

Treasury Committee

Oral evidence: Budget 2017, HC 1069

Monday 13 March 2017

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Members present: Mr Andrew Tyrie (Chair); George Kerevan; Kit Malthouse; John Mann; Chris Philp; Mr Jacob Rees-Mogg; Wes Streeting.

Questions 1 - 93

Witnesses

I: Robert Chote, Chairman, Office for Budget Responsibility; Professor Sir Charles Bean, Budget Responsibility Committee, Office for Budget Responsibility; Graham Parker CBE, Budget Responsibility Committee, Office for Budget Responsibility.

Examination of Witnesses

Witnesses: Robert Chote, Professor Sir Charles Bean and Graham Parker CBE.

Q1 **Chair:** Thank you very much for coming to give evidence to us this afternoon. Can I begin, Mr Chote? This is not an idle question any more, now we have had an allegation of interference in the past with the process by which you come to your conclusions. Have you come under any undue pressure from the Executive to alter or amend, in any way, anything that you have reported?

Robert Chote: No, we have not and we have been provided with all the information we requested.

Q2 **Chair:** Do you think the new MoU is working satisfactorily?

Robert Chote: The test of that will be over time. It has obviously just been agreed and adopted.

Q3 **Chair:** You have had it in place in practice for this, have you not?

Robert Chote: Yes. It has certainly been a useful opportunity to make everybody clear of what the rules of the game are. Over time, the personnel you are dealing with evolve, so it has been less necessary for us to remind people of what the rules of the game are, because they have been freshly set out, and people have been talking about them and looking at them relatively recently.

Q4 **Chair:** Is it serving as a discipline on the Executive not to be over-enthusiastic in trying to get what they want into your report?

Robert Chote: Yes. I would not overstate the degree to which that has happened beforehand. As you know, we have had unsolicited drafting advice in the past, which I would not regard as pressure, having seen pressure.

Chair: That was the evidence you gave whenever it was. I cannot recall.

Robert Chote: It seems a long time ago.

Q5 **Chair:** It seems a long time ago now that I found myself trying to get agreement to a radically changed MoU from Terry Burns. Professor Bean, you have now had an opportunity to scrutinise the OBR economic models, I take it, and see them from the inside. What do you think of them and do they need any alteration?

Professor Sir Charles Bean: That is quite a big question, because there are inevitably lots of moving parts, and there are certainly some I want to talk a bit more to the staff about. In some cases, that is because I need to get to grips in a bit more depth with why things might be the way they are. The one thing I would say about the forecasting approach is that there is obviously a central role for a top-down judgment on the cyclical position of the economy and the evolution of potential output over the forecast period. In some ways, that is a rather different way of



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forecasting from the way we would have done it at the Bank, and it has merits and demerits, but it very clearly puts centre stage a central judgment, which is where productivity will go, and that drives a lot of conclusions about fiscal sustainability and the like.

Now, it is fair to say that, even if you did not have this top-down approach, judgments about the course of productivity would be embedded in individual equations in the Bank's model but, because it is so central, it is one area that I will want to talk a bit more to the staff about over the next few months. One other area I know I want to spend a little bit of time talking about is the way that they go about evaluating the degree of uncertainty associated with the cyclically corrected budget deficit. There are some methodological issues that need to be engaged with.

It is a very small staff. At the Bank there were about 100 people working on the forecast, in one way or another. At the OBR, the economy team is six people. It is only a pretty small operation.

Q6 Chair: What extra bang do you get for your 94-person buck?

Professor Sir Charles Bean: That is a good question. Of course, the other 94 at the Bank will be doing things apart from forecasting. There is lots of policy analysis. What they have at the Bank, which we do not really have at the OBR, is scope to do more in-depth research on a range of economic issues, but one obvious thing would indeed be why productivity growth has been so slow.

Chair: That was a skilful sidestep of the point I was making, really.

Professor Sir Charles Bean: I was going to come back to it. It is fair to say that there are probably diminishing returns to the amount of time you spend forecasting. Doubling the resources does not halve the—

Q7 Chair: Where is the kink in the returns curve? Is it at six, eight or 12?

Professor Sir Charles Bean: You can probably do a pretty good job with a team of a dozen or something like that. If you look around other forecasting groups, like the National Institute of Economic and Social Research, some of the better City forecasters like Goldman, the teams are about 10 or a dozen people. They might have a few research assistants doing some number crunching or whatever, but the payoff to having big staffs is that you can do more research into the underlying economic issues and go well beyond the mechanics of forecasting.

Q8 Chair: Now that we have two fiscal events reduced to one, why have we not got two forecasts reduced to one? I know that there is a statutory rule

Professor Sir Charles Bean: I was going to say that that is the straightforward answer. So long as Parliament tells us that we have to do two a year, we will do two a year.

Chair: Now is your opportunity to tell Parliament that Parliament ought



to take a look at it.

Professor Sir Charles Bean: It is a quite reasonable question: why do you want to do a forecast, if you do not need a forecast? Clearly you need a forecast around the time of the fiscal event, the Budget, because you need an assessment of where the economy is likely to be going and an appropriate policy setting. I think it is a perfectly reasonable view to take that you might want to drop the second forecast.

It is worth saying, though, that this hefty document is more than just an economic forecast. One thing that has impressed me about my first couple of months at the OBR is the role it plays in fiscal scrutiny. I told you that there are half a dozen people doing the forecast. You could say, "What are all the rest doing?" The answer is that the rest are holding departments' feet to the fire on their assessment of what is happening to the numbers on receipts, spending and so forth. I would say that 80% of the time during the forecast round is spent in that process. That is a pretty fair judgment, and it is worth recognising that you probably want that fiscal scrutiny process on something of a higher frequency than just annual.

Now, any document that goes with it obviously would not have the same form as the EFO, but there is a role for that fiscal scrutiny element. It is more like a conjunctural assessment of what is going on, but the actual forecast, it seems to me, you only really have to do at the time you need to make a forward-looking policy judgment.

Q9 **Chair:** You are going a bit further than you were at the beginning of your answer, when you said there was a respectable case to be made. You are now saying that your view is that we should probably only have one.

Professor Sir Charles Bean: As I say, it is not obvious to me that you need the second forecast for policy purposes, if you are genuinely only going to have one fiscal event a year. Of course, we know that Chancellors in the past have said that they only intended to have essentially one budget a year and slipped into having two, so we will have to see whether the intent is indeed carried through but, if you do that, it is not obvious to me that you would need a second forecast.

Q10 **Chair:** Do you think that not having one might reduce that risk and reduce the risk that they encourage Chancellors to fiddle with the policy unnecessarily?

Professor Sir Charles Bean: Possibly, yes.

Q11 **Chair:** Do you think that it would make for better policymaking to have one forecast, because Chancellors have fewer opportunities to meddle?

Professor Sir Charles Bean: Clearly there will be occasions when you need a second fiscal event, because something really unusual is happening, such as a fiscal crisis. Leaving that to one side, you could say that not giving them the opportunity would make them likely to say less.



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Q12 **Chair:** You could indeed say that. Would you say that?

Professor Sir Charles Bean: I have just said it.

Chair: Okay, I was just moving from "could" to "would".

Q13 **Chris Philp:** I certainly echo the Chairman's sentiments about minimising the number of forecasts, given that they are sometimes not wholly accurate. Just on your audit point, you mentioned that it might be useful to do a fiscal audit twice a year. Most audits of departmental receipts and spending are done, as you would audit in a business, annually, not biannually. Do you not think that one might do a once-a-year audit more thoroughly, rather than twice a year less thoroughly?

Professor Sir Charles Bean: The evolution of the public finances and exactly what is going on is sufficiently important that it probably makes sense to be doing it six-monthly. The risk, if you do it annually, is that you have a story that is playing for most of the year and then, all of a sudden, at the end of the year you come to the point when you do your audit and there is a big change in the explanation about what is going on, whereas, if you do it twice, there is a little more opportunity for a change in the narrative.

Q14 **Chris Philp:** I understand, thank you. I would like to turn now to the question of business rates. There are some small businesses, particularly in London, including in my constituency, that will see business rate increases of 60%-odd over the next three or four years. To what extent, Mr Chote, do you think the measures in the Budget, particularly the £435 million discretionary support fund, will prevent increases of that magnitude coming through over three or four years?

Robert Chote: It would depend very much on where that money is distributed and how it is distributed. You have a change that is intended overall to be revenue-neutral, so there will be gains and losses. The question then is how much and in what ways you wish to limit that. The difficulty at that stage, for people who look at the distribution impact of this, which is obviously not part of our remit, is exactly how that would be restricted. As I understand it, the money is being given to local authorities without much instruction to them as to how to dole that out. Whether they will choose to limit the most severe increases or whether they will choose to spread the available jam that they have been given more freely is for them to decide, and that will determine the answer to your question.

Q15 **Chris Philp:** The Centre for Cities has suggested that the relief fund will be directed almost entirely at London, which as a London MP I welcome. Is that an analysis that you share?

Robert Chote: We only produce the forecast at an England-wide level, so we do not look at the distribution. Certainly the Centre for Cities', the IFS's and the general view is that London is the area where the increases



are seen to be largest, but again it comes back to the issue about how the authorities decide to use the money they have been given.

- Q16 **Chris Philp:** Looking at the profile of the discretionary support fund over time, in the Red Book, it starts off at £180 million in the 2017-18 financial year, tapering essentially to nothing by 2020-21, yet the most severe increases in business rates, if you look at the upward cap on small businesses, do not really kick in until that time, around about 2020. Would I be right in saying that, actually, the discretionary support fund will not help soften the most severe impact of the blow because, by the time the upward cap has cumulated upwards, by about 2020, the discretionary support fund will have tapered down to almost zero?

Graham Parker: That sounds a reasonable point of view, because there is the transitional relief system, which actually smooths out the effect of the increases over the years. As you say, the full effects of the revaluation will not be felt for a few years.

- Q17 **Chris Philp:** In fact, there is a timed mismatch, in the sense that the discretionary support fund is front-loaded, but the business rate increases are back-loaded in time.

Graham Parker: That is my understanding of how the transitional relief scheme works.

- Q18 **Chris Philp:** Yes, it is. On transitional reliefs, I have noted that the largest businesses, with a rateable value of over £100,000, have a downward cap that cumulates to about 29%, whereas small businesses have an upward cap that cumulates to 64.2% over the six-year period. Have you done any analysis on what would happen if you set the downward cap at zero and reinvested the money saved in lowering the upward cap?

Graham Parker: No, I am afraid we have not. We are mainly concerned with the overall effects of this. We are just not looking at the distribution effects between different small and large businesses.

Robert Chote: We do not look at alternative policy design either. If that is a variance, then that would be outside our remit anyway.

- Q19 **Chris Philp:** I thought you might say that. Given you do not look at alternative policies, this may render my next question obsolete. The Chancellor, in his budget statement, said that in the coming autumn Budget this year he would look at measures to try to address our pollution problems by looking at alternative regimes for taxing vehicles in different ways, particularly diesel vehicles. Have you looked at or assessed any potential models for doing that, either in this country or overseas, and formed any view as to which might be effective?

Robert Chote: No. We will look at whatever proposals the Chancellor decides to go with or to consider at that time, but we do not do any pre-emptive analysis of that sort.



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Q20 Chris Philp: I thought you might say that. Let me just turn briefly to the question of stamp duty. I should draw the Committee's attention to my declaration of interest as a shareholder in a business that provides finance for construction projects. There have been a number of stamp duty changes, first in the Autumn Statement 2014 and again in the 2015 Autumn Statement, which were effective on 1 April last year. What is your assessment as to whether those changes have raised more or less revenue?

Robert Chote: Than they were expected to?

Chris Philp: Yes, than they were expected to and relative to no policy change.

Graham Parker: For the most recent one, the 3% supplement, the extent of forestalling surprised us. It has also raised more revenue than we thought it was going to, but that is a provisional assessment. There is a facility for claiming it back within three years, I think, so we do not quite know yet. We have got in extra money so far, but we may lose it later on in the forecast.

Robert Chote: Making a judgment about that steady-state repayment rate is not straightforward. Interestingly, you have a reform of the same type but with different parameters in Scotland. The evidence in both cases, one implemented earlier, you are seeing evolve over time. I think we end up at 15% for the UK non-Scottish one, but knowing where you end up is not straightforward.

Chris Philp: Is that a 15% reclaim rate, sorry?

Robert Chote: Yes.

Q21 Chris Philp: I think I am right in saying that the original forecast was that this would raise just under £1 billion a year. Based on the last quarter of calendar year 2016, it raised about £500 million just in one quarter, which implies a £2 billion run rate. That is to say it is raising about twice as much as was expected. Disregarding the immediate aftermath, because you had forestalling before and the reverse of that after, does that broadly correspond to your understanding: that it is raising about twice as much as expected?

Graham Parker: Yes. Our latest estimate for 2016-17 is £1.3 billion and it was £0.7 billion originally.

Q22 Chris Philp: What is your estimate for 2017-18 for the 3% surcharge?

Graham Parker: I do not have that, but it will probably be quite similar.

Chris Philp: It will be higher, because the run rate has gone up. The last quarter of calendar year 2016 is much higher.



Graham Parker: Again, it depends on these repayments. We are going to get repayments in the second year from the first year's statements, so it is by no means clear that it is going to go up.

Q23 **Chris Philp:** Some people have suggested that the stamp duty changes that I have referred to will reduce the total amount of stamp duty tax collected. Given that, in quarter four calendar year 2016, we saw the record ever stamp duty collections, would you say that people claiming that these changes reduce total receipts are right or wrong?

Graham Parker: If you look at our forecasts for stamp duty, it is going up rapidly.

Q24 **Chris Philp:** According to your forecasts, it is going up from £11 billion this year to £15 billion in the year 2019-20. Is your judgment that these changes will result in more or less stamp duty collection?

Graham Parker: It is difficult to say.

Chris Philp: You are forecasting a big increase.

Graham Parker: Yes, but it is probably not as big an increase as we were forecasting. I am not sure that we have actually looked at it in enough detail yet.

Chris Philp: Really? It is quite a big tax.

Graham Parker: It is quite difficult to isolate the counterfactual. With the higher rates for above £1 million, there has certainly been a slowing down in that area of the market, which means that we have had to reduce our stamp duty forecast in the last couple of exercises. How much of that is due to the measure and how much is due to other things?

Chris Philp: "Other things" means a slowdown in that part of the market.

Graham Parker: Yes, or just a reduction in demand for that level of property.

Robert Chote: There is a question then about what is driving that change at the top end of the market. It is striking with stamp duty as a whole that people look at the path of house prices on the residential side, but where you are with the level of transactions and, in particular, the level of transactions at the top relative to the rest can make a big difference to this and make it very hard to disentangle the policy impact from the fact that the transaction movements may be different from what you expected and differentially distributed across the house prices.

Q25 **Chris Philp:** HMRC produces a very interesting stamp duty report every year, most recently published on 30 September, which showed that the total stamp duty revenue in relation to houses over £5 million actually went up slightly in pound terms after the December 2014 changes, which is the opposite of what some commentators have suggested.



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Robert Chote: I would guess, and the number of transactions at that level suggests, that that is probably quite a volatile path. Let us see whether that persists over time, before drawing any firm judgments on it.

Q26 **Mr Rees-Mogg:** Good afternoon, gentlemen. Moving on to tax more generally, tax as a percentage of GDP is going to go up to 34.4% in 2019-20, the highest rate since Harold Wilson was Prime Minister in 1969-70. Do you think that this is as high as it can get and what effect do you think such a high rate of total tax take has on the economy?

Robert Chote: In terms of how high it can get, if you look at the range of tax-to-GDP ratios in different countries, they range from a lot lower than us to a lot higher than us. In that sense, the technical obstacles to having a higher tax-to-GDP ratio are not necessarily there. Where you end up is partly a political choice, as much as it is an economic, technical Laffer curve argument that, if you try to raise the overall tax rate too high, then you will not nudge it above a particular peak. I think it is quite hard. You can do that sort of analysis for individual taxes and individual tax rates, but it is not straightforward, as we had the debate over the 50p rate for example. Doing it at an economy-wide level is hard.

You are right that we are nudging up to this 1969-70 level. In the UK, the tax-to-GDP ratio moves within a relatively narrow band over decades. It was striking, for example, that even at the time of the financial crisis, if you look at how things diverged from pre-crisis forecasts in shares of GDP, it was because spending shot up as a share of GDP, not because tax receipts plummeted. Nominal GDP was weak. Charlie may know better than I, but from the various studies that have been done of the relationship between the tax-to-GDP ratio and the growth rate of the economy, for example when you want to look over a relatively long period, there is not a clear relationship. You worry at least as much about how that tax is being raised, and if it is being done in a relatively efficient and non-distorting way, as about the total amount.

Professor Sir Charles Bean: If you look across countries, there is not a clear regularity. You might think high taxes imply lower growth or whatever, but that does not stare out at you from the cross-section picture. Of course, the key thing is that taxes are raised efficiently and then the proceeds are used efficiently.

Q27 **Mr Rees-Mogg:** If you take a cross-country look at the UK, as Mr Chote was saying, there is a fairly narrow band, particularly if instead of just taking tax receipts you take total government revenue. It almost never gets above 38%. If it does, it only stays there for a very short time. Do you think that that indicates that we are pretty near the top of what the UK economy can bear or do you think that this time it could be different?

Professor Sir Charles Bean: I have to say that my interpretation would not be that it is at the limits of what we can bear. This goes back to the point of whether we are at the Laffer curve tipping point, and I suspect that we are well short of that. I suspect it is more that we are at



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something like a political equilibrium, if you like, and an attempt to push it a long way beyond that would not be sustainable. Equally, cutting it too low, because of what it would imply about government spending, would also be regarded as unacceptable.

Q28 Mr Rees-Mogg: You think the 34% to 38% band is basically the political equilibrium.

Professor Sir Charles Bean: That would be my interpretation of what we observe, yes.

Q29 Mr Rees-Mogg: Mr Chote, you were hinting at the balance between taxes that gets to this level. There seems to be some shift between income taxes and capital taxes. As we were discussing with stamp duty and various other taxes, there seems to be an effort to push more tax on to capital. What effects do you think this might have?

Robert Chote: If you compare it back to the 1969-70 period, you would have seen national insurance contributions rising as a share of GDP, while income tax falls as a share of GDP. That is partly down to political choices and where, until recently, the greatest amount of squealing occurs when you move the taxes at that level. We have had policy changes that have pushed up national insurance, not the most recent, but the contracting out, for example. The other change you would have seen on this is that VAT, which did not exist in 1969-70, has come in. Other purchase taxes and local taxes on production have come down. That overall margin has not changed a great deal. If you look at the one that has gone up over that period, it is probably NICs.

Q30 Mr Rees-Mogg: I was not quite going back that far. I was just thinking more recently that you have a forecast of a significant increase in capital gains tax coming in; that was reported in today's paper. Death duties are bringing in more money. Stamp duty has gone up. There seems to be quite a focus on capital taxation with this absolute promise to freeze all income taxes.

Robert Chote: Yes, as I said, there is a set of policy choices about whether you want to freeze these things. On the contrary, you have had the income tax base narrowed over time by increasing the size of the tax-free personal allowance. Yes, you do see those things. With capital gains tax, the degree to which you have seen increases in revenue over the last couple of years is very striking, and it is particularly striking how much it appears to be going up. It went up last year and is going up, despite a fall in the FTSE All-Share at the same time. There are some interesting questions about quite what is driving that, because it is not simply the value of the obvious assets.

Mr Rees-Mogg: Cutting the rate may be one reason. If you have a lower rate, people are more willing to pay voluntary taxes.

Graham Parker: There was not much in 2015-16, was there?



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Mr Rees-Mogg: It went down from 28% to 20%.

Graham Parker: Was that before? I cannot remember, to be honest.

Mr Rees-Mogg: It went up to 28% in 2010, mid-year.

Robert Chote: Entrepreneurs.

Q31 **Mr Rees-Mogg:** This is not coming from entrepreneurs. A lot of this is coming from people selling equities, which they may have held for years and years. Therefore, it is essentially up to them when they pay the tax. To my mind, it is quite a neat example of the Laffer curve at work, because you pay when the rate is low, but I do not seem to be able to draw you on that one.

Robert Chote: It is also a question of whether you can sustain that or whether people are selling and bringing forward a period of future disposals.

Mr Rees-Mogg: That is because they think the rate may go back up again.

Graham Parker: We have a chart in the book on page 101, which actually sets out the contributions to the increases in the tax-to-GDP rate. Apart from 2017-18, where there is a reversal because of the dividend forestalling, the biggest single factor in most years is still income tax and national insurance.

Mr Rees-Mogg: Yes, overwhelmingly, and then with VAT they are the three biggest contributors.

Graham Parker: The other thing to note is that we are going up from 36.0% this year to 36.4%, but our forecast for this year is an increase of 0.6% on last year. 2016-17 has gone up.

Mr Rees-Mogg: That is a big increase in a single year.

Graham Parker: As we go on at length in the book, there are lots of reasons for that, some of which are one-off.

Q32 **Mr Rees-Mogg:** I want to move on to a specific decision, which was not on the Treasury's scorecard and might not have got to you in time. That is misleadingly called probate fees. In fact, it is a death tax. Do you think that this creates a disincentive for saving? It would encourage people, because it is a fairly obvious tax, to reduce their estate.

Robert Chote: Is that relative to the impact of inheritance tax more generally?

Graham Parker: It is a question of how much extra incentive it produces to reduce the size of your estate, because there are already big incentives. You are right; it is the slab, et cetera. We did allow for some extra incentives to reduce the size of your estate, but it is actually quite



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difficult to calculate the value of the estate exactly before death. It is not as easy as saying, "Let us forestall some dividends", et cetera. It is a bit more uncertain, so I am not quite sure how much scope there will be. When you talk about the really big new probate fees, the stakes there are quite big and the inheritance tax they should be paying is much larger than the fees, so you have to think what extra disincentive there is.

- Q33 **Mr Rees-Mogg:** This is a fee that hits people who are exempt from inheritance tax, so the husband/wife transfer. This catches widows in a way that death duties do not, so there would be an incentive to transfer assets to a wife or a husband, obviously depending on the circumstances. It does not exclude charitable giving like death duties do, so it catches much more than death duties. Do you think it is a rather peculiar tax, because the rate essentially peaks on someone who owns a property in London but, if you are a billionaire, it is still going to be loose change as a percentage of your estate? Is that not just a bit peculiar?

Robert Chote: For those who are nostalgic about the slabby structure of the old stamp duty, it is being revisited to some degree. Coming back to your point about whether this is a death tax, the working assumption is that this is going to be defined as a tax, because the size of the fee is not obviously proportionately related to the cost of the service that you will be provided, which would be the basis for calling it a charge or treating it as a charge, as is currently the case in the national accounts. There is an element of that, yes.

- Q34 **Mr Rees-Mogg:** There is some countervailing offset in expenditure, is there not, because the fees that it covered are now deemed government expenditure.

Robert Chote: Actually, the increase has a very modest net effect on the public finances. At the moment, it is treated as negative expenditure. That has already been taken into account in the Ministry of Justice's spending settlement, so the net effect on the public finances is, we assume, a relatively small loss of inheritance tax, because of people thinking that they can take some action to get themselves slightly below a threshold, which knocks off £30 million to £40 million at most.

- Q35 **Mr Rees-Mogg:** It is not a hypothecated tax, is it? It is not going to stay in the Ministry of Justice. It is going to go in the consolidated fund.

Robert Chote: It is not formally hypothecated.

Graham Parker: Treasury and MoJ will have to decide if they treat it as a tax, and whether they make a classification-related change to total DEL or not.

Robert Chote: It is for the Office for National Statistics to decide, at the end of the day, whether it treats it as a tax. It is rhetorically hypothecated to school sports or something. No, hold on; I am guessing. Sorry, I am confusing my hypothecated taxes. That is another one.



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Graham Parker: There will be a Treasury decision as to what it does about the DEL. If ONS declares it a tax, it will be for Treasury to decide.

Chair: I think that we have as much clarity as we are going to get now.

Graham Parker: You are right that we were told about this quite late and we need to look at it in more detail, next time.

Q36 **Mr Rees-Mogg:** You are going to scrutinise the Treasury's yield of £300 million.

Graham Parker: We will decide what to put in the forecast, because I do not think it is going to put it on the scorecard.

Q37 **Mr Rees-Mogg:** Finally, if it was to hypothecate it, is that something that the OBR encourages, as a general rule?

Robert Chote: That is not something on which the OBR has a view. If you talk to my former colleagues at the IFS, they would urge you to be careful about hypothecation. On the example that I was briefly confusing that one with, the sugar levy, if you end up with the receipts not coming in as you expect, you then have to decide what to do about the expenditure that you had hitherto hypothecated.

Mr Rees-Mogg: You have hypothecated a non-existent tax, yes.

Chair: You used to be against hypothecation, but it now slips your mind when you are asked questions about it.

Robert Chote: I used to be as part of the IFS and, if I ever return there, I will have to revisit that issue.

Q38 **Kit Malthouse:** I just want to ask you about quarterly tax returns and Making Tax Digital. You have obviously looked at the bare numbers, but have you done any work on what the economic impact of Making Tax Digital might be?

Graham Parker: We have not actually looked at the effects on the numbers from making quarterly tax payments yet. That is a separate part of Making Tax Digital, which they have not asked us to look at yet. They talked about it, but they have not sorted the details of when they will actually do it and how. The only bit of Making Tax Digital that we have actually looked at is the effect that HMRC thinks it will have on the quality of the returns and the payments, not the actual quarterly payments.

Kit Malthouse: You have had conversations with the Treasury about the possibility of quarterly payments.

Graham Parker: They asked us, but we said, "We are not going to certify anything on that until you tell us when you are going to do it and how you are going to do it". They have not got to that stage yet.



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Q39 **Kit Malthouse:** That is quite interesting, because the Treasury is saying that it is not about quarterly payments at the moment. It is just about quarterly returns of information to the regulator.

Graham Parker: This is about making things digital and therefore ironing out some errors.

Kit Malthouse: You are saying that the policy direction is that there would be quarterly payments of tax.

Graham Parker: I think that is where they might be going, but they have not told us to do any work on it.

Robert Chote: If they come to us with that, we will put it through the normal process.

Q40 **Kit Malthouse:** Have you done any assessment of the compliance cost to business of Making Tax Digital? There are other organisations that have estimated the average compliance cost is going to be about £2,500 to £2,700 to business.

Robert Chote: We have not. I presume that there has been an impact assessment of the decisions that have been announced to date, which presumably came out with the legislation. I presume that they have not tried to estimate the quarterly payments yet.

Q41 **Kit Malthouse:** If, for instance, the average business rates bill was to rise by £2,700 on a business, you expect that to have an economic impact?

Robert Chote: I would have to look at the numbers in greater detail to see the number of firms that are affected and with what frequency.

Q42 **Kit Malthouse:** Line 17 in the scorecard seems to be an amalgamation of two factors: the delay that they have announced and the change to the cash accounting limits, to who and who cannot cash account. Did they tell you what the split is and how much they are saying the delay is going to cost them?

Graham Parker: Yes, they did tell us. We looked at both. They gave us separate notes on each of these components and we certified each one.

Q43 **Kit Malthouse:** The cumulative change, then, is £20 million, £65 million and £150 million cost. Do you know what the split is between cash and the MTD?

Robert Chote: I do not, off the top of my head.

Q44 **Kit Malthouse:** Would you mind telling us?

Graham Parker: It is really a question for Treasury.

Kit Malthouse: Okay, we can ask the Treasury.

Chair: They have not told you.



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Graham Parker: They have not given us costing notes with this information in, but it is their information, not ours. It is the costing, not the forecast.

Q45 **Kit Malthouse:** When this policy was first announced, the Treasury reckoned that, by 2021-22, it was going to raise getting on for a billion quid extra. There is a body of opinion, not least shared by some members of this Committee, that the Revenue assumption that all the errors were going to be in their favour may not be correct. Have you reached a view on that?

Graham Parker: They did not assume that it was 100% of the errors. They assumed that it would be mainly in their favour, but I cannot remember the percentages. It was certainly not 100% in favour of the Revenue.

Q46 **Kit Malthouse:** You would not have done any work on Making Tax Digital, which was announced in the Autumn Statement 2015, and the financial assumptions it made, which have not changed since then, I assume. In the two years since then, it has been at £965 million and has not moved.

Graham Parker: They certainly gave us a lot of information. They had done an analysis of errors, et cetera, and then tried to estimate how many of them would be cured if it was all digitised, so there was a lot of information there on the errors in each direction. I do not think we have looked at it since. I do not think we have any new information on that.

Q47 **Kit Malthouse:** You do not know whether the numbers they are presenting from the Spending Review 2015, against the numbers they now say would be saved, are accurate.

Graham Parker: I do not think we have any reason to change them, apart from these measures.

Kit Malthouse: You are saying you have not done any work on it.

Robert Chote: We have not re-costed that measure.

Kit Malthouse: They sent you a load of stuff. You said, "Thanks a lot", and took it as read.

Graham Parker: It does not work quite like that.

Q48 **Kit Malthouse:** How does it work?

Graham Parker: They send us something. We say, "We do not like that bit. Tell us more about it", et cetera. We can go through several loops of this process, until they satisfy us that it is reasonable.

Q49 **Kit Malthouse:** Did you on MTD?

Graham Parker: Yes, we certified it. I cannot remember; I suspect we gave it one of our higher uncertainty markings.



Q50 **Chair:** What does that mean?

Graham Parker: It means that we certify as reasonable and central, but the range around that central estimate could be quite big.

Robert Chote: We give every measure that is certified an uncertainty rating, based on the quality of the data that underpins it, the likelihood of behavioural changes and the complexity of the modelling that underlies it.

Chair: We would be very interested to see something on a piece of paper about that measure.

Kit Malthouse: We would. You are saying that they have given you pretty good data on these numbers, which no one else has seen, even in the impact assessment or the consultation. It was not even presented in evidence to us.

Q51 **Chair:** We might have been interested in it, but it did not cross our minds to press it that rigorously. I have just one further point, moving from the particular to the general, Mr Parker. Is there any reason why, retrospectively, most of the costing information that you are supplied with cannot be put in the public domain? Is there any individual taxpayer information in there? There might be.

Graham Parker: If there were, we would not see it. I suspect that there are some compliance aspects that HMRC would be worried about, if they divulged too much.

Q52 **Chair:** Explain that.

Graham Parker: One of the things we frequently ask them is how the new measure is going to stop people exploiting this loophole and then not open up new ones. As part of that, there might be information that would help people open up loopholes.

Q53 **Chair:** We can create a principle of predisposition for disclosure at an interval after the publication of the OBR—I do not know what that would be—with a number of caveats for exemption from the transparency requirement. Would you consider taking a look at that, Mr Chote?

Robert Chote: Yes. The thing that would need very careful thought about there is what that would do to the quality of the information and the analysis we were provided in the first place.

Q54 **Chair:** You mean you think it would all dry up.

Robert Chote: I think it could be a lot less candid.

Q55 **Chair:** Why?

Robert Chote: On the basis that the stuff is going to be published later on, discussions of different variants that you could opt for and the pros



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and cons of those might be something that you would lose. We can certainly think about it.

Chair: Yes. We are into a behavioural game theory issue there.

Robert Chote: I am wary of unintended consequences.

Chair: It needs a little bit of thinking through, but we cannot exclude everything just because we think somebody might throw a tantrum.

Robert Chote: No, but it may affect the quality of the analysis that we are able to present.

Q56 **Chair:** If it is not a tantrum and it has a sound basis, we need to think about that too, but there is a predisposition for transparency and some good reasons for it. There are some policy implications on MTD, which we are discussing here in this Committee, so we would be particularly interested in the information that we have just been discussing, as an illustration.

Robert Chote: Sure, and the other point to bear in mind here is that, unusually, in the comparison of us and the Congressional Budget Office, the Government own the costings that we then certify. It is not our costing; it is a costing that is presented to us by Government, so it would not be for us. We would not be able to give it to you unilaterally, even if we thought that was sensible.

Q57 **Chair:** No, and I am not raising that at present. I am raising a different point. Perhaps you could come back to us. Try not to make it one of your completely deadpan straight-back letters, please. I am sure you can add a bit of colour to it, a bit like your shirt.

Robert Chote: Is this all the thanks one gets?

Chair: All that hard work, I know. We have been having exchanges on the Committee for too long now.

Q58 **John Mann:** Mr Parker, total managed expenditure is going up over the six years by £100 billion. Of the total managed expenditure, how much would be rightly apportioned to Scotland?

Graham Parker: I cannot remember. What is the formula? I cannot remember what the Barnett formula is.

Robert Chote: For total managed expenditure, we are producing a forecast on a UK basis, so we do not forecast on a country-by-country basis. There are revenue and spending figures published for Scotland by GERS, where that information is, I presume, but it is not something that is in the book.

Graham Parker: It is not something we look at.

Q59 **John Mann:** I am just wondering how much would be lost to Scottish



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responsibilities, should they choose to separate off. I will presume around 10% then. I do not know who would answer this, whether you are representing the labour force and migration mandate in answering questions, Professor Bean, but you have presumed departure from the European Union at a set date. What is your projection in the year after that date for the reduction in EU nationals living in this country?

Robert Chote: We do not produce a forecast on that basis. What we do is use the Office for National Statistics population projections as the basis for the fiscal forecast. We are currently using the principal population projection, which gives you an overall number showing net inward migration declining from roughly the rate that it has been in recent years to 185,000 net incoming in five years' time. The latest outturn data, for what it is worth, appears to be consistent with that trajectory, but there is a long way to go.

John Mann: You are obviously very aware of what Government policy is.

Robert Chote: Is that on the migration regime we are going to move to?

Q60 **John Mann:** No, it is on migration from non-EU countries and government targets. I am more interested in your projection and how you have teased this out, because you must have something built in. There are lots of people suggesting that lots of EU nationals will either be thrown out of the country in 2019 or, because they presume they are going to be thrown out, will act accordingly. That obviously impacts on your projections. I am just trying to see how much you are counting in for this or are you not counting on that happening?

Robert Chote: We are not making an explicit adjustment on a particular policy development. We have not changed this assumption since the one that we made back in the autumn that, of the available Office for National Statistics population projections, the most sensible one to go with was the principal projection, which implies slightly less net inward migration than there would have been in the absence of a vote to leave, through a combination of the presumption that you end up, in some dimensions, with a tighter regime at the end of it, but also that there would be a weaker pull factor in the meantime. We have the net inward migration numbers coming down from about 270,000 to 280,000 at the moment to 185,000 at the end, in a relatively smooth line.

Q61 **John Mann:** In the Autumn Statement, the Chancellor's big thing that was going to totally revitalise the economy was going to be housing and he allocated a tremendous amount of money to help bring forward housing. Is this working through yet? He allocated over £5 billion, which is a significant new sum of money to entice housebuilders to build. Are we seeing the products of that and how is that impacting on your projections?

Robert Chote: In fairness, I cannot remember what we did with this at the time, but it would have affected our residential housing investment forecast last time. I do not know how substantive the adjustment was,



but I do not think you would expect there to be much firm new data available between the Autumn Statement and now, on which you would expect to come to a very different view, whether the original view turns out to be correct or not.

- Q62 **John Mann:** This is one of the areas where Government could decide to create a lag by slowing down the processes. As there is so little publicity about how anyone can get hold of any of this money, that would appear to be happening. It was not just that public expenditure, but obviously the huge multiplier effect of stimulating the housing market that the Chancellor eulogised as his main theme in the Autumn Statement. He did not mention it at all this time. I cannot see any suggestion that that is working through. When would you normally expect that to be working through, in terms of something that you can be quantifying and building in either the tremendous success or the abject failure of policy, in terms of the real economy?

Robert Chote: I presume, by the time we get to the next Autumn Statement, you will at least have a sense of what the outturn data is for the first year. Doing it on the basis of three months, and particularly the three months over the Christmas period, is not going to give you very much new useful information. By the time you get through to a year's worth of full data, you can start to see the two issues. There is the money moving as you anticipate it and the houses moving as you anticipate it. Presumably we will have more data on both of those than we do at the moment. I do not think it is something where we felt that, if you probed a great deal, you were likely to learn a great deal new, at this stage, but it is something you would come back to.

- Q63 **John Mann:** In terms of the objective to return public finances to balance at the earliest possible date in the next Parliament, do you interpret that to be at the beginning or the end of the Parliament?

Robert Chote: As early as possible within it. You could say that the limit to that policy is at the end of the Parliament, if it does not prove to be possible to do it earlier than that. Our forecast does not formally go beyond 2021-22, so we cannot definitively judge progress against that target but, on the face of it, it does not look like they are on course to achieve that yet. You still have a deficit of about 0.7% of GDP in the final year of our forecast 2021-22, which is either the first or the second year of the Parliament, depending on precisely how you define it.

Moving forward thereafter, if you were to assume that the Government increased tax allowances and benefits in line with inflation, rather than with earnings, you would get a further fiscal tightening through the process of fiscal drag. You would be pushing up the tax-to-GDP ratio even higher; you would be reducing the generosity of working age benefits by about 10% relative to earnings. That would probably be sufficient, all other things being equal, to get you to a surplus by the end of 2025 or thereabouts.



At the same time, there is also evidence that you would have upward pressure on health costs and pressure on spending from an ageing population. It is obviously for the Government to decide whether to accommodate those, but that would be an equal pressure in the other direction. All we can say at this stage is that the Government have not made it clear what policies are in place, and would be in place over the course of the next Parliament, to make you confident that they are on course to achieve that.

Q64 **John Mann:** Does that make the fiscal mandate somewhat meaningless?

Robert Chote: The Government used interesting language, for the first time describing it as an “interim target”, which one had not heard before, placing emphasis on the ultimate fiscal objective. It is a striking contrast between the quite considerable amount of room for manoeuvre that there is on the fiscal mandate, the target for the cyclically adjusted borrowing, and how difficult it looks to be to get to that ultimate fiscal objective in the course of the next Parliament. It highlights the transition path that you would have to go down from meeting the fiscal mandate to being where you want to be in the end of the next Parliament. If you have used up some of the fiscal mandate room for manoeuvre, you have an even tougher task of getting to the end.

Q65 **John Mann:** I would have thought the members of the MPC would be paying particular attention to how you are contemplating the fiscal mandate as a body, whether the Government are on target or whether this is being reworked and reworded into something pushed into the longer term. Is that creating any real dilemmas for you at the moment?

Robert Chote: It is not, in that sense. As far as the Bank is concerned, obviously it has a shorter forecasting horizon than we do, so it does not even get as far towards the end of the Parliament as the one that we use. As I say, our job is to produce the best projections that we can and to hold the Government to account or to be transparent about whether we think that leaves them on course to achieve the objectives. We think that they are on course to achieve the fiscal mandate with considerable room for manoeuvre, fractionally less room for manoeuvre than they had in November, but a statistically and fiscally insignificant difference. Then going from where you are at the end of this forecast to balance thereafter poses a lot of challenges that the Government will need to explain how it is going to address, in order to be confident that they will get there.

Q66 **John Mann:** You are confident that they will meet the fiscal mandate by 2022.

Robert Chote: In the earlier time horizon, they have more than 1% of GDP of room for manoeuvre on the fiscal mandate. On past forecast performance, that suggests about a 65% chance of hitting or achieving the fiscal mandate. That is clearly bigger than 50%, but by no means a done deal.

Q67 **John Mann:** I have one final question. There is a spike in capital



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spending in 2020-21. What is that?

Graham Parker: It is a good question.

Robert Chote: It comes from the plans that the Government set out. I think that is a legacy of a Spending Review when the Government had particular objectives for what they wanted a variety of indicators to look like in 2021. You sometimes end up with a strange path, which ends up being smoothed out the closer you get to it. We will see if that happens to this one as well.

John Mann: We can anticipate some smoothing, then.

Robert Chote: We forecast on the basis of current policy. Policy can always change.

Q68 **Chair:** I would like to turn briefly to business rates. The Government have withdrawn their plans to disregard appeals against valuations that were within the bounds of reasonable judgment. You will have seen this, I am sure. It is reported that this could yield £2.5 billion over the next five years. Why is that not in the scorecard?

Graham Parker: It is not in the forecast either, so it is nowhere, as far as we are aware.

Q69 **Chair:** It is a very unusual £2.5 billion, is it not? It is not in the forecast; it is not in the scorecard. It is a bit like Heisenberg's uncertainty principle, which was on my mind earlier today.

Robert Chote: Who is claiming £2.5 billion?

Chair: The Government. Oh, I am not sure it is the Government. You are quite right; even that is uncertain.

Robert Chote: I would check the robustness of the estimate.

Graham Parker: There was an article in the *Times* on Friday, I think.

Q70 **Chair:** Do you think that they will need to process a lot more appeals in order to get this money, or have you not given it any thought at all?

Graham Parker: They will get this money by not allowing some appeals to go forward.

Chair: Yes, but they have to process the ones that they do in order to get the money.

Graham Parker: Most of the appeals will actually cost them money, so not processing them saves them money. We have not put it in yet. I suspect it is because they have not decided how they can do it and we have not seen any information on it at all.

Q71 **Chair:** We are back to the question, which is part of the reason I was raising this. It would be handy to have some of the information about



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costings. Wherever possible, it would be helpful to have more published, so that we can have a more meaningful conversation than we have just had. I think you are agreeing, Mr Parker. You are nodding your head.

Graham Parker: Yes, but there is no costing yet. It is not a question of publicising it.

Robert Chote: I do not think the policy is firm enough to have a costing to have a debate about at this stage, is it? The original intention with this was to try to set this in such a way that you removed quite a lot of the frivolous appeals, which would not, therefore, have a great deal of cash impact. It is not something that we would be in a position to scrutinise if it had been brought to us at this stage.

Q72 **Wes Streeting:** On page 33 of the "Economic and fiscal outlook", you set out some of the difficulties in producing forecasts on the basis of current government policy in relation to Brexit, which I know is a theme we have discussed with you before. With that in mind, I want to turn to page 90, where you say, "Looking ahead, our PAYE forecasts assume relatively uniform earnings growth across the distribution, but that the top end will be disproportionately hit by the UK exiting the EU". How much work have you undertaken to confirm that statement?

Robert Chote: It is a relatively modest, broad-brush adjustment assuming that the impact on the financial sector might be disproportionately large relative to the rest of economy. Given the fact that that is a relatively important source of receipts, making some modest adjustment seemed to be appropriate, but it is a relatively broad-brush adjustment on the basis of the information that we have.

Q73 **Wes Streeting:** How much of a hit are we talking about in terms of the impact?

Robert Chote: We can get back to you.

Graham Parker: It is the same as we did in the autumn.

Robert Chote: There is no new number on this now. I can get back to you.

Q74 **Wes Streeting:** Relatively speaking, how much of a risk is there arising from the judgment that you have made?

Robert Chote: As this whole box that you are referring to here points out, the distribution of wage increases across the income distribution has been a source of forecast error in the past, generally speaking. Also, when you are producing a macroeconomic forecast you are focusing on some overall number for average earnings growth. However, you can see from here that, going back to 2001, you have had some very distinct periods of different behaviour from the top to the bottom of the income distribution. One thing that is striking here is the weakness of weekly earnings growth at the very top of the distribution, which you have seen in both the 2010 to 2013 and 2013 to 2016 periods. Obviously, that is



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more significant for revenues than movements of an equivalent size at the bottom end of the income distribution.

Q75 Wes Streeting: Overall then, there is a significant source of uncertainty in terms of forecasting public finances.

Robert Chote: The specifics for the financial sector, yes, but this point makes the broader issue that even if you could know with confidence what the average earnings growth is, the impact on the effective tax rate can be significantly different depending on whether it is skewed with the more rapid growth rates at the bottom and slower ones at the top, or even across or a whole variety of different patterns.

Professor Sir Charles Bean: You might be tempted to think that that weakness in the 2010 to 2013 and 2013 to 2016 at the top end is a financial crisis aftermath effect concentrated in the financial sector. It is not. It is more widely spread than that across a number of professional occupations; doctors are certainly part of it. We think some of the story may be compositional with changes in the age distribution within given categories. There is more going on than just the financial sector there.

Q76 Wes Streeting: A couple of questions arise from that. The first is: your analysis of the distribution of earnings growth shows that growth was stronger in the lower half over the past few years. How sustainable do you think that growth in the lower end is over the coming period?

Robert Chote: One thing you have had is an adjustment to the national living wage, so there will be a readjustment of the earnings distribution in response to that. Obviously, that depends, in part, on how that evolves, but to begin with you might see more of an effect than you would do when the system has settled down into something more like steady state.

Q77 Wes Streeting: It is the increase in the national minimum wage that is largely the driver in the lower earnings growth.

Robert Chote: Yes.

Q78 Wes Streeting: You have talked already about the difficulties in forecasting the extent to which wages and, therefore, the income tax take are going to rise. The OBR has consistently over-forecasted in this area. What have you done or what might you do to correct some of your over-optimism in that aspect of your forecasting?

Robert Chote: In terms of what has happened over the past, a striking, regular feature has been that earnings growth has been weaker than we anticipated, but employment growth has been stronger than we anticipated. There is one issue about whether the overall size of wages and salaries, based on which income tax and national insurance, to a degree, is paid, you get that right. Also, it is about whether, if there is growth in that, it is coming more from earnings or from employment growth. If it comes from earnings growth, that tends to be better for the revenues and better for the public finances, because you are pulling



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people up into different tax brackets, whereas if you have a lot of the increase in aggregate wages and salaries being driven by employment being relatively strong, that can be income spread around amongst a lot of people who pay little or no income tax. One of the reasons that we have made those sorts of forecasting errors is not over the overall amount of wages and salaries, but that that mix has been fairly consistent and that is linked to the productivity puzzle: weak productivity growth has corresponded to weak earnings growth, but then strong employment growth, and that has had its effect.

Professor Sir Charles Bean: Both the OBR and the Bank, for several years, have been suggesting in their forecasts that they expect to see productivity growth picking up. They also expect to see pay growth picking up, not only because of productivity growth picking up but also as the labour market gets tighter. Both of us have been surprised to the downside. Both of us have pencilled in falls in the equilibrium unemployment rate; that was something we put in this particular round again.

In our central projection we still have some modest pickup in productivity growth towards the end of the period. This is a really big unknown, in some sense: are we going to revert to the sorts of productivity growth rates that we saw historically, or are we in a world of permanently lower productivity growth? This is something there is genuine debate about in the academic world. There are productivity pessimists who think that we are reverting to pre-Industrial Revolution productivity growth rates. Personally, I am not in that bucket. I think we will eventually see pre-crisis productivity growth rates being re-established. We will not make up the shortfall relative to the pre-crisis trend in the level of productivity, but the actual growth rate, I think, will come back, essentially because there are enough advances in knowledge taking place in nanotechnology, biotech, all these sorts of things, which will eventually start feeding through into tangible productivity growth.

Q79 **Wes Streeting:** I am tempted to lead you into debate about productivity growth a little further. Has the OBR done any analysis corporately, as it were, as to why productivity growth has been so weak? I am also interested in your individual opinions on what you think the drivers are for weak productivity growth and what, if any, levers could be pulled in the short term to try to reverse that trend.

Professor Sir Charles Bean: It is very difficult to change the underlying productivity trend. Governments have said year after year after year that what they want to do is boost productivity, and they are quite right to say so. At the end of the day, it is almost the be all and end all that drives living standards. However, it has proved remarkably difficult to change that underlying trend.

In terms of the explanations for the recent weakness, obviously the OBR has relatively limited resources to research in this area. It is an area, of course, where the Bank did a lot of work while I was there and I have no



doubt it has continued to do it. In the years immediately after the crisis, there was a bunch of explanations, which now look less plausible the further into the past the crisis has receded. There may be an element to do with low productivity firms being kept alive by continued low-cost credit—the “zombie firm” story. I do not think we know how big that is, but there may be a bit more to it than certainly I thought originally, back in 2010-11, when we started talking about that. In that view, if interest rates start rising, you might expect to see some weeding out of some of the low-productivity firms. Of course, the crucial thing also is whether the high-productivity firms get brought in as well to get the process of creative destruction going.

- Q80 Wes Streeting:** There is a very obvious link between low productivity growth and the subsequent impact on wages, but I wonder if you agree with Michael Saunders’ view that weak pay has led to lower productivity growth, i.e. that the causality works both ways.

Professor Sir Charles Bean: Certainly. Absolutely. It is bi-directional. If pay growth is weak, then it encourages firms to adopt labour-intensive forms of production, especially also since that is potentially more flexible than more capital-intensive forms of production in a world where uncertainty is high. That also makes sense, so he is absolutely right on that. I would take the view that if you had a given path of output growth, it would be better to have an employment-rich, productivity-low mix. I would far rather see more people being in work, but then the crucial thing is that as you start reaching the limits to expansion in the economy, you start seeing the work as being reallocated and productivity being driven up. This is why both we and the Bank have continually expected to see productivity picking up at some point, because that is the process that should kick in as it gets harder for firms to find the labour they need. As there is upward pressure on pay growth, then you should see people moving away from labour-intensive forms of production.

- Q81 Wes Streeting:** Finally, in some ways, our debate in Parliament about what is happening in the labour market, the rise in employment and the decline in unemployment has masked somewhat some of the underlying trends in the labour market, particularly concerning self-employment, zero-hours contracts, the gig economy, particularly around some of those low-paid, insecure jobs. I am curious to know, from the OBR’s perspective, to what extent you believe this has contributed to weak pay growth and what the implications are, in this respect, for the public finances. Obviously, there is a lively debate about self-employment, which we are having at the moment in relation to class 4 national insurance contributions. However, there is a bigger issue here for public finances, which you have already touched on a bit in terms of what happens if people are re-entering the labour market but on low pay. There is a clear issue there in terms of income tax contribution if they are earning below the threshold, but I wonder if you might say a bit more about the extent to which the OBR has its eyes on this and the extent to which we should be concerned in Parliament.



Robert Chote: In terms of its impact on the public finances and the story of the increasing importance of self-employment, we have made an assumption that self-employment rises as a share of total employment in this for the first time, rather than assuming that they move in parallel. The experience over the past has been that the increase in self-employment has been more disadvantageous to receipts than we had originally anticipated, because more of those self-employed people were on relatively low incomes and not earning a great deal. Leave aside the question of the relative generosity of the tax treatment, but just, for a given growth in self-employment, more of that was taking place at low incomes than was implicitly assumed in the forecast and that was one of the other issues that was making the effective tax rate on labour income come in lower than originally anticipated.

Graham Parker: We also ought to think about incorporations, where both the self-employed and the employed are incorporated. That results in, usually, a big drop in labour income, in that, if an employed person incorporates, they will pay themselves a much lower amount to cover pension contributions, et cetera, and the rest will come in dividend income. It is the same for the self-employed. That, as well as costing a lot of tax revenue, will reduce average incomes, and it is big.

Robert Chote: Again, with incorporations, it is not just driven by the tax advantages. In particular sectors and particular jobs there might be reasons why more people will want to arrange their affairs in that way. Therefore, you should not purely see the rise in incorporations as people grabbing for the tax advantages. There may be other factors in the organisation of work and the labour market that contribute to that.

Q82 **George Kerevan:** Good afternoon. I am interested in your growth forecast. Recent growth very much driven by consumer spending and you analyse the savings ratio falling to an historic level in 2016. Looking forward across the forecast period, you suggest the savings ratio will stabilise. What do you mean by "stabilise" and why are you so sure it will stabilise?

Professor Sir Charles Bean: "Stabilise" is the easy bit: mainly broadly stable. Why are we so sure? We certainly are not sure. I have spent many happy years on the MPC gaily expecting consumers to stop spending like mad ahead of the crisis and continually being surprised at their resilience. However, the savings rate now, particularly if you take out the pension element, which a lot of people probably will not be really conscious of, is down to levels that we saw very early on in the crisis period, so historically pretty low. It seems to us unlikely that the continuing trend downward—

George Kerevan: People just cannot borrow any more.

Professor Sir Charles Bean: It is worth pointing out that what we have seen over the past year is not just borrowing, although there has been reasonably rapid growth in consumer credit and that is something that



the FPC has started to get worried about, but it is also consumers running down some of their savings as well. Both of those are ways of financing an excess of spending over income, but there is clearly a limit to how much you can do that. Basically, consumers have been bringing forward, to a degree, spending from the future to the present. We are entering a period where real incomes are going to be stagnant, at least in our central forecast. That may turn out to be wrong if productivity picks up, but the chances are pretty weak real income growth. That is a marked contrast with 2015, when you had strong real income growth, largely on the back of very weak inflation.

One of the reasons why consumer spending was strong through last year and surprised most commentators for the up side was, in part, because of that projection of the strong real income growth in 2015 and through into the future. What we think is reasonable is basically for households to think they cannot afford to keep consumer spending growing rapidly at a time when their real incomes are relatively stagnant, which is why we expect a significant slowing. I just want to finish with emphasising this point about the uncertainty, precisely because it is uncertain and is obviously a key judgment in terms of the outlook for the next year or two. It is why the scenario that we have put in chapter five has the different saving rate assumptions.

Q83 George Kerevan: I agree with your hunch that it is likely the savings ratio will stabilise, but whenever I put this to the Bank I have had a much more optimistic view.

Professor Sir Charles Bean: They are certainly more bullish than we are, yes.

Q84 George Kerevan: People are asset-rich and unsecured lending is quite small as a proportion, et cetera. I get a much more gung-ho view from them about the potential for continued consumer spending. Any comment?

Professor Sir Charles Bean: It is possible. I would still be worried, though, if the savings rate was falling to very low levels on the basis of perceptions about the durability of recent wealth increases. The consumer is, potentially, quite vulnerable if that continues.

Q85 George Kerevan: I agree on that. Other members of the Committee might like to say something, but does the OBR have some kind of view—intuitive, theoretical, no matter how detailed—of the vulnerability of the household sector to shocks?

Robert Chote: It is something that we look at in terms of the potential risks to it. We occasionally use the scenarios for exactly the sort of thing that we have done in this case and say, “What are the fiscal implications of these things moving?” However, we focus more on if there were to be a continued movement in the saving ratio in the direction there has been recently, if it were to snap back what would the implications of that be for the fiscal position rather than the level of granular interest that, for



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example, the FPC would have to take in, whether they are particularly concerned about the precise growth rates of consumer credit, for instance. Obviously, if they were taking policy measures that looked likely to move this sort of behaviour, then that is something that we would potentially want to take on board.

Q86 George Kerevan: Geek that I am, I was fascinated by the two scenarios until I read that they did not lead me anywhere. You said that whichever way we had, the boom or the bust scenario for consumer spending, it did not really impact on the growth rate. If there was a boom, the Bank would take action, raise rates and curb the boom, so over the forecast period we would be back to where we were. If there was a bust, if people decided they did not want to go on saving and there was a fall in consumer spending or a serious moderation, you think the Bank is going to move into negative interest rate territory, which the Bank has never admitted here in this Committee.

Robert Chote: We use that illustratively. That is the way in which you model: it could be QE or—

George Kerevan: Okay, but either way your two scenarios end up with the boundaries still being the same growth rate. Is that a reasonable interpretation?

Robert Chote: It is partly the way in which this is structured. These are cyclical hits, effectively speaking. We have increased growth in calendar year this year, for example, but we have reduced growth in future years. That is because we have stuck with a view about what you think the path of potential GDP is going to be and, therefore, if the Bank is setting monetary policy in order to hit the inflation target, where, implicitly, they want GDP to be at the end of that five-year horizon. If you make that sort of broad underlying assumption that you are not moving potential GDP around, then if you have cyclical hits or boosts it does tend to shift the amount of activity intertemporally rather than leave you in a different structural position at the end. Obviously, there are concerns and people have written lots of work on this. If you do have an extended period of a negative output gap, for example, does that move potential in and of itself? However, for the purposes of illustrating the implications of a cyclical shock from higher or lower consumption, we were trying to isolate the analysis around that.

Q87 George Kerevan: Having had my fingers burnt in the forecast game myself and knowing where we have been over the last 18 months, I am just trying to test the validity of your forecast, and we know how difficult that is. You seem to be saying you are relying on the Bank of England keeping growth broadly in line with its inflation targets. Therefore, it does not matter what happens and we can have the extreme scenario of consumers stopping spending or of them borrowing like there is no tomorrow, but we always end up, at the end of the forecast period, back with roughly the trend rate of growth, because that is what the Bank will deliver. That does not seem, to me, satisfying somehow, because it



suggests that the OBR will simply tell us that the Bank will deliver a certain growth rate and, therefore, whatever scenario happens it does not change.

Professor Sir Charles Bean: There are two key assumptions in this and you are right to question them. The first is that policy has traction. That is not a problem, obviously, if it is a consumer boom, because you can raise rates and bring it back, but there is a genuine question: if you needed to provide a lot of additional stimulus, how much traction would you get from further QE? Of course, we talked about that a week or two ago. Second, is the point Robert has already made: that at least the assumption here is that cyclical movements do not have lasting effects on the path of potential output. You could take the view, particularly if it is a long-lasting downturn, that you might have lasting damage to potential output. Indeed, one view, obviously, for the weakness of productivity growth for the best part of the last 10 years is that it is a consequence of the financial crisis and everything that has wrought. With a significant downturn of that sort, it is reasonable to start thinking about an impact on potential output. What you then need to do is put the simple cyclical savings scenario that we look at here together with what you looked at in the November one, which is a productivity variant. Anything that changes potential output significantly has big effects on public finances.

Robert Chote: If you look at the series of things that we have chosen to use to do the scenarios, whatever is driving it, whether it is the oil price or whatever, if it is something that is affecting potential and, again, exactly what the mechanism is, then that has a longer-lasting, more significant effect and it matters more when you have a fiscal target that is set in structural terms.

Q88 **George Kerevan:** Where I am going with all this is if the savings ratio/consumer spending “stabilises”, then what picks up growth has to be largely business investment. What makes you feel confident that business investment is going to pick up?

Professor Sir Charles Bean: It does not have to be solely through that. It could also be through the exchange rate. If you have monetary relaxation, you may get some stimulus through the exchange rate.

Q89 **George Kerevan:** You would have an even bigger drop in the exchange rate.

Professor Sir Charles Bean: You would, yes, absolutely. You might well get that if we had a sharp downturn and an aggressive monetary policy response. Of course, some of the effect may come through inventory.

Q90 **George Kerevan:** I know the Chancellor is expecting a pickup in business investment, but I am just trying to be sensible about the path of business investment.



Professor Sir Charles Bean: We have business investment picking up, to a degree, in our central projection. The question is whether you could get it to pick up much more than that, given yields are already pretty low, getting effective yields even lower through more QE or whatever. There is an open question about how much traction you would get from that, and that was something I discussed with you when I was here a week or so ago. There are genuine questions about how much stimulus could be provided in the event of a significant downturn, but the scenario that we have certainly does not have that. It assumes that policy is still sufficiently effective to ensure that the weakness in consumption gets offset within two or three years.

George Kerevan: By a rise in business investment.

Professor Sir Charles Bean: Partly by a rise in business investment, partly net trade.

Q91 **George Kerevan:** Why is business responding in that fashion?

Professor Sir Charles Bean: Some of it is consumer spending, of course. You are working, in part, against the rise in savings and slowing in consumption. You are trying to offset that and get consumers to do some more spending. That will be part of it, but you are right: some of it will come through the investment channel and some of it through the net trade channel.

Robert Chote: There is also the issue about to what extent—and this is obviously very hard to judge—business investment has been depressed below where it would have been because of the uncertainty surrounding either side of the referendum. You have seen business investment is weaker than it was a year earlier. We are assuming that it continues to be depressed relative to where it otherwise would be, but on a shallower and more protracted path than had previously been the case.

Q92 **George Kerevan:** It has to rise because it has been low for so long.

Robert Chote: There can be elements of that. One thing you do have to be very wary about this is the quality of the data that you are judging this on. The volatility or the size of movement in business investment and the degree to which the picture can be revised is quite significant. At the moment, we have the evidence that it has been weaker, perhaps related to uncertainty, perhaps related to other things, and some expectation of it picking up thereafter.

Q93 **George Kerevan:** Finally, for your autumn forecast, will you be examining the potential for an independence referendum in Scotland in the next two years?

Chair: The answer is yes or no.

Robert Chote: We base this on UK Government policy and I am not sure what it was when I left the office.



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Chair: Thank you very much, all. We always pick up something when we bring the OBR in and it has been an interesting exchange. Thank you very much indeed. You are going to send us one or two things.