



Select Committee on Economic Affairs

Corrected oral evidence: Chancellor of the Exchequer annual evidence session

Tuesday 12 September 2017

3.35 pm

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Members present: Lord Forsyth of Drumlean (The Chairman); Baroness Bowles of Berkhamsted; Lord Burns; Lord Darling of Roulanish; Baroness Harding of Winscombe; Baroness Kingsmill CBE; Lord Kerr of Kinlochard GCM; Lord Lamont of Lerwick; Lord Layard; Lord Sharkey; Lord Tugendhat; Lord Turnbull KCB CVO.

Evidence Session No. 1

Heard in Public

Questions 1 - 11

Witness

I: Rt Hon Philip Hammond MP, Chancellor of the Exchequer.

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Examination of witness

Rt Hon Philip Hammond MP.

Q1 **The Chairman:** Chancellor, you have had a very busy summer. Welcome back to the Economic Affairs Committee. I understand that you have an announcement that you would like to make to the Committee.

Mr Philip Hammond: If it is your wish, I can share with you hot-off-the-press news that the Budget will take place on 22 November, which makes this meeting very timely.

The Chairman: The clerk and I had a small wager on the date, and she has just lost 50p.

Mr Philip Hammond: Less duty.

The Chairman: As you know, our inquiry on the economics of higher, further and technical education is just beginning. It will look at the financing of student loans, among a number of aspects, so we have some questions for you on the Treasury aspects of that. Can you explain why the discount rate for student loans was reduced in 2015?

Mr Philip Hammond: Sorry, the discount rate? In what sense?

The Chairman: The discount rate previously was reduced from RPI plus 2.2% to RPI plus 0.7%, which of course increased the future value of the loan repayments.

Mr Philip Hammond: I am afraid I cannot answer that question. I do not know. I am very happy to write to you. You must be referring to an internal discount rate used within the department. Of course, the intention is to market portfolios of loans, and the price—and thus the discount rate—will be set by the market when a package of loans is brought to market.

The Chairman: The effect of lowering the discount rate increases the value of the future payments on student loans. At the same time, for students who are starting their studies, the rate of interest they have to pay while they are still studying has increased to 6%. It is the disconnect between those two things that we find difficult to understand.

Mr Philip Hammond: Let me try to explain some of the logic behind that. First of all, let me recognise that the whole issue of the value-for-money proposition to students in higher education is clearly of concern. We have heard that message, and we are looking carefully at the overall proposition that students face, which is not just about the financing of higher education but about the value proposition presented to students.

The interest rate charged on a student loan is not like the interest rate charged on a commercial loan from a bank. This is a loan, the repayment of which is income-contingent. We know at the outset, by design, that a significant proportion of loans will not be repaid. When we know that the

loan will not be repaid, the interest added to it is, in a sense, notional. It will not be repaid if the borrower turns out to be a low-income graduate.

By design, the system has an element of transfer, a redistribution from higher-income graduates to lower-income graduates. That was how the system was always intended to operate. As I said at the beginning, I recognise that questions have been raised about the overall proposition, and we are looking carefully at how it works to make sure that the way it operates is justifiable.

The Chairman: Are you still planning to sell off part of the student loan book? If so, why are you prepared to lose money on the sale?

Mr Philip Hammond: It is the Government's intention, where they find that they hold assets on the public balance sheet for which there is no policy or strategic reason, to realise those assets and thus reduce public sector debt, helping us to achieve our debt targets and/or create capacity to do other things in line with policy priorities.

As regards selling debts at a loss, as I said, the design intention of student loans is that they will not all be fully repaid. That is not the expectation. Clearly, there is a notional anticipated repayment level for any particular tranche of loans. Each tranche of loans has a different design structure. The market will price a book of loans, both to reflect risk and the market view of recovery rates and the market's requirement for a discount rate.

The Chairman: Would the conditions of any sale limit future changes in the terms of the loans?

Mr Philip Hammond: The conditions of sale will see the loans continue to be administered by the Student Loans Company, with the terms remaining as they are at the time of sale. The buyer will not have any ability to change the terms on which the loans operate and will not have direct contact with the borrowers, who will continue to make their repayments through the Student Loans Company.

The Chairman: I was thinking from the other point of view—whether the Government would be unable to change the terms of the loans, perhaps to the benefit of students, if the loan book had been sold off.

Mr Philip Hammond: I believe the draft proposal—obviously, this is subject to market testing—is that the Government would retain an ability to change the terms, but on the basis that they would have to provide compensation to the purchaser, to be assessed independently and objectively.

Q2 Lord Sharkey: I declare an interest as a council member of UCL.

The OBR expects that accrued interest on student loans will subtract £3 billion from the deficit this year alone. It also said that "the writeoffs associated with recently issued loans are not expected to pick up until the mid-2040s. So accruing interest will flatter the fiscal position in the

meantime". The OBR went on to describe that as a "fiscal illusion". Do you agree?

Mr Philip Hammond: I do not see it as a fiscal illusion. Colleagues round the table who have had experience in the Treasury may have some sympathy with the general description of public sector accounting as something of a fiscal illusion. It is a very particular system, but I think I have understood how our accounting for all stages of the life of a student loan works during the life of the loan on the Government's books and at the point where we transfer it to the private sector. I do not think it is an illusion, but it is a matter of judgment which stage in the life of the loan is the correct point to recognise some of the design impairment.

I emphasise that point. Unlike a bank's lending, this stream of loans is designed to be impaired during their lifetime. There is no expectation of 100% recovery.

Lord Sharkey: Why is the full amount of interest payable on student loans recorded in the public sector net borrowing as it accrues, when in fact 70% of students will not repay, or will not repay in full?

Mr Philip Hammond: I am afraid I cannot tell you why that is the requirement of the National Statistician, but these things are agreed with the ONS, usually on the basis of internationally agreed accounting standards. Having discussed this matter over the last few weeks, it is quite difficult, and sometimes counterintuitive, to understand how each transaction in the life cycle of a loan is recorded, but I am satisfied that what we are doing is correct and in accordance with the requirements of the ONS.

Q3 Lord Lamont of Lerwick: In 2016-17, the fair value of the existing loan book, which is what the Government expect to get paid back, was reduced by £5 billion due to what were called modelling changes. To what extent do you think the uncertainty in future student loan repayments is a matter for concern?

Mr Philip Hammond: You talked about a £5 billion change in the anticipated recovery. That is on a loan book with a nominal value of around £100 billion, from memory. It is a relatively small change in the anticipated recovery. Obviously as the performance of the economy changes, employment conditions change and experience about the income patterns of graduates who have taken loans builds, we will have a greater and more accurate picture. We have a model. Clearly as we feed new information into the model, it may predict changes in the recovery amount, and it is right that we recognise them.

Lord Lamont of Lerwick: The Treasury has a target impairment for student loans. Would you not expect that to be reduced in line with the discount rate that was referred to earlier?

Mr Philip Hammond: The impairment rate?

Lord Lamont of Lerwick: Yes, the target impairment.

Mr Philip Hammond: The target impairment rate will reflect the real-world conditions and experience of graduates repaying loans rather than a financial modelling change around the discount rate, I would have thought.

Lord Lamont of Lerwick: What would you expect the Department for Education to do if impairments were above the target or the predicted level?

Mr Philip Hammond: That is a matter we would discuss with the Department for Education in relation to the department's settlements in the normal way.

Q4 **Baroness Kingsmill:** I should like to ask a few questions about value for money, for the country and students. What is the evidence that increased funding for universities produces an increase in value, for both the country and students themselves?

Mr Philip Hammond: I think that is a question that would be better addressed to the Secretary of State for Education. I am not in a position to go into the details today of analysis that has been done of the performance of the higher education sector and its response to increases in its income levels.

Baroness Kingsmill: But it must be part of your remit to ensure that there is value for money in those increases.

Mr Philip Hammond: Of course.

Baroness Kingsmill: Is there anything in the Treasury that enables you to assess whether there has been any increase in value for the country?

Mr Philip Hammond: As far as I am aware, there are no alarm bells at the moment telling me that we should review value for money from a policy perspective. There is clearly another aspect, which is value for money to the individual, and the situation the individual finds themselves in. There is a significant difference between a graduate who leaves university with a significant level of debt and a well-recognised degree in an area known to provide strong employment opportunities and, on the other hand, a graduate who has a similar level of debt but may not have a degree that will enhance his or her employment opportunities in the same way.

We have a responsibility to look at the way the system is working in practice. It is probably fair to say that the original expectation was that there would be a bigger range of outcomes in relation to fees charged than has actually turned out to be the case.

Baroness Kingsmill: That is true, but do you have any hard evidence that you could share with the Committee on this subject?

Mr Philip Hammond: I do not, but I am very happy to ask my colleague, the Secretary of State for Education, to write to the Committee if she has anything that would be useful.

Baroness Kingsmill: That would be helpful, and I am sure you would find it helpful, too.

Mr Philip Hammond: I am sure I would.

Baroness Kingsmill: To know that these fiscal efforts are bearing fruit. The other thing that concerns us all is the relatively low level of productivity we have been experiencing over recent years. Do you think an increase in university education is going to assist with that? Has it assisted or is it in any way responsible for the low levels of productivity? What is the relationship between university education and productivity?

Mr Philip Hammond: The reasons for our relatively poor productivity performance over a long period, and the developed world's poor productivity performance in general over a shorter period, are something of a conundrum. Economists cannot come to a settled view on the reason.

Our view is that skills are a significant factor in the UK productivity challenge. Ensuring that the workforce has the right skills is an important part of enhancing productivity. I do not think that is quite the same as making a generic statement that just because everyone has a degree, productivity will rise. The key question is whether the skills being acquired are the right skills for the employment opportunities on offer.

Baroness Kingsmill: On that basis, do you think that the recent funding changes are incentivising universities to focus on offering low-cost courses rather than the higher-cost STEM subjects, which presumably are associated with the skills that the Government consider appropriate?

Mr Philip Hammond: We have a long historical deficit in STEM skills in this country, so it is right that we focus on them. Equally, it would be a mistake to get ourselves into a mindset where only STEM subjects matter. We need graduates in a broad range of subjects. It is a matter of concern, which several vice-chancellors have drawn to my attention, that universities incur significantly higher costs in teaching some subjects compared with others, and the funding system does not reflect those higher costs in a way that necessarily incentivises universities to focus on increasing their STEM teaching. Indeed, some have argued that there is a perverse incentive in the system, in that they can generate surpluses in relation to some of the humanities subjects that are cheaper to teach.

Baroness Kingsmill: Indeed. From the other side of the coin, do you think that the funding system is such that it is a disincentive to poorer young people to go to university because of the burden of debt they may have at the end of their studies? I know the burden is income related, but many may want to go into public sector work for example, which is lower paid. If they ever want to apply for a mortgage they will have to declare

the fact that they have an outstanding student debt, so from the point of view of affordability, do you think it provides a disincentive in the sense of its being a prospective burden to young people?

Mr Philip Hammond: It is of course precisely to protect those who will go into lower-paid employment that the system is designed in the way it is. I certainly hope that mortgage lenders are sophisticated enough to understand the income-contingent nature of the liability that student debt holders have.

The Chairman: On the point about the income-contingent nature, which is that they pay 9% after £21,000, are you familiar with the fact that if students go abroad to work after they have graduated—for example, in Antarctica, India or Indonesia—they have to pay 9% after earning £4,200? Why is there discrimination on the threshold, according to where students work overseas?

Mr Philip Hammond: I will deal with that question and then come back to the substantive question that Baroness Kingsmill asked me. That simply reflects local market conditions.

The Chairman: A wage freeze in Antarctica.

Mr Philip Hammond: The intention is that people should be able to earn a level of income that allows them to provide for their reasonable living needs before they start making a contribution to repayment of their student loan. Clearly that level of income will be different in a country with significantly lower costs of living.

To go back to the original question, there is no evidence to suggest that students from poorer backgrounds are being deterred from higher education. Over the last few years, there has been a huge amount of speculation that that would occur. In fact, the evidence points in the opposite direction. We now have higher levels of participation by students from lower-income backgrounds and disproportionate increases in participation by students from lower-income backgrounds. We can be reassured that the system design has been effective in avoiding the risk of deterring students from lower-income backgrounds.

Lord Burns: I was involved in the financial services industry for some years after the Treasury. The agenda there was very much about treating customers fairly and making sure that contracts were appropriate and the terms did not change. We have a very different situation in relation to the arrangements for student loans. The Government appear to be able to change the terms of the loan long after the student has taken out the loan. Do you not feel uncomfortable that the Government are adopting a very different approach towards the student loan end, compared with all the effort being made elsewhere by the Financial Conduct Authority to try to improve the way financial services firms treat their customers?

Mr Philip Hammond: The Government are not a financial services firm and are not operating to generate a profit. They operate as the custodian

of public policy and to deliver public policy outcomes. They will act responsibly, and are accountable to Parliament and to the wider electorate for the decisions they make. That is fundamentally different from a private sector financial services business motivated by profit.

Lord Burns: I am not sure that it looks quite so different through the eyes of the person taking out the loan. They take out the loan on one basis and then suddenly discover, because various factors have changed—such as incomes not rising as rapidly as they thought might be the case—that the basis on which they are repaying the loan is not the one they understood when they took it out. It seems to me a question of looking at it from the point of view not just of the provider but of the person who took out the loan.

Mr Philip Hammond: The term “loan” can somewhat mislead us. Income-contingent student loans are a category in themselves. People round the table would probably agree that the only viable alternative system to the loan system we have adopted in this country would be some kind of graduate tax system. Clearly, in a graduate tax system, graduates would be exposed to the risk of changes to the rate of graduate tax that was levied, which would be entirely at the discretion of the Government of the day. I do not think it inappropriate that there is some flexibility in the management of the loan portfolio.

Lord Burns: It may be possible that part of the reason why there is so much unease about what has been happening with student loans is the way it has been described. It is described as a loan; there is no doubt about that, yet it is not operated as what we would customarily think of as a loan.

Mr Philip Hammond: Principally because the design of the system is such that the lender does not expect to recover all of the money loaned. Clearly that would be an unattractive business model for a private sector lender. I think the system has broadly served us well. I acknowledged at the beginning that some concerns have been expressed. It is interesting that these concerns have become more vociferous as inflation has spiked, and thus the nominal interest rate has risen in the way it has. Different graduates face different conditions and have different viewpoints about the loans they are taking out, because they see them in a different way, depending on their earning expectations.

Lord Lamont of Lerwick: It is a very interesting point that loan is a misleading term. Does that not place the Government in a very vulnerable position in terms of perception? Would it not be better, if you are really saying it is a tax, actually to call it a tax and have it as a tax?

Mr Philip Hammond: No, it is not a tax. It is money advanced.

Lord Lamont of Lerwick: It is redistribution through a non-loan.

Mr Philip Hammond: It is perfectly well understood that the design intention of the student finance scheme is that there is an element of

redistribution in it. Under the current tranche scheme, higher earners pay a higher rate of interest on their loans than lower earners. The system is designed such that lower earners will be forgiven the balance of their loan after a certain number of years. It is a very different animal from a loan that one would take from a bank or a building society. Sometimes that is not understood clearly enough.

The Chairman: You are probably not going to answer this question. There have been press reports that the Government are reviewing, or are keeping under review, the loan system. Could you share with us the sort of options that you might be considering?

Mr Philip Hammond: I can confirm that the Government keep under review all these sorts of things, and in the run-up to a fiscal event of course we look at all these areas. It is a very large and complex system. There is a very large amount of existing debt in the system. As we have seen from the statements by the Leader of the Opposition, it is easy to talk about trying to make the burden disappear but not quite so easy to deliver it.

It is right that we look at how the system works. I do not think it would be helpful to look only at the financing side of the equation. We need to look more broadly at the range of products offered to students, the way in which we offer them and the information that we provide for students to enable them to make value-for-money assessments about what they are buying and what it is going to cost them. Our focus should be on satisfying ourselves as the Government—as a responsible body—that the package in the round we are offering to would-be students represents a value-for-money offer. Obviously that is a combination of earnings potential, change as a result of gaining a degree and the cost of financing that degree.

The Chairman: We hope our Committee report might be able to help you in your deliberations.

Mr Philip Hammond: Thank you.

Q5 **Baroness Harding of Winscombe:** I declare my interest as a non-executive director of the Court of the Bank of England. I will not be asking questions about the Bank of England or its responsibilities.

I have a complete change of subject. The rise of automation and machine learning—so-called artificial intelligence—will drive enormous change in the economy as we look forward over the next five, 10 or 20 years. Could you share the work you and your team in the Treasury are doing to prepare us for those changes?

Mr Philip Hammond: You are right, of course. Artificial intelligence, and indeed other technological changes, will have a significant impact on the UK economy. I will start with a slightly optimistic thought. For most of my lifetime, technological change has been something imposed on the UK economy from outside. A raft of technologies that are about to become part of our everyday lives are being developed and commercialised in the

UK, so we have the benefit of both sides of the equation. We will see employment, economic and fiscal benefits from the development and exploitation of those technologies in the UK, as well as facing the structural effects of the changes on the UK economy.

We are acutely aware of the fact that the pattern of employment is likely to change. I have said many times that young people today face two realities. They are almost certainly going to be working for longer than their parents before taking retirement, and they are almost certainly going to have to retrain at least once during their working life to accommodate changing technology. Both of those realities point to the need for a better system of what we call in-work lifetime learning.

I announced in the spring Budget that the Department for Education was going to pilot a number of different models of delivering lifetime learning, so that we can establish the most cost-effective way to deliver opportunities for people throughout their working life, for them to be able to acquire new skills, embrace new technologies and retrain for changes of career during a working lifetime. The core of the Government's response will be the lifetime learning agenda.

Baroness Harding of Winscombe: Given the all-consuming nature of Brexit preparation, how will you make sure that we protect that work and that investment? Technological change will not wait for our Brexit negotiations.

Mr Philip Hammond: That is right. The work is being led by the Department for Education, which is fortunately one of the departments less directly affected by Brexit preparations. You are quite right, of course, that the immediate and urgent priority for government is Brexit preparations, but if the economy is to prosper after 29 March 2019, we have to continue to focus on investment in economic growth. In the UK's case that particularly means the challenge of our differential productivity performance, and skills are a key area.

If I want to be optimistic, I would say that addressing our relative poor productivity performance at a point of significant technological change may offer more opportunities for us than would be the case if we were in a static-state period of relatively low technological change. The UK economy is pretty well equipped for some of the change that is coming down the line. We are one of the most digitally engaged economies. We obviously have a very large services sector. A lot of the changes that are being developed will have particular applicability in the services sector.

We are in a good place, but we have to recognise that there is significant change coming down the line. Of course, government itself will be changed very significantly by some of this technology. The Bank of England is embracing new technologies such as the distributed ledger technology. The Government are looking at how we can apply artificial intelligence. There are significant areas of government activity that involve relatively low level decision-making that will be highly susceptible to the application of artificial intelligence, probably over a relatively short

period. That presents the tantalising possibility of being able to drive some real productivity enhancement in the delivery of government processes.

- Q6 **The Chairman:** A report was published last week, Chancellor, by the IPPR that claimed that the British economic model needs “fundamental reform”. Do you agree? What is your overall assessment of the current state of the British economy?

Mr Philip Hammond: My view is that the British economy, if I go back to, say, the beginning of 2016, is fundamentally in good shape. We recovered well from the challenge of the financial crisis and the recession that followed. In the real economy, we are significant players in a number of areas of technology that are likely to become very significant over the next years. It is not just artificial intelligence, but fintech, biotechnology, synthetic biology, some materials technologies and big data manipulation—areas where the UK is a significant player. There is the internet of things. Foreign investors tell me that the UK—Cambridge, in particular—is the place where the technologies that underpin the internet of things will be developed and refined.

Our economy was in a good place. It has inevitably been overshadowed by the uncertainty of the Brexit negotiation process. The quicker we can generate some clarity about the future for business and consumers, the better, so that we can get back to the business of pursuing what I think looked like a very positive outlook for the UK economy in early 2016.

- Q7 **Lord Darling of Roulanish:** I refer the Committee to my entry in the register of interests. I chair the Standard Life Foundation and I am a director of Morgan Stanley.

Chancellor, Brexit; I wonder if you could answer a couple of questions on the transitional period you have spoken about. I want to ask about two specific areas, starting with the movement of people. During the summer, you said a number of things that seemed to me to have quite a lot of common sense in them. You said there would need to be a transitional period of up to three years and that you would need to consult with business as to what the skills requirements were at the high end, as well as the medium and low skills. The Home Secretary announced that she was conducting a formal consultation. All of that is very sensible.

Last week, a document leaked to the *Guardian* painted a more draconian picture of everything ending in March 2019; people would be allowed to stay for two years, or maybe between three and five if they were very high skilled and so on, and there would be a control regime that I would have thought was beyond the Home Office at the best of times. It would be very helpful if you could clarify what the Government’s policy is in relation to the movement of people and, in particular, in relation to the transition period that you think will be necessary to get from where we are now to where you think we might want to be in three or four years’ time.

Mr Philip Hammond: I will say three things. First of all, in relation to the transition period, the Home Secretary made a clear statement in late July that she envisaged that during a transition period EU nationals would continue to be able to come to the UK on the same basis as they do now, but with the additional requirement—provided for in EU law—that they would be required to register with the authorities so that we have a record of which EU nationals are here.

Lord Darling of Roulanish: It is not true that the new regime would start in March 2019. There will be a transitional period.

Mr Philip Hammond: The Government have made it clear that their aspiration is to negotiate a transitional or interim period. Of course, that has to be negotiated. It is an aspiration; we cannot guarantee that it will be possible to do that. That is our aspiration, and it is our expectation that it will make sense for our European Union partners as well to have a period during which we can adjust, and which provides additional certainty to business and to citizens.

The other point I would make is consistent with long-standing policy of Governments of all persuasions. We do not comment on leaked documents.

Lord Darling of Roulanish: We know that, but we would like to know what the Government's policy is.

Mr Philip Hammond: The point is that the regime that obtains during a transition or interim period will, of necessity, have to be negotiated with the European Union. There will be a negotiated transition arrangement. I advise the Committee to listen to what the Home Secretary said rather than what some document that somebody has dug out from somewhere, and which I certainly do not recognise as our current state of thinking, purports to say.

Lord Darling of Roulanish: Did you have a third point?

Mr Philip Hammond: The three points were that the Home Secretary made a statement; I do not think I recognise that document as our current view; and the transitional arrangement will be a negotiated arrangement.

Lord Darling of Roulanish: The Government's policy is that you want a transitional period; it has to be long enough to allow firms to adopt it, and initially it will look very much like what we have today, save that people would have to register.

Mr Philip Hammond: On migration, that is what the Home Secretary said in July. There is general agreement that it would not make sense to ask business to face two sets of changes. That implies that a transition or interim period would need to look a lot like the current status quo, otherwise business will be making one set of changes at the beginning of the interim period and another set of changes towards the end of it.

Lord Darling of Roulanish: That sounds very sensible and I hope it holds. I want to ask you about the single market and the customs union. Logically, the same argument would apply, would it not? You would have a transition of probably the same period, during which things would look pretty much as they do today. In other words, we do not get some big change in March 2019. Is that right?

Mr Philip Hammond: When we leave the European Union, we will leave the single market and the customs union. That is a matter of fact. What we hope to be able to do is to negotiate an arrangement with the European Union that will allow us to continue to operate across borders between the UK and the European Union, trading goods and services in much the way we do today. The obvious impediment to such an arrangement is the desire to be able to conclude third-party trade agreements with other countries.

We have been clear that during such an interim period, we want to be able to negotiate future trade agreements with third countries, but we would not expect to be able to implement them. That clears the way to our being able to have a harmonised customs arrangement with the European Union during the interim period.

Lord Darling of Roulanish: It sounds like, to coin a phrase, “We have checked out but we have not actually left”, and I do not understand that. You are saying that, in order to be frictionless, everything stays the same with the customs union and the single market until the end of the transitional period. But we have left it. Surely that is incompatible with the way the EU is organised.

Mr Philip Hammond: No, everything does not stay the same, because we will have left the European Union. We will no longer be members. We will no longer sit at the table. We will no longer take part in EU proceedings. But, in relation to arrangements for access to markets and the customs procedures, it should be possible to negotiate with the European Union an arrangement that, during the interim period, as long as the UK is prepared to accept the constraint of not being able to implement third-country trade deals, we can harmonise our customs structures and procedures in such a way that we continue to see frictionless trade.

Lord Darling of Roulanish: Your hope is that during the time we might be negotiating deals with other people, including presumably the European Union itself, people can import and export without any friction whatsoever. No one is going to be stopping lorries—

Mr Philip Hammond: When you say import and export, do you mean between the European Union and the United Kingdom?

Lord Darling of Roulanish: Yes.

Mr Philip Hammond: That would be the ideal solution for the interim period; trade in goods and services would be able to continue as it does now during that time-limited period.

Lord Darling of Roulanish: Do you have any sense of whether, on the other side of the channel, this sort of thing would be entertained or accepted?

Mr Philip Hammond: If you look at the Commission's negotiating mandate and the guidelines, you will see that it has addressed the issue of where its starting point would be for any negotiation about the transitional period. It clearly contemplates such an arrangement being possible.

Lord Darling of Roulanish: On the question of its being frictionless, in the longer term, once we are through the transition, how can something be as frictionless as it is now? I heard the Secretary of State for Brexit going on about all sorts of new technology, which a couple of days later he said probably would not work. I do not understand how you can get a better deal than you have now on the frictionless aspect of trading goods and services.

Mr Philip Hammond: When we are talking about friction at customs borders, we are essentially talking about goods. I do not think anybody is looking for a better arrangement than there is now. It may be that it cannot be as frictionless as it is now in a long-term settlement—

Lord Darling of Roulanish: That is the crucial point.

Mr Philip Hammond: —because of the desire to be able to negotiate third-country trade deals. The design challenge is to use technology to minimise the friction to a level that is acceptable to business.

The Secretary of State for Exiting the EU was at the US/Canada border last week looking at the arrangements they have there for trusted trader traffic passing through that border, which is a customs border. I was reading the report of his visit this morning. He was told on the American side of the border that it took about a minute for a normal vehicle to clear the customs procedure. For someone using the trusted trader channel, that was halved to about 30 seconds' delay in the truck movement. That is with the use of a deep technology system with pre-filing of manifests, ANPR as the truck approaches the border and the matching of manifests to drivers and trucks.

Technology can help us with that, but I do not think we suggested in the paper we published three weeks ago that we would necessarily expect the border to be completely frictionless. We will seek the lowest possible level of friction at the border that is compatible with our other aspirations for an end-state settlement.

Lord Lamont of Lerwick: You have partly answered my question in the full and persuasive answer you gave Lord Darling. Could you fill in a bit more? Are you completely satisfied with the work that Customs and

Excise is doing and its contacts with customs authorities in other parts of the world, primarily in the event of a deal with the European Union? In the event of no deal, which I do not want—I want us to have a deal—what preparation is being made for the extra facilities and technology that might be needed. You mentioned the border between NAFTA countries, which is obviously extremely relevant to a no-deal situation. That is not a customs union, and in theory there is a hard border. Are you satisfied that Customs is making real progress in preparing for those two different scenarios?

Mr Philip Hammond: Yes, I am. The timescales are very challenging, I have to say. That is another reason for seeking a transitional or an interim period. It is not only businesses that need time but government agencies on both sides of the channel and both sides of the Irish border. The consequence of not agreeing an interim period will be that public agencies in the UK and in our European neighbours find that they incur significant expenditures, possibly of a nugatory nature, depending on the outcome of the negotiations. That is clearly not the sensible thing to do.

HMRC is preparing for all eventualities, including a no-deal scenario. We recognise that the timescales are very challenging, and in a no-deal scenario not everything we would want to put in place will be in place on day one, but we will have a working system in place on day one. I have that assurance from HMRC.

We are engaged with customs agencies around the world beyond Europe to look at other examples of the use of technology in particular. The Swedish/Norwegian border is of course of great interest to us, as a border between an EU and a non-EU country.

At the customs service level, engagement with our nearest neighbours has been limited, because the view of many of our neighbours is that, until such time as the Council of Ministers has declared sufficient progress, they are not authorised to engage with us on post-exit planning and arrangements. We have had less engagement than we would like with our customs counterparts in our immediate neighbours at a technical level, both to discuss possible deal scenario technical challenges and no-deal scenario technical challenges.

Lord Lamont of Lerwick: Do you think the capacity of the ports and warehousing is all adequate?

Mr Philip Hammond: No, it clearly is not. Anyone who has ever visited Dover will know that Dover operates as a flow-through port. The volumes of trade at Dover could not be accommodated if goods had to be held for inspection. Even if they were only held for minutes, I suspect it would still impede the operation of the port. Roll-on, roll-off traffic at Dover is predicated on trucks rolling off a ferry immediately, going out of the port, and the ferry reloading and departing pretty rapidly, with Ryanair-style turnaround times. Anything that caused delay in vehicles exiting the port, such as delay in vehicles offloading, would cause significant disruption to patterns of movement. We will be looking at contingency arrangements in

the case of a no-deal exit to ensure that the port of Dover and the port of Calais—essentially a single area for customs processing—are able to operate smoothly.

Lord Tugendhat: I would like to come back for clarification on a question Lord Darling asked. If I understood you correctly, what the British Government would like is to have a transitional arrangement during which we can negotiate trade agreements that then come into effect after the end of the transitional period and when the new regime has been established. Presumably when the new relationship with the EU has been established, it will include a new immigration regime; there will be conditions on which EU citizens can come and work in this country that are different from the situation that exists today.

My question is this. When we start negotiating free trade agreements with other countries, some of those countries—India is a particular example I have in mind, but Australia also said something about it—would wish to include greater access to the UK for their citizens as part of any free trade agreement. Will we not be in a very difficult position if we are negotiating free trade agreements that involve further opening of our borders to citizens from non-European countries that might then lead to a clash with the regime we have instituted in relation to EU citizens?

Mr Philip Hammond: I do not think that is logically the case. It is perfectly possible for a country to negotiate on a bilateral basis with different countries, or groups of countries, preferential arrangements for dealing with access by their citizens. I see no reason why we would not be able to agree one regime, for example, with Australia and a different regime with the European Union.

Lord Tugendhat: But as the European Union will be our principal trading partner, if the conditions we negotiate with India or Australia, or anywhere else for that matter, look to be more generous than those that apply to the European Union, do you think that would be compatible with the agreement we have with the European Union?

Mr Philip Hammond: That depends on what the agreement we make with the European Union is. It is possible in a negotiated solution to seek to impose some kind of most-favoured-nation-type provision that, “No one else will get a better deal than I have”. Equally, it is quite normal in bilateral agreements to accept a set of absolute terms and to agree that those are the terms between the parties, and to accept that either party may negotiate other deals with other third parties on different terms. I do not think it will be a big issue. I would also find it quite unlikely that in practice we would expect to negotiate significantly more liberal migration agreements with third countries than with our nearest neighbours.

Lord Tugendhat: I agree. That is why I think negotiating the agreements with some countries might turn out to be extremely difficult.

Mr Philip Hammond: That is another question: how difficult agreements are to negotiate. The history of trade agreements tells us that they take

time to negotiate. For that reason, I do not personally feel that a self-denying ordinance that, "We will not be able to bring into force any of these new agreements during a transition period" will, in practice, pose much detriment to us. I suspect that it will take some time to negotiate those agreements.

Lord Tugendhat: That is a very realistic approach, if I may say so.

Q8 Baroness Bowles of Berkhamsted: I declare my interest as a non-executive director of the London Stock Exchange, and as chair of the Ownership Effect inquiry.

There is a flurry of reports at the moment, many on corporate governance and many on the style of company and things not necessarily fitting our economy and so forth. There was one a couple of weeks ago by PwC focusing on family companies. It said that, although family companies were pretty good at a lot of the strategic vision stuff, there was a big blind spot, if I can put it that way, when it came to succession planning, with only 15% of companies having succession plans. An even smaller percentage ever make it to the third generation. This is a pattern that repeats a lot in SMEs in general; more than 60% of them have no succession planning, so they get lost completely if they do not manage a trade sale.

In the Finance Act 2014, there were some good tax changes to help employee ownership. It appears that employee ownership has quite a strong correlation with productivity. The tax changes in 2014 made it very useful for succession planning, even in cases where trade sales were not possible.

My question in general terms is this. Are you open to looking at more incremental tax changes to help with succession planning down the employee ownership line, which would mirror the incremental changes that previously have been made on employee share ownership in general? That was a progressive thing over many years. Would the time now be right to think about that kind of mindset with regard to employee ownership companies because of the additional benefits it brings?

Mr Philip Hammond: The Government are generally supportive of employee share ownership. There is good evidence to suggest, not just through ownership, that the higher the level of employee engagement with the business, the greater the productivity of that business. Generally speaking, encouraging employee engagement in one form or another is a positive step in tackling the productivity challenge.

We would need to see a clear correlation between the case for ownership and the productivity performance of businesses. I do not have the statistics to hand, but I think it is the case that there is a very wide range of productivity performance in family-owned businesses in the UK, and indeed in other countries. We often hear the family-owned business sector in Germany lauded as an example; but it is also the case that there is a wide range of productivity performance in that sector. Our

focus has to be on using available government support in the place where it will deliver the greatest boost to the UK's overall productivity.

There are legitimate questions that can be answered only by examining the evidence base. Is that by investing in our top performing companies, international companies? Is it by investing in the poorest performing companies to bring them up to speed, or is it by looking to focus on a cohort that may be somewhere in the middle? This is a crucial piece of analysis that we need to bottom out to understand how best to target the limited resources the Government have available to support private sector productivity enhancement.

Q9 Lord Turnbull: A number of members of this Committee have put recommendations to you on "Making Tax Digital". Thank you for seeing sense on that. I hope it is not simply deck clearing around an election but a permanent change. Where we have ended up is a much better place than appeared likely.

The Treasury has been closely involved in Hinkley Point. On an earlier visit, you told us that it was a "well-designed transfer of risk". Do you still think that?

Mr Philip Hammond: Yes. The partners—EDF and CGN—are taking on the construction and operational risk of the project.

Lord Turnbull: Do you really think you can maintain that conclusion in the light of the criticisms in the NAO report, which I hope you have been briefed on if you have not read it, and in particular the revelation that the CFD cost could increase from £6 billion to £30 billion? The risk there falls to consumers. It does not seem to me that that is a risk transfer that we should be too happy about.

Mr Philip Hammond: We have to be careful about how we look at costings of energy. I do not want to teach my grandmothers to suck eggs, but nuclear power provides essential baseload to the system. We saw yesterday or the day before an eye-wateringly attractive headline price for offshore wind bids. Of course, as we put more intermittent supplies into the system we also impose costs on the grid. There are balancing costs and alternative generation costs, as well as capacity market costs. We have to look at the costs in the round of what is proposed. It remains the Government's view that the strike price at Hinkley Point and the consequent potential CFD costs remain good value for money for baseload electricity that does not impose significant additional grid balancing costs.

Lord Turnbull: There was also a briefing as part of the announcement that the amount that should be added to allow for intermittency would be, say, £10 to £15. If you add that to £50 you are still miles short of £93, going up by inflation for 30 years.

Mr Philip Hammond: I am sorry, what is the £50?

Lord Turnbull: The strike price apparently agreed for the latest new

offshore wind.

Mr Philip Hammond: I think it is £57.50.

Lord Turnbull: As part of the same announcement, it was said that another £10 was to provide for the cost of intermittency. Add those two together, and we still come up with a price well below £93, rising—

Mr Philip Hammond: I am sorry but I do not recognise that additional £10. On a system-wide basis, if the question is, “What happens if you take the nuclear out and replace it with more offshore wind?”, you have to look at the whole system costs you would be imposing, including capacity market costs and additional grid costs.

Lord Turnbull: But you can replace it now with much cheaper gas and still get a large proportion of the CO₂ savings you want.

Mr Philip Hammond: The Government’s planning horizon is a 99% decarbonisation of the power generation sector by 2050. If you move to looking at gas as a substitute, you will quickly move away from being able to deliver that planning objective in order to deliver our legal obligation on decarbonisation. It clearly makes certain assumptions about decarbonisation in other sectors of the economy, but the Government’s view remains that delivering the marginal unit of decarbonisation in the power sector will be better value for money than trying to deliver it in other sectors of the economy on the 2050 time horizon.

Lord Turnbull: Every aspect of this Hinkley deal has gone for the worse. The fossil fuel price trajectory has been revised down. No one thinks that we are starting at \$100 a barrel and going on in real terms from there. The fall in the renewable price is greater than ever. Costs are rising. The commissioning date is delayed.

Mr Philip Hammond: If I could stop you there, costs are not rising for the bill payer or the taxpayer. They may very well be rising for our development partners, but that is their problem.

Lord Turnbull: You are like a landlord who says, “As long as I get rent this month, I do not care that my tenant might not be able to pay in the future”. EDF is a much weaker company as a result of this. What is more, part of the strategic case for going ahead on a very expensive basis was that it would be a pathfinder for other nuclear developers. They are all in ruins, and that benefit is not going to be collected. The NAO recommended that once in a Parliament you should have a fundamental re-look at this. I argue, and it is implicit in the NAO report, that enough has changed since the 2013 deal was struck for you to have a major re-look at the whole deal.

Mr Philip Hammond: I disagree with that analysis. I think you are missing a number of points. EDF and CGN are state-owned companies. I agree that if they were private sector companies we would have to take a much more detailed interest in what the equation looked like from their side. It is fair to say that both partners are pursuing the deal for strategic

business reasons rather than transactional reasons, and they are not motivated primarily by the economics of the individual project.

I do not think that the idea of reviewing once in a Parliament projects with a 60-year lifespan and 15-year development cycles is credible. All we would send to potential partners around the world is a signal of uncertainty. We would make ourselves an incredible partner. I do not see anybody wanting to invest the pre-development costs of looking at a nuclear project in a country that was going to review its appetite for those projects every five years.

I do not recognise the comments you made about the pipeline of projects. We have two Japanese projects at Wylfa and Moorside still in pre-development discussion with the UK Government. We have a further EDF project with Chinese partners at Sizewell. We have a Chinese-led project at Bradwell. Of course, they are all at different stages of discussion, but that pipeline exists.

Lord Turnbull: Can I recommend that you read the speech of Lord Howell in the debate of 17 July on the electricity market? The view he puts forward is that the three participants—HMG, the French Government and their electricity company and the Chinese—all realise that the project is in great difficulty. It is a bit like the prisoner's dilemma. They can all wait around while one of them tries to cancel it and then the other charges them or wants compensation. The three need to get together to find some way through.

Lord Howell asked what the way forward is and said, "Fortunately, the plan B that I think is beginning to take shape is being led by the Chinese themselves, who appear to recognise the sorts of difficulties we have discussed this evening. I think they see shrewdly that this cannot continue on the present path because it will lead to disaster. Incidentally, they have not paid their contribution yet to the project". He thinks that the solution will be that the site gets used, but the technology that is part of it is not the as-yet uncompleted EPR technology. He is a man who studies the sector in great detail and thinks that we cannot go on thinking we are on a satisfactory trajectory.

Mr Philip Hammond: The technology in question is design approved. As you rightly point out, there are projects in France, Finland and China using this technology that are currently delayed. We have a contractual commitment from our partners in this project. Clearly if the partners in the project were to come to the Government at some stage and seek agreement to a variation along the lines you have suggested, of course the Government would look at any such proposal, without any commitment. At the moment, the project is progressing. Construction is under way. There are 1,600 people working on the site, and I have no reason to believe that our partners will do anything other than faithfully deliver on the commitments that they have made.

Q10 **Lord Tugendhat:** Given that we have now learned that the number of international students overstaying their visa is much lower than

suggested previously, could you tell us what the rationale is for keeping students in the net migration target?

Mr Philip Hammond: Students are defined by the UN definition as migrants. It is as simple as that. The UN defines a migrant as somebody who takes up residence in a country other than his own with the intention of remaining for more than a year. As the Prime Minister has made clear on this issue, she feels that the British people would think we were moving the goalposts if we were to change our definitions.

Lord Tugendhat: I am not sure that the British people would have any such view at all. You are attributing this to the United Nations. You are not making a British case. You are saying, "Here is a United Nations rule, and because we are such rule-keeping people we are going to ensure that we do not deviate on the question of students".

Mr Philip Hammond: I am explaining why students are included in the total in the first place. It is because we followed the UN definition, and the Prime Minister's clearly stated view is that to change the definition now would look like moving the goalposts. That would sit uncomfortably with a message to the public that they should have confidence in politicians to deliver on commitments made.

Lord Lamont of Lerwick: Is it not the case that the target is a matter for the Government, but the definition is entirely a matter for ONS?

Mr Philip Hammond: No, I do not think so. I may be wrong on this, but I think it was the Government's decision to use the UN definition. I am sure that the ONS, currently bound by Eurostat, will follow that same definition.

Lord Darling of Roulanish: If you are talking about reassuring the public, would it not reassure them that 97% of international students coming here go home? You would not know that from the discourse that is around generally, but it is a fact from all the information we have. To that extent, if we are worrying about immigration in relation to international students, they actually go back to their own countries after they have completed studying, having contributed handsomely to our higher education budgets.

Mr Philip Hammond: Yes. If 100% of students arriving in the UK return, and the numbers of foreign students are static, it will mean that their overall impact on the migration numbers will be zero.

Lord Tugendhat: But on the other hand we want British universities to get an increasing share of the international market in higher education.

Mr Philip Hammond: Then the overall impact on the numbers would not be zero.

The Chairman: It is perhaps a bit unfair, Chancellor, to throw this back at you, but when you were Foreign Secretary you strongly expressed the view that "Britain's role as a world class destination for international

students is a highly significant element of our soft power". You argued then that they should be removed from the migration targets. I completely understand that collectively the Government have taken a different view, but to what extent is the decline in the numbers of international students coming to the UK a source of concern and perhaps a reason for looking at this again?

Mr Philip Hammond: We certainly would not want to see numbers declining—

The Chairman: Which they are.

Mr Philip Hammond: We are at pains to explain, particularly in India, that there is no cap on the number of student visas available for suitably qualified students attending properly accredited universities in the UK. We very much welcome international students. I am afraid a bit of a myth has grown up in India that there is a cap and that it is difficult to obtain a student visa. We are doing everything we can through the high commission in Delhi to dispel that understanding.

- Q11 **Lord Layard:** I have two questions. The first is on apprenticeship. Would you agree that the top priority is to ensure that every young person gets some sort of skill by the age of 25? Does it worry you that, in spite of the welcome increased emphasis on apprenticeships, much of the money has gone towards rebadging training schemes that were paid for by the employer as apprenticeships so as to benefit from the fund, while we still have much the same situation for people up to 25 as we had before and a large number of NEETs? Can the Treasury not do something to make sure that apprenticeship money goes in some prioritised way to deal with the young people first, until the rest is available for lifetime learning?

My other question is about child mental health, which we know is one of the Prime Minister's main priorities. It is a big burden on the economy and society. We are having a Green Paper. I do not know if it has come your way yet, but it is not really possible to deal with this problem without some new money. If it could be shown that actually this new money could be funded completely from flowbacks to the Exchequer from savings on other health and education parts of the system, would you be sympathetic to that?

Mr Philip Hammond: On the second part of your question, colleagues around the table who have done this job will know that the Treasury is institutionally resistant to the suggestion that, if you just cough up some money now, you will get it back in spades in a few years' time. Somehow it never quite seems to happen that way.

You are right that it is a priority for the Prime Minister, and she and the Health Secretary are looking carefully at how to deliver a sensible programme that addresses the concern. The Education Secretary has already announced some measures in this area.

On the question of apprenticeships, the apprenticeship fund is focused on 16 to 19 training in particular. It is of course the case that the

apprenticeship money you talk about is provided to a large extent by employers paying the apprenticeship levy. I think it is not the case that that money is being used to pay for rebadged training that was already going on. In some cases, of course, employers will have in-house training schemes. Provided those training schemes are delivering the required type of training and meet the requirements that have been laid down for the apprenticeship scheme, they will be eligible to use the funding. What is happening is that non-compliant schemes are being addressed across different sectors of industry to redesign the training to make it eligible for apprenticeship funding. That was exactly the intention.

I will give you an example. Financial services firms tell us that they do a lot of training, but most of it is not eligible and it does not qualify. The onus is on them to redesign the high-quality training that they offer, so that it can be rewarded with one of the awards that will make the training eligible for apprenticeship levy expenditure. That is entirely appropriate.

If we have an employer-led system, we are much more likely to be assured that the kind of skills that are being imparted and the kind of training that is being delivered are the most relevant to the employment opportunities available. Employers are unlikely to invest in airy-fairy theoretical skills that may or may not be useful. They will be focused very much on the needs of the workforce today.

Baroness Bowles of Berkhamsted: If what you are saying is true, that means the net effect is perhaps better training rather than more training for individuals.

Mr Philip Hammond: In the House of Commons that would be verging dangerously close to disorderly. I assure the Committee that what I am saying is undoubtedly true. It would imply better-quality training.

Baroness Bowles of Berkhamsted: Yes. I am saying it is better-quality training, because it is upgraded from systems that did not get the money, but it is not increasing the overall number, or is it? What is the split?

Mr Philip Hammond: I think it is doing both. Employers who already had training schemes, or who contributed to training schemes that are not eligible for apprenticeship levy, are quite understandably looking, usually on an industry-wide basis, at ways they can redesign their training to comply with the requirements of the apprenticeship levy scheme. We welcome that, but we have also brought into the net employers who were not delivering that type of training at all. Some of the largest employers in the country are now paying apprenticeship levy and may not have had substantial in-house training schemes at all.

Clearly, there are big differences between different sectors of the economy. The services sector in particular is finding that, in general, it is paying a large net apprenticeship levy contribution from which it cannot necessarily benefit. It would be very much in the interests of our productivity agenda if services businesses and the service sector were looking at redesigning training so that it met the requirements for

qualification as full apprenticeships, with the focus on basic skills as well as the industry-specific learning that is required.

Baroness Bowles of Berkhamsted: I get that. It means that, when we say that there are so many more apprentices, that is not really the best yardstick; it implies that there are new positions, whereas in fact many of them might be better positions.

Mr Philip Hammond: No. Remember that the apprenticeship levy came into force only last April. This is a new element to the system. The apprenticeships delivered between 2010 and 2016 were net new apprenticeships to the system.

The Chairman: I promised your office, Chancellor, that we would finish this session by 5 pm. That completes the evidence session. On behalf of the Committee, I am grateful to you for coming and for answering a variety of questions on a variety of topics so openly and effectively. Thank you very much.