budget, but the savings ratio is falling.

Sir Stephen Nickell: It is not falling.

Rachel Reeves: It has fallen compared with your previous forecast.

Sir Stephen Nickell: The savings ratio is going up. Our estimate of it is lower than it used to be.

Rachel Reeves: The impact of the measures in this budget only see the savings ratio being lower than you were forecasting four months ago.

Sir Stephen Nickell: Yes, but by and large most of that fall has nothing to do with the measures.

Q70 Rachel Reeves: The Government are spending £2 billion on measures to boost saving, but your verdict is—

Robert Chote: You would have to ask them whether this policy is aimed at the overall saving rate or particular people that they want to aim particular incentives at. In terms of the forecast revision, as you can see from paragraph 380, part of this is a judgment as to what has happened on the saving ratio in the final quarter. We do not have the numbers for that yet, but the evidence from what is going on with consumer spending and labour income is that consumer spending is growing more rapidly; therefore, the starting point for the forecast is lower and that naturally pushes through the rest of it. I suspect that is dominating the movement—rather than any judgments we have made.

Sir Stephen Nickell: Yes, definitely.

Robert Chote: Yes, it absolutely dominates.

Q71 Rachel Reeves: The Government say about their Lifetime ISA that there is going to be a 5% exit penalty if you take your money out before you are 60, but not if you are buying a house. Have you made any assumptions about whether people will keep their money in ISAs or is it just too early to say? What does that 5% exit penalty mean? Does it apply to the full amount in the ISA or the Government's contribution?

Graham Parker: I am not sure. We did not look at this too much, because it is not going to have any effect over this scorecard period.

Rachel Reeves: Only to the extent to which people will put their money into it.

Graham Parker: There will not be any significant effect. There will not be many people who start one in a couple of years' time or whenever and then withdraw it before the end of this forecast. We have not really looked at it.

Chair: We have already been going over an hour and we have a number of other colleagues who want to get in. I am going to call Mark Garnier, who has one or two follow-up questions to what has been asked, and then George Kerevan.

Q72 Mark Garnier: Carrying on with household debt, savings, balance sheets and all the rest of it, when you look at 2020, you guys forecast that net lending from the rest of the world—i.e. the current account deficit—is going to be 3.5% of GDP, while the government surplus will be 0.5% of GDP, and this is going to be offset by a 1% of GDP deficit in the corporate sector but a 3% deficit in the household sector. Is that a sustainable position for households to be in?

Robert Chote: Having a household deficit of that size over a period that protracted is not something you can see easily in the historical data, so to that degree it is unprecedented. On the other hand, also unprecedented is the combination of a fiscal consolidation continuing over the next few years and very loose monetary policy. In that sense, it looks the best rationalisation of how all of these central balances add up. However, in this forecast and in previous ones we have identified as one of the risks to the central forecast the fact that clearly you could have these sectoral balances adjusting in different ways.

Some outside commentators will look at this picture and say, "That looks to me like a recipe for a fall in the exchange rate," which could result in a different contribution, for example, from the "rest of the world" sector. It is in there; it is our best guess. It seems consistent with

the policy settings and the rest of the forecast, but we recognise that things could turn out differently—and other people, as I say, have particularly advanced that.

In terms of the rest of the balances, it is worth making the point that another bit of new news since the last time we did a forecast is that the trade deficit looks worse in the most recent period. We have been focusing quite a lot on when the income balance was going to improve the results of the net overseas investment. What we have had in this forecast is more disappointing news on the trade side as well. That feeds through and means that you end up with the other elements of the sectoral balances taking the strain.

Sir Stephen Nickell: Another point worth making in terms of sustainability of household positions is that the household balance sheet is in an unprecedentedly healthy state—in the sense that assets, relative to liabilities, are at an unprecedentedly high level.

Chair: We have had dramatic price inflation.

Sir Stephen Nickell: Well, yes.

Q73 Mark Garnier: This is a point I wanted to come to. You are right. Your March forecast has increased that; it is 825% from 800% in the November forecast, which is quite encouraging. Does this not have a sniff of the financial crisis about it, however? You see the requirement for households, through household consumption, to sustain the economic recovery. We do have rising wages—that is good—against zero inflation. Households do have more disposable income, but they are saving less. If you take out pensions, you have negative savings. It will be -2.5% by 2020, according to your chart on page 67. Ultimately, it seems to require more debt and more rising asset prices in order to fuel household consumption to try to continue the economic recovery.

As you rightly say, we could see a collapse in sterling, which could obviously have an effect on the trade balance, but it could also have an effect on how the Monetary Policy Committee treats interest rates in order to try to stop importing inflation. In that case, you would have highly stressed households, which we are asking to buy stuff in order to keep the economic recovery on track, that cannot buy stuff because the cost of their mortgages has gone up. Discuss in under five minutes.

Robert Chote: I will let Steve take most of this. There is an issue about higher interest rates etc. and the stress that causes. We have discussed this but, obviously, if interest rates rise more rapidly than is currently anticipated because the economy is doing better—

Mark Garnier: That is a good thing. I am not worried about that.

Robert Chote: It is not necessarily a source of stress. If they rise for reasons that are not related to a stronger performance in productivity and wage growth, you would be more concerned.

Q74 Mark Garnier: You would have a problem. If you look at the 2014 stress test the Bank of England brought out, which we were discussing with the governor last week or the week before, this could create a scenario—I am not going to try to draw the EU

referendum debate into this—where things go wrong. This is exactly the case. If people worry about sterling and about the UK trade balance, as you have just said, and you saw a fall in sterling, that could prompt a reaction from the MPC to raise interest rates to try to salvage the sterling exchange rate. That is exactly the kind of bad scenario that sees a rise in interest rates when households are not prepared because the economy is not getting better; it is getting worse. You then need a rise in interest rates for the wrong reasons.

Robert Chote: Obviously, the Bank would be making its judgments based on what they thought the prospects were for inflation, presumably looking through any resulting one-off price-level effects and whether they saw a need to deal with underlying domestic inflation. Steve, do you want to add anything on that?

Sir Stephen Nickell: No, you are right in the sense that if, as we forecast, household gross debt—not net of the assets—is on an upward path relative to incomes and, for whatever bad reason, interest rates go up to a relatively high level, obviously that will have an impact on households and will reduce household consumption.

Although some people will argue that higher interest rates also benefit lots of households, the fact is that the benefit is outweighed by the negatives in this particular context. Overall consumption would fall and that, of course, would not be good for overall economic growth; it would probably lead to a recession. There is that danger. Obviously, on our central forecast, that danger does not crystallise, because the interest rate path the markets expect and so on is such a minimal rise that the implications for households are tiny.

Q75 Mark Garnier: Ultimately, you cannot hypothecate on every single scenario like in a stress test; that is just not the job you are being asked to do, is it?

Sir Stephen Nickell: Yes.

Mark Garnier: Nonetheless, you do see the point. The fundamental question, I suppose, is this: do you agree that there is a bit of a sniff of the financial crisis about what is going on with households?

Robert Chote: I certainly would not use the phrase, “I see a sniff of the financial crisis.” You can read the paragraphs on the risks, we see and the way we have outlined is not the only way the flow of funds could evolve.

Q76 Chair: It is only a small step from shuffling to sniffing. Could I follow up on that? Sir Stephen, are you saying—I am not sure you were saying this—that, in your view, if we start to raise interest rates to a substantial degree, we are at risk of a recession?

Sir Stephen Nickell: No. I said if there were a sharp rise in interest rates brought about by the kind of scenario we are suggesting—

Chair: I just wanted to clarify what you were saying. For the avoidance of doubt, just say again what your view is.

Sir Stephen Nickell: If there were a sharp rise in interest rates brought about by some scenario that involved a large trade deficit, trying to stabilise the pound etc., that would have a negative impact on household consumption.

Q77 Chair: I realise you do not want to be pinned down on this, but give us some order of magnitude about time and numbers for what constitutes a sharp rise in interest rates from 0.5%.

Sir Stephen Nickell: I mean 5%.

Chair: So, back to normal levels, but in the space of how long?

Robert Chote: A year.

Chair: It is just helpful to have clarification about what you were, in fact, talking about. It could have been misunderstood.

Q78 George Kerevan: Your report says that the most important uncertainty in our economic forecast is the timing and strength of the long-awaited return to sustained productivity growth. You also say that in the eight years since 2007 UK productivity has grown by barely 0.1% a year. We have accumulated less than 1% since the top of the boom, yet your forecast, this most uncertain of forecasts, is saying that in the next three years we will suddenly, from nowhere, ramp up to near historic-trend levels of productivity growth in the UK. Why do you think that?

Robert Chote: One of the big judgments we have taken in the forecast is to essentially place more weight on the weak period of productivity growth that has taken place since the crisis as a guide to what is likely to happen over the next five years or so. The view we had effectively taken until this forecast was that there is no obvious reason to believe, or no reason to be confident, that in the end the economy is not going to get back to the sorts of productivity-growth rates we have seen in the past prior to the crisis.

George Kerevan: Tell me why, please.

Robert Chote: Because over a very long period, that has been a relatively stable relation. This changed sharply at the point of the crisis. If you go back to the set of information we had available to us at the time of the November forecast, you had signs of productivity growth and, along with it, earnings growth picking up in the middle part of last year. At that stage we took the view that there was not a strong case at that stage for pulling down your view of where you were going to end up over a five-year horizon.

The outturn data we have received since then has basically wiped out the improvement in productivity growth in the middle of last year. Earnings growth, which was at 3%, has fallen back to about 2%. Therefore, it looks sensible to place a bit more weight on the last eight years, relative to the previous 100, in terms of where you think you are likely to be going. It remains very uncertain, however.

Q79 George Kerevan: I will come to your revisions. I am just trying to work something out. You appear to be saying that, historically, productivity growth has been 2.2% or in that ballpark and, because it has always been that way, despite the fact it has not been there for eight years, suddenly in the next three years it will ramp up to something like 2%. Apart from, "It has always been this

way so it has to happen sometime,” do you have any concrete proof that is going to happen?

Robert Chote: We do not have concrete proof.

George Kerevan: What weight should we place on your judgment that, suddenly, after eight years, average annual productivity growth in the UK is going to go from 0.0% or 0.1% to 2%? That is a 20-fold increase.

Robert Chote: Yes, if you were returning to 2% from a negative, it would be more than 100%. The point, however, is that there are explanations that people come up with for why productivity growth has been weaker in this period than it has been previously. As I mentioned, one of those is that a legacy of the financial crisis has been that the financial system is not as effective as it might be at getting capital reallocated from not terribly well performing firms to potentially higher growth and more innovative ones.

As the financial system mends, you would expect that drag to become less important and for productivity growth to pick up that much more. That would be one reason. It is an ebbing of the factors holding it back, as distinct from new factors driving it up.

Sir Stephen Nickell: One point is that, although productivity growth collapsed in the last quarter, our best estimate of actual productivity relative to the year before is 0.8. The jump or the increase in productivity over the next three years, to some extent, has already started.

Robert is right. The fact is that, fundamentally, productivity growth slowed down. It must have been because of the financial crisis, in the sense that it happened everywhere in the world.

George Kerevan: Apart from China and Brazil.

Sir Stephen Nickell: China perhaps did not have quite as much of a financial crisis then. We will see what happens in the future. It certainly happened all over the developed world. There was certainly a slowdown in productivity growth.

There are many hypotheses, but a lot of them come back to the financial crisis as the common cause. The impact of the financial crisis is ebbing, in the sense that credit and so on are becoming much freer and there are improvements across the board. Therefore, if this tightness of credit was one of the fundamental factors underlying the slowdown in productivity growth, it seems quite logical that as this ebbs productivity growth will come back.

Q80 George Kerevan: I understand it in theory. In practice, in the last two quarters for which we have data—hard evidence, as you said, Mr Chote—productivity growth has slumped again in the UK and wage growth has slowed again.

Sir Stephen Nickell: Yes, along with it.

George Kerevan: The quarters we have evidence for go against your prediction of what is going to happen over the next three years.

Sir Stephen Nickell: The quarter-by-quarter measures of productivity growth go up and down all the time. Even in normal times they go up and down quite a lot. It is much better to smooth it. On a smooth basis, 2015 was a lot better than we have seen in the past.

I admit, however, that the last quarter was very disappointing—in the sense that, along with many other people, we thought that, given the middle two quarters of the year, we had turned the corner and so on. That proved not to be the case. Nevertheless, 2015 was better than a number of previous years. Therefore, whilst we adjusted our projections a little, we did not lose faith completely in the view that we are going to get back to something like the norm.

Q81 George Kerevan: Okay, let us move on then. Nevertheless, you have come back since your previous forecast at the end of last year to tell us that you have decided that long-term trend growth in productivity is going to be less than it was historically. You have made some kind of calculation. How did you calculate that?

Robert Chote: As I say, it is a judgment based on the fact that, as the period of weakness you refer to gets longer, you have to place a greater weight on it. We are not saying we do not believe we will ever get back to historic rates of productivity growth. However, in making a judgment as to how far you think you are likely to go over the next five years, as this period of weakness since the financial crisis gets longer, it seems only logical to place a bit more weight on that relative to the earlier period as a guide.

As I say, whichever forecasting methodology you are bringing to bear on this, whether you are doing a statistical approach or drawing lines through things or doing things that are more sophisticated, essentially speaking you have two historical periods that are very different from each other: a weak recent period and a stronger earlier period. It is not very easy to explain quite why things are so much weaker in the new period than in the previous period. Therefore, saying, “Right, the last eight years are now representative of all we have to look forward to in the future,” seems to go too far in one direction. However, we felt that snapping back relatively quickly to the old long-term historical average as the new weaker period gets longer does not look particularly attractive either.

You have to make a judgment and be transparent about where you draw the line between those two things. The idea that there is some very technical calculation that suddenly drops out “2” as the optimal number at the end is wrong. No, you are making a judgment: “We think you probably have to nudge this a bit lower.”

Q82 George Kerevan: I do not want to put words in your mouth, but I want to see whether I understand you correctly. It is an exercise in averaging. The traditional average was 2.2%. Because, against all your predictions and the predictions of December, the collapse in productivity growth continued, you have decided that the new average is 2% rather than 2.2%. However, that is not based on an analysis of real factors in the economy; it is simply statistical averaging of the long-run data series you are looking at.

Robert Chote: Quarters of productivity data are real facts. That is what you have to go on. Looking at how that has evolved, yes, you are having to decide what weight you place on those two things.

As you say, there is a whole variety of potential explanations for why productivity growth has slowed. We have talked about the reallocation of capital. People have composition stories to tell; they have other stories to tell as well. In terms of making what seems to be a sensible judgment for a five-year horizon, weighting in that way is interesting.

It is striking. One of the most surprising things I discovered when we were putting together this report was how similar that judgment ends up being to the one the Congressional Budget Office has taken for the data in the United States over the same period.

Q83 George Kerevan: I noticed that was your defence: “It is happening in America, so it must be happening here.” I do not buy that as a defence.

Robert Chote: It is not a defence; it is information. I am not saying we are doing this because the CBO has done this in the US.

George Kerevan: I appreciate that.

Robert Chote: I am pointing out this phenomenon is not unique to the UK. That is important to state.

George Kerevan: I have deep respect for the OBR. I am just doing a bit of testing. The trouble with that kind of courtroom judgment is that you get to choose the evidence that supports your case, rather than choosing other countries that do not support your case, which is why I am dubious about using US data to underpin your decisions.

Robert Chote: As I say, we are not using it to underpin the decision. We took the decision and then I said to my staff, “It would be interesting to see how this compares with what is happening in the US,” and it turned out to be almost exactly the same. That was something that emerged after we had taken the judgment, not before it.

Q84 George Kerevan: My interpretation of the report is that you seem to be suggesting that, with the revision down, in your view, of the trend for productivity growth, wage growth will also slow and that will have an impact on budgets. Is that correct?

Robert Chote: That is right. Fundamentally, we assume that it is productivity growth that drives wage growth and, therefore, while it is not quarter-by-quarter exactly the same, it follows automatically.

George Kerevan: We are looking at a period of lower wage growth than previously forecast.

Robert Chote: Yes, lower trend productivity growth feeds through to lower potential output growth, and that means lower growth in both the income and expenditure components of nominal GDP. On the income side, it shows up in wages; it also shows up in profits on the expenditure side; it shows up in consumer spending and business investment.

Chair: I have three more colleagues who want to chip in. Halfway through your extended exposé on productivity, Sir Stephen, I had the impression that you were pregnant with another thought and were cut off.

Sir Stephen Nickell: I do not think so. If I was, I have forgotten.

Chair: In that case, it cannot be that important. We will move on.

Q85 Mr Baker: Congratulations on another excellent report. It has been a fascinating session already. I want to ask you about your forecast assuming that monetary policy will be cut by the Bank and not raised above its current level until 2019. The governor has told us that the next move is more likely to be up rather than down. Do you agree with Mark Carney that your forecast is likely to be wrong?

Robert Chote: As I say, the approach we have always taken with the forecast is to take the market's expectations of where interest rates are going and not to make our own subjective judgment on that.

On the basis of what swaps rate prices were telling you at the time we closed the forecast, it went down and it went closer to 0.25% than to 0.5% for a period. We have plugged that into the forecast. It has subsequently moved back up and then back down again. I am not quite sure where it is now, but on the basis of what we had at the time it was more likely down than up.

Q86 Mr Baker: The governor would clearly like us to expect interest rates to go up. That is why he has told us what he has. I am just looking at your very helpful chart on page 43, which gives successive market expectations for bank rate. It shows us that, over a period of years now since sometime in 2010, the market has expected interest rates to rise and they conspicuously have not. How does this affect your forecast and your expectations of what interest rates will do versus what the governor has said, which is that he expects they are more likely to go up than down?

Robert Chote: We have plugged in these successive lines as we have gone along, because we have continued to take the approach that the market expectations are the sensible guidepost. As we put on the right-hand side—coming back to Mr Kerevan's questions previously—this is obviously related to the fact that there have been a succession of disappointments and people taking a less optimistic view of the path of growth in the medium and longer term as well. The two are related in that sense.

Q87 Mr Baker: That is a very good point, because next to that chart you put the successive disappointments on hourly productivity. When I look at page 53, on the oil-price assumption and how that has changed, the changes are so wild as to make one wonder whether the forecast had any value at the time.

Robert Chote: Again, for the oil price, we take futures prices for a couple of years and hold it flat thereafter. As you can see here, that works some of the time and does not work other times. The evidence, certainly from the IMF, is that is probably about the best approach to take.

Mr Baker: I think you would agree would me, however, that markets have been wildly wrong on a number of important prices for a while.

Robert Chote: Indeed, yes. If I could be confident of that ex ante, I would be a very rich man. On that basis, taking the expectations is the sensible thing to do.

Chair: That is why we need you to tell the public that they really should not be relying on forecasts. You should put that message across more than you have so far in the first five years—though you have been doing a great job. It is a point we have been making over and over again to you.

Q88 Mr Baker: I would certainly recommend these records of how forecasts have changed to any student of economics and, indeed, astrology. I do beg your pardon.

Robert Chote: You slipped that one in there.

Mr Baker: Yes. In the Autumn Statement report by this Committee, we recommended that you should share your assumptions on the future path of monetary policy with the Bank of England and discuss whether they are reasonable. Have you had those conversations on this occasion and was the particular path of monetary policy discussed?

Robert Chote: The issue there, which you rightly raise, is your interpretation of what they have said about, but not the actual level of, rates. We continue to use the market expectations, but how do we interpret that in terms of policy? We check with them here that we have interpreted the chunk of the February 2015 inflation report that I read out a few moments ago, and that it was appropriate—given current guidance.

The Bank was not leaning against us saying that we are choosing to follow the expectations going down rather than up, because they had said, “If rates need to go down, we will take them down.” That is slightly different guidance from what they were giving in earlier periods, when they had greater concern about the profitability of particular banks and were steering people away from the expectation that rates might go down. What they have said there is, “We are not pre-judging it, but if that is what is needed for the inflation target, that is what we will do.”

Q89 Mr Baker: From your answer, what I infer is a quite considerable difference of approach. On the one hand you appear to be quite mechanical: you look at market expectations; you plug them into the forecast. Mr Parker, I hope you will not mind me saying for the record that you are nodding. On the other hand, from what you have just told us, the Bank is in the business of manipulating expectations within the market. Whilst the Bank is trying to set market expectations and you are mechanically plugging those expectations into your model, do you recognise that that leaves you vulnerable to the words the governor of the Bank might use and how that might shift market expectations? Indeed, that is his stated purpose on occasion.

Robert Chote: Yes. To what extent you believe that what central bank governors do does shape the curve over that period of time is obviously an interesting debate and one that is quite hard to verify one way or the other.

In the end, people put their money where their mouths are. There are technical reasons why swaps-rate prices might not give you exactly what the market thinks is happening here, but in terms of what we need out of this and the broad set of assumptions we need, it is a sensible one to use. Certainly, we would not rule out ever doing it in the future, but rather than coming up with our own guesstimate of exactly where rates are going to be at each stage, putting in the market rates is the sensible approach.

Q90 Mr Baker: There is no question of the Bank giving you a little nudge about what they might do in six months or a year.

Robert Chote: No. As I say, if they nudge the markets and the markets move, that would be reflected. As you can see, however, we do not aim off the curve—other than this particular issue of whether 0.5% is a de facto floor. We clearly wanted to satisfy ourselves that we were not over-interpreting what they had said in the February report.

Q91 Mr Baker: The Bank thinks the economy is going to be almost 1% larger in 2017 than you do and will grow faster thereafter. They have also downgraded their forecast by less since November. Why have you reached these different conclusions?

Robert Chote: This is page 86. We are broadly in line with the outside average. The bank is a bit higher, but you can see that one of the reasons why the Bank is higher is that they back-cast. They are assuming there will be upward revisions to the past path of GDP, so when the white-shaded bit moves to the blue-shaded bit there is already a gap between the Bank and everybody else. We do not try to back-cast. We do not try to predict how the past national accounts data are going to be revised.

I am not complaining that they do that. It is a choice they make; this is the choice we make. They might have slightly higher forecasts for us on private consumption and business investment and be a bit less negative on net trade, in addition to the back-casting. Those are the main reasons.

Q92 Mr Baker: That is a clear difference in method, however. Further to Mr Mann's questions earlier, if the Bank is right, the Chancellor will meet his fiscal targets more easily, won't he?

Graham Parker: The back-casting bit of that would not apply to that. When it comes to the forecast of tax receipts, we are basing our forecasts on actual receipts. We look at what receipts are coming in. It is future growth from now that affects the tax receipts forecast.

Mr Baker: I do not quite follow.

Robert Chote: If the ONS decides that, last year, the economy was 1% higher than they thought it was, that is not going to mean that tax receipts are 1% higher than we thought—because we know what the tax receipts were.

Q93 Mr Baker: I see. The Bank is saying that GDP will be higher by 1% in a couple of years' time.

Robert Chote: Yes. That then shows up as the tax-to-GDP ratio being lower in outturn than it appears to be at the moment, because you have moved the denominator in the calculation.

Graham Parker: It is just the back-casting bit. The Bank has slightly higher growth than us going forward, which would have an influence, but it is only a small part of the gap between the yellow line and our line.

Chair: What proportion is that?

Robert Chote: You can eyeball this on chart 3.4. It looks like about half of the gap at the end is already there in the back-cast.

Chair: It is about half, then.

Robert Chote: I am merely going by what I can eyeball from this chart. It looks about half.

Graham Parker: It depends where the difference is. If it was higher business investment, it would have a negative effect on the tax forecast because of higher capital allowances.

Q94 Mr Baker: Looking at page 48, which is back to interest rates again, global bond yields are next to a chart of bank rate, which has been the pedal to the metal since 2009. I notice that since November your forecast on global bond yields has disappointed as well. It has been markedly different from what it should be. I am just wondering why we should expect this trend in global bond yields. The trend has been downward since 2007 and the forecast expects bond yields to start coming up. This is a forecast that has already been disappointed once.

Robert Chote: Again, these are market prices, not our assumption that things are going to turn around. You are absolutely right that those current market prices may not be validated by subsequent outturns, but again we are plugging those in from market prices.

Q95 Mr Baker: What will it mean for your forecasts if the trend continues downwards, insofar as it can?

Robert Chote: That depends a bit on why that was the case. If it is as a consequence of the fact the world economy just looks a lot weaker than it has done previously or as implied by the lines you have here, that would show up as weakness of exports and a weaker global environment more generally. The same issue would arise if UK yields were to be lower: it depends a bit on why that is.

Q96 Mr Baker: To try to tie together one or two things, we have monetary policy on the floor, and about a year after monetary policy went down the saving rate starts falling off over the period in the reports. Household net worth has risen. The Chairman asked about asset price inflation, something which

we have previously discussed in relation to monetary policy, and productivity has disappointed. Have you ever considered a way in which all of these things might tie together with one neat theoretical explanation?

Robert Chote: One neat theoretical explanation—no. The set of judgments we have made is consistent with a view of a weaker outlook for medium- to longer term growth prospects. The fact is that you have had the productivity changes we have had and the changes we have made to our productivity assumptions; you have the prospect of the first rise in interest rates receding into the future; and you have the expectation or possibility there might be a cut in the near term. All of that is consistent with a picture of a weaker medium-term outlook, which is obviously why we have reflected that in the forecast. I would not go as far as describing that as a theoretical framework.

Sir Stephen Nickell: One possibility that has been mooted is that the easy environment, as far as interest rates are concerned, has helped sustain low-productivity firms in being, whereas otherwise they would have been eliminated and released capital etc. That sort of argument is about, but I have not seen anyone quantify that and turn it into a neat, tied-up and quantifiable piece of analysis as yet. If productivity growth were to disappoint into the future, that kind of possibility will certainly get considered more and more.

Q97 Mr Baker: I understand the United States is moving towards recording total output and looking at all stages of production in order to make that kind of analysis possible. Is that something you have considered or might recommend in the UK?

Sir Stephen Nickell: We have not taken that approach, partly because it is difficult and it would require quite a lot of person-hours of effort to do so. I am sure, however, that there are people out there who are thinking along those lines. As I say, if productivity growth continues to disappoint, there will be more effort devoted to that kind of activity.

Q98 Mr Baker: I feel whole vistas of interesting conversation opening up before us on this point, as always. Finally, what conversations or exchanges of letters did you have with the Treasury about the issue of the extent to which you discussed Brexit in your report?

Robert Chote: We met with the Chancellor on whatever date it was—the 7th. I explained then what approach we were intending to take, which you have seen in the box where we set this out. As usual, we sent a draft of that for fact-checking. We got one thing where they pointed out we had misinterpreted what Deutsche Bank had said but no further interaction other than that.

Q99 Stephen Hammond: Good morning. Could I go back to the issue of business-rate relief? On table A.1, which is your scorecard of policy decisions, we can obviously see that for business-rate relief you have a reduction in revenues, over the four years, of something like £7 billion. Can you tell us what you forecast in growth against that? Presumably, an effect of that is to see small businesses

grow faster and see more economic activity from that sector. Can you point me to where you have the uptake in growth accompanying that?

Robert Chote: On “the indirect effects of the measures on the economy” forecast, we generally take a view on the package as a whole rather than the individual components of it. There are sometimes components or measures, for example, that have a particular impact on the cost of capital, where you might change the mix of business investment versus other components of expenditure. We look at the total net giveaway or takeaway rather than the specific measures.

What has happened there is that if you look at the overall package the Government has announced, it is a giveaway in the near term and then a takeaway in the two years to which the surplus target applies. That boosts growth a little bit in the giveaway period and nudges it down slightly in the takeaway period. We do not break that down individually. Certainly, this measure would be too small to have a measureable effect on GDP growth.

Q100 Stephen Hammond: Like Mr Parker said regarding the big flows in public expenditure in terms of the reimbursement back to local authorities, you also would not measure any boost in growth from this measure that would show through business-rate retention.

Robert Chote: No. As I say, the view of the package is that sometimes there are specific measures that affect inflation or business investment in particular, but then we look at the package a whole. If you have a measure that is, in its own right, fiscally neutral—it is giving with one hand and taking with the other—you would generally expect that. If that was the whole package, it would not have a great deal of impact.

Stephen Hammond: But we do not know yet whether this package is going to be fiscally neutral.

Graham Parker: No, not about business-rate retention. We do not know that yet. The Government say they are aiming for it to be neutral.

Q101 Stephen Hammond: Nor do we know the actual numbers. It may well be that it stimulates much greater economic activity than a £7 billion reduction. We do not know that either.

Of course, in the Budget the Chancellor made the statement that outlook for the global economy is weak and it makes for a dangerous cocktail of risks. What is the balance, in your assessment, in terms of the downgrade to your forecast, of domestic versus international factors?

Robert Chote: The vast bulk of the downward revision to the growth forecast is related to our productivity judgment, which is a judgment based on the UK. In addition, the weaker global environment feeds through to weaker outlook for UK export markets. However, this is predominantly a judgment based on UK productivity, performance and outlook.

As we discussed earlier, however, that disappointment on productivity is not unique to the UK. While the downward revisions are not a result of something nasty happening in the rest of the world since November that has pushed this down, the fact that we have taken down our

view of UK productivity growth is consistent with judgments that other forecasters have made in other countries—for maybe the same reasons or different ones.

Q102 Stephen Hammond: Sure. I take your point on UK productivity, but if we look at the balance in terms of the international factors, there has obviously been a big drop in the Chinese economy. Broadly, there is very low, if not stagnant, growth in the eurozone. Does that have a deflationary impact on your expectations?

Robert Chote: Obviously, a lot of the view we take on the world is basically looking at the forecasts of people like the IMF and the OECD and adjusting them where we think that is appropriate. Obviously, we do not have enough people to do a full bottom-up global forecast. We were struck by world-trade growth being weaker than anticipated. It is fair to say that the real-economy data has not been as weak as some of the financial-market activity and responses over the last three months. We have revised things down modestly, but not enormously, on the basis of that background. The big picture, however, is much more driven by judgment on UK productivity performance.

Q103 Stephen Hammond: On that basis, the current-account deficit, which is potentially going to be even more of a problem if we see negative interest rates not only in Japan but in Europe as well, is a relatively small part of your forecast.

Robert Chote: The forecast for the current-account deficit is worse in this one than it was in the previous one, but that is primarily driven by the recent outturn data and the fact that, in all the national accounts data that has come up for the fourth quarter of the year, things looked particularly bad at that stage. Obviously, in most recent forecasts tension has tended to focus on when the income balance is going to improve. That used to be in surplus and has moved in to deficit. You assume there is going to be improvement there, but we have also had here disappointment on the trade side that knocks through the forecast, to some degree, from the most recent outturns.

Q104 Stephen Hammond: That is pretty clear. The international factors are relatively limited in your forecast. I have got that point. If I just look at your table 4.2, obviously the headline number is that your forecast for real GDP has been revised down.

Robert Chote: I am sorry—which page are you on?

Stephen Hammond: I was looking at your two determinants of fiscal forecast, pages 98 and 99. Obviously, your headline numbers for GDP are 2.2, 2.1, 2.1 and 2.2. In terms of the overall debate about the potential elements the Government are going to have to find in the Autumn Statement to save the extra £4 billion or £5 billion, what revision to your real GDP number funds £4 billion?

Robert Chote: The impacts of a change in welfare spending that size would not have a material impact on GDP growth over that horizon.

Q105 Stephen Hammond: My point is that if, given the global cocktail of uncertainties and other factors, in next year's forecast you revise growth rates for 2018-19 and 2019-20 up again, the £4 billion is barely a blot on the landscape.

Robert Chote: Yes, you would not need a very large revision of that level to get those numbers. That is why the fan chart is as wide as it is for the deficit at that horizon.

Stephen Hammond: Yes, that is a pretty key point to make.

Q106 Mr Rees-Mogg: Thank you, Mr Chote. You were much more judicious than the Bank of England in your statements on Brexit. I am supporting the Vote Leave campaign, so I am quite pleased that you are doing your proper, independent job. The Chancellor said—I am not keen on his grammar or his opinion—"Mr Deputy Speaker, the OBR are"—it ought to be "the OBR is", but never mind—"explicit today that their forecasts are predicated on Britain remaining in the European Union."

Legally, however, you have to make your forecasts on the basis of government policy, don't you? You cannot wander off and use opposition policy, which has been a matter of contention in other areas.

Robert Chote: That is exactly right. Whether he regards us as singular or plural, I do not know. Fowler is debateable on football teams in regard to this; he may have had that in mind.

However, as you say, the Government's policy is clearly to stay in, but it is also policy to hold a referendum—and presumably to abide by the result of that referendum. The result of the referendum is not a policy choice of the Government; it is a choice for the British people.

Basically, the approach we have taken is to say, "We assume, in this forecast, that we stay in. It is not our job, given the job we have been given by Parliament, to come up with a quantified estimate of what Brexit would imply." Given the fact that people have a lot of interest in what our role is here, it is worth spelling it out—and making the point that lots of other people have done analyses of these things. Some are positive and some are negative.

To make a couple of points that would be relevant, even if you take a positive view or a negative view, in both cases people do not expect those effects to show up overnight. They would take quite a long time and probably well beyond the five-year horizon we would be looking at. If we did assume that we were leaving, it might not have as much effect, positive or negative, as people might think—because little of that would show up.

In terms of the elements that the Chancellor highlighted, obviously he quoted the bits of it he chose to quote. If there were to be a vote to leave, whatever your long-term view of the pros or cons, there is a fairly widespread consensus that there would at least be a period of uncertainty in which policy was being reformulated and the new relationship with the EU was being put together. It was sensible to reflect that, partly because there is a question mark as to whether any of that is showing up already in business confidence and market behaviour. We did not find very much evidence that it was showing up yet in business confidence.

Sterling has fallen quite a bit, and it is obviously debateable how much that has had to do with it. However, that is not a particularly controversial thing to point out. Boris famously referred to a Nike tick or swoosh of a period of initial uncertainty followed thereafter by a tick up. We tried to set that out as clearly as we could. Obviously, the Chancellor did not read out the entire box. Fans of grammar probably would not be very happy with that outcome either.

Q107 Mr Rees-Mogg: He did not point out the point you have just made—that it was not within your five-year time horizon to make forecasts on it anyway, if you wanted to. It seemed to me that he was being slightly selective in what he was fishing out of your report—rather overegging the pudding. Were you entirely happy with that? Obviously, your independence is very important.

Robert Chote: One has to be realistic. He devoted 230 words of his speech to that part of it. There are rather more than 230 words here. It is not the first or last time things will be selectively quoted. He did not misrepresent us. If he had said that we said something we had not, it would have been different. This has happened before. The Prime Minister gave a speech once when he said we had said X and we had not said X; we had said the complete opposite. Then you come out and robustly respond to that.

Obviously, as people are listening to the speech they pick up one impression, but once people had read what we had said and we explained to people what we were saying, most people realised what the score was.

Mr Rees-Mogg: Being quoted out of context is just one of the risks of political life, then.

Robert Chote: It is historically not unprecedented.

Q108 Mr Rees-Mogg: I wonder whether I can move on from overegged puddings to fizzy drinks and the issue of the sugar tax. My sister, Annunziata, is involved in a campaign to stop the sugar tax. My business, Somerset Capital Management, is an investor in emerging markets. It would not have a direct interest in any UK companies, but it would have one in foreign companies that would be involved in sweet drinks.

One thing I am very interested in is that your calculations show that there will be a £1 billion cost to the Exchequer from the up-ratings in benefits to pay for the potential inflationary effects of the tax on sugary drinks. Could you talk us through that, please?

Robert Chote: Yes, certainly. The impact of the tax is to push up the level of retail prices, on the assumptions we have made, by about 0.25%. That has the impact of raising inflation, for a year, by about 0.25%—and then inflation goes back to where it would have been previously. We assume the Bank of England—because this is a shift in the price level—would look through it and they would not look to squish down this increase in prices in advance.

A consequence of pushing up retail-price inflation for that period is that the accrued interest on index-linked gilts goes up. This is really confined very much to the effect on index-linked

gilt. It is a small temporary transfer from drinkers to linkers. It is not an implementation cost, in the sense that it is not the set-up cost of producing the tax system; it is a consequence of having a temporary blip in inflation. It is about £1 billion.

Q109 Mr Rees-Mogg: What about the effect on up-rating benefits? Is there an impact there as well?

Robert Chote: It has other effects, for example the way we will uprate excise duties etc. All of the rest of it kind of comes out in the wash. There are other effects. The other effects net to broadly zero.

Graham Parker: The other thing to add to that is that the weights for the RPI are set in advance. Even if the new levy did reduce consumption of these drinks, there will still be that inflation rise.

Helen Goodman: Yes, for a time.

Graham Parker: Yes, just for that year.

Q110 Mr Rees-Mogg: Yes, for that year. There is a £1 billion cost to implementing it in the first year.

Graham Parker: By the time this is implemented, we are assuming that there is going to be less consumption of these drinks.

Mr Rees-Mogg: Yes, absolutely. Your initial assumption is that the tax would raise nearly £1 billion but, because of behavioural differences, you revised that down to £0.5 billion, broadly speaking.

Graham Parker: That is right.

Q111 Mr Rees-Mogg: From international experience, will it significantly reduce the consumption of sugar?

Robert Chote: That is beyond us. We basically have to look at the fiscal implications here. We have made a judgment on the consumers' price responsiveness. We have basically assumed that, to begin with, for every 1% rise in the price of sugary drinks, people consume 0.8% less, rising to 1% further on.

There then is some assumption about people reducing the sugar composition of the stuff they are doing. There is about 0.5% decline in volumes on that basis. The last component is that you have the creation of an incentive for avoidance and evasion activity, which is inevitable when you start to tax anything new. There is an element of that. Taking all of those things together, as you say, roughly speaking you move from a static pre-behavioural yield of about £900 million to the £500 million they are aiming for.

Q112 Mr Rees-Mogg: On the up-rating benefits side, is it to some extent the situation that the sugary drinks are going to be taxed and then people are going to be given the money back to buy the sugary drinks in the increase in benefits?

Robert Chote: I am not sure, by that stage, how many of the benefits will be frozen or limited. Inflation up-rating does not apply across the board as it would do under normal circumstances. I suspect that is less the case than it would have been in normal times.

Mr Rees-Mogg: Pensioners will still be able to buy their fizzy drinks, but the young will not. Is that it?

Robert Chote: The pensioners will be enjoying the benefits of the triple lock. At the moment, it does not look as though inflation is going to be the driving of the three surviving elements.

Mr Rees-Mogg: Those adding tonic to their gin and tonic will not be affected very much, but those who are younger and buying Coca-Cola may be.

Robert Chote: If you are buying relatively low-priced fizzy drinks, remember this is a volume tax and not a proportionate tax. The proportionate increase in the price of a relatively cheap fizzy drink is higher than the proportionate increase in one that is initially more expensive.

Q113 Chair: Are you surprised that the Chancellor has decided to adjust his overall fiscal arithmetic twice a year to take account of what are, after all, relatively small changes in your forecast—rather than say, “Well, I am going to wait a year or so to see what comes out in the wash”? He is spending right up to the limit the extra room he was provided with in the Autumn Statement, and he is now trying to find a way of plugging a gap, albeit at some political cost. That gap was created by your somewhat—relatively small—downward revision to that forecast.

Robert Chote: I am not sure whether “surprised” is the word, but you highlight a very interesting issue in respect of policy design and application. Inevitably, the pre-measures forecasts that we produce are noisy: they move up and down. We have detailed this in annex B of the report. We have done 13 forecast revisions to date. The revision to the underlying fiscal forecast on this occasion is pretty much bang in line with the absolute average. The famous 27 billion last time was only the ninth-largest revision of the 13 that we did.

In an environment in which that happens, the choice any Chancellor would have to take, confronted with this, is: how much do you allow the noise in the pre-measures forecast to go through and feed into noise in the final forecast, and how much do you try to offset it by fine-tuning policy to end up with a number you first thought of X months previously? It has certainly been the revealed preference recently for most of this change to be offset.

Chair: Only an economist could come out with a phrase like that—but do carry on.

Robert Chote: The Chancellor clearly sees a £10 billion in 2019-20 as a desirable feature of successive forecasts. It is for others to judge whether the degree of policy fine-tuning that is required for that to be the case is a sensible response to the noise in pre-measures forecast or not.

Clearly, in an environment in which you are setting yourself and many other countries are setting themselves clear quantitative targets, which most people applaud as a way of securing accountability and discipline, it does then raise this issue about whether you accept the degree

of noise and say, “It has gone up this time; it may go down next time. I am going to wait and take a judgment on this after I have looked at a few of them together,” or whether you do it time by time. As I say, we have to do the forecasts on the basis of the policy decisions that are taken.

Q114 Chair: Declaring my hand, it does strike me that there is a good deal of logic in trying to set those decisions in a medium-term fiscal framework rather than making those adjustments to what you have described as something that could turn out to be noise in the forecast. As you have said, this noise is much of a muchness with the kind of noise we have come to expect from forecasts, both yours and those that predated you, on which there is a lot of published data.

Robert Chote: Yes, I can see the logic of your position—although it would be inappropriate for me to comment. It is not our job to say how policy should be set.

Chair: After all these years, Robert, do you not feel you can offer even a hint of an emotional response—surprise?

Robert Chote: I will save it for my farewell appearance before you.

Chair: We will certainly take you up on that. Thank you very much for coming. I am so glad to be able to bring a smile to your face at the end of the hearing.

Robert Chote: It has been a long week. Thank you very much.

Chair: We look forward to seeing you again not before too long.