

Treasury Committee

Oral evidence: The Budget Autumn 2017, HC 600

Wednesday 29 November 2017

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[Watch the meeting](#)

Members present: Nicky Morgan (Chair); Rushanara Ali; Stephen Hammond; Stewart Hosie; Mr Alistair Jack; Catherine McKinnell; Kit Malthouse, Wes Streeting.

Questions 70 - 144

Witnesses

I: Ann Pettifor, Director, Prime Economics; Professor Jagjit Chadha, Director, National Institute of Economic and Social Research; Paul Johnson, Director, Institute for Fiscal Studies.

Written evidence from witnesses:

- [Ann Pettifor, Prime Economics](#)
- [Professor Jagjit Chadha, NIESR](#)

Examination of witnesses

Witnesses: Ann Pettifor, Professor Jagjit Chadha and Paul Johnson.

Q70 **Chair:** Good afternoon. Thank you very much indeed for coming in for this second of our post-Budget scrutiny sessions. I am sure that we know all of you, but for the benefit of those who are watching—we have an audience who are not necessarily in the room but are definitely watching—perhaps I can ask you to introduce yourselves very briefly.

Professor Chadha: I am Jagjit Chadha, the director of the National Institute of Economic and Social Research.

Ann Pettifor: My name is Ann Pettifor and I am the director of Policy Research in Macroeconomics, or Prime Economics.

Paul Johnson: I am Paul Johnson, director of the Institute for Fiscal Studies.

Q71 **Chair:** Thank you very much indeed. I suspect we are going to ask you at some point this afternoon to get out your crystal balls and do your own forecasting. I wanted to start, inevitably, with the Brexit question, the scenarios facing this country in terms of the outcomes of negotiations and the impact on the forecasts we saw last week from the OBR. I wonder, first of all, whether you agree that there are now two broad likely categories of outcome for the Article 50 negotiations, one in which no deal is reached by March 2019, and one in which a transition deal is reached that preserves the status quo and current arrangements for several years. Professor Chadha, perhaps we can start with you. Do you agree that those are the two most likely outcomes?

Professor Chadha: There are clearly a number of outcomes, but the first one to plan around is the central case. The appropriate central case, it seems to me and the institute, is the second scenario you outlined, whereby there is an agreement for a transitional deal of a certain amount of time, for the tail end of the negotiations to be completed. That is a sensible central case for any forecaster to have. Within that, there are a number of other possibilities, one of which is the risk of no deal whatsoever and some form of cliff edge that we would like to consider making contingency plans for.

Ann Pettifor: Your question really relates to the OBR's forecast, I expect.

Chair: Yes.

Ann Pettifor: I sympathise to an extent with the OBR. It was given very little information by the Government on which to base the forecast. Having said that, our view is that the OBR has not taken into account the likely shocks that the British economy will face with Brexit. Whether they



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will be moderate or extreme is something we could debate, but we feel that the OBR has not forecast a range of outcomes to guide the Government. That might be because it is nervous of doing so, but it also has to do with errors in its own forecasting work.

Paul Johnson: That is right. The OBR is clearly basing it on a relatively smooth transition. As I understand it, the OBR is not permitted to make forecasts on things other than what it considers to be government policy. If it thinks government policy is not to crash out, as I understand it, it is bound not to provide a forecast of that kind. The impact of a no-deal type exit would be significantly worse than a smoother transition. My colleagues here will know more about how you would model a crash-out, as opposed to a transition, but I am not sure that macro models are up to measuring something quite so big.

Ann Pettifor: Having said that, the OECD report came out yesterday. The OECD has managed to model a range of outcomes, not all of which would be good. It is possible, and the OECD has shown that it is possible.

Professor Chadha: There are two things that go on in a model when you come out with a range of possibilities. The fact that there are a number of possibilities is already being factored into the OBR's forecast and, indeed, the institute's forecast, because it generates something called uncertainty. We just do not know which path we are going to be on at the end. That leads, generally, to delays in investment, which we are seeing this year and are projected in the forecast, and reactions by households. They are complicated and we will have to talk about them later on, but the first response would tend to be an increase in savings, which the OBR does not have in its scenario. We can deal with that.

To come back to Paul's point, how can we deal with extreme scenarios? We have a pretty good handle on the transmission mechanism to the economy from leaving the European Union. There is a compression of trade. There is the uncertainty that I have already talked about. There is volatility in the exchange rate, which leads to inflation, which particularly impacts on poorer households and their consumption basket. We can say to ourselves that those effects may be magnified, so we can get some measure of that. Paul is right that we cannot get complete measure on it, but we can have a pretty good idea of the impacts that they may have.

Ann Pettifor: We do not have that. The OBR has not provided that. There is something self-reinforcing in the fact that the OBR is not allowed or even able to do so, and the fact that its forecast, which is pretty gloomy anyway, reinforces government policy for further contractionary policies. You have this self-reinforcing mechanism between the two of them, when in fact the OBR is meant to be independent and to be there to provide us, the public, with some realistic forecast of what will happen in the future, or at least a range of forecasts.



Q72 **Chair:** Building on what you have all said, which is effectively that they are forecasts, sometimes they are set out as tablets of stone, and it is worth reminding people of that. I have heard some of Mr Johnson's interviews, and I know the IFS reminds people that they are forecasts and not certainties. You have mentioned the word "shock", Ms Pettifor. Given what you have all just said, the enormity of the negotiations that are ongoing and the significance of what is happening, does the fact that the OBR is not modelling different scenarios undermine the forecasts and the ability to rely on them? Is there a danger that the OBR is falling between two stools, in the sense that it has to make assumptions, because of lack of information received from the Government, and therefore that is undermining the forecasts and their overall usefulness in informing the public about the economy?

Professor Chadha: There is a distinction here between the production and the consumption of the forecasts. In the production of the forecasts, the OBR, like the national institute, is very careful to paint a set of possibilities: what you might call a fan chart or, more technically speaking, a density. A density forecast is a way of thinking about the probability of events. Naturally, our eyes are drawn to the central tendency, because we think that is the path that will happen. We also know that that path is as likely not to happen as it is to happen. We want policymakers to consider that path but, at the same time, design policy to deal with the contingent risks.

We might say to ourselves, "Yes, the most likely path is the one we have outlined, but there is a set of contingent risks that may well be on the downside". The distribution of risks may be particularly skewed towards the problems associated with a cliff-edge scenario. In that world, a policymaker who is consuming the forecast has to design a path for the instrument that deals with that contingent risk. In this world, it becomes an argument that the Chancellor has to make about how much fiscal space he should retain, in the event of that cliff edge. That is the appropriate way to think about the policy. Think about this distinction between the producer and the consumer. It is a very important distinction.

Ann Pettifor: The problem is that the OBR suggests there is very little fiscal space. The OBR is of the view that there is a very small output gap and we are close to full potential in terms of the economy. Furthermore, the OBR puts productivity at the very heart of all its forecasting. From our point of view, productivity is an outcome; it is a residual. It is not causal. By making it causal, the OBR is consistently forecasting a shrinking of the economy, which is why it has had to revise almost all its forecasts these last 10 years. The Government, reacting to those forecasts, have decided they do not have fiscal space and cannot afford to make the provision that they should be making for the scale of the likely shock.



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In a sense, it is the analysis by the OBR that inhibits the Government. We know the Government ask the OBR for advice before preparing for the Budget. These two things are interacting. Furthermore, the OBR makes very little use of the multiplier. It does not believe government spending and government investment have a major impact. Again, that is flawed. That is a flawed way of looking at it. The IMF and other countries all understand that there is a significant multiplier from government spending, not just government investment, but the OBR tends to ignore the multiplier.

Q73 Chair: Mr Johnson, what do you think about this issue of the OBR, the forecast being neither one thing nor the other, and the lack of information? You mentioned that the OBR, in its remit, is allowed to take into account only what the Government choose to give it. Should the OBR be asking for more or for a change of remit, given the complex and extraordinary situation that we are facing? Does this lead you, as the IFS, to treat the OBR's forecasts with even more caution at the moment than you otherwise would?

Paul Johnson: One problem with the way it is presented at the moment is that it has a fan chart, as Jagjit said, showing uncertainty going forward, but that uncertainty, as I understand it, is based on forecast errors in the past. It is essentially symmetric around the central case. It is not obvious to me, given the risks we have just talked about in terms of the outcome of the negotiations, that the risks really are symmetric in this particular situation. As we discussed, if we end up with a more difficult leaving of the European Union, that will push things down. Within the constraints it has at the moment, something that was clearer about the fact that the certainty is not as symmetric as it normally is might have been helpful.

Q74 Chair: The OBR is forecasting that the trade intensity of the economy will fall gradually over a period of 10 years after the UK leaves the EU. Would you agree that that forecast is more consistent with a smooth and orderly Brexit? Jagjit, you already said that that is probably a more likely scenario at the moment, although there are other possible outcomes. The OBR's forecasts are less consistent with what would happen if the negotiations were to break down and there were to be a disorderly Brexit.

Professor Chadha: Rather than trade compression, the quantity of trade does not grow in the way that it has in the past in its forecasts, to be exact in that sense. Given our central scenario, that seems an appropriate assumption to make. There is downside risk to that, and the tone of my comments is very much about considering the downside risks we are now facing. But I would not like that to be the central case in the way we think about the evolution of the economy.

Ann Pettifor: The whole trade thing is somewhat exaggerated. Net trade is a small part of GDP. It is improbable to predict and forecast 10 years hence, but I think it is quite right that, within the next five years, there may need to be an adjustment on trade, because there may



be effects on both exports and imports. That is a reason why the Government should take back control, and do more to stimulate the domestic economy and increase demand—because the real issue is weakness of demand, in our view—rather than relying on trade negotiations. It is a failure of the Government to prepare for whatever outcomes there may be in relation to trade by turning the light on to the domestic economy and trying to increase demand there. If we did that, we would be prepared for whatever effects there are on trade.

Q75 Catherine McKinnell: I want to focus on trade a bit more, particularly in relation to Brexit and the forecasting for the economy. The OBR assumes that trade will grow at a slower rate as a result of Brexit, both imports and exports, but it will not have a significant material impact on GDP, because it assumes that, due to a greater openness to trade, it will not affect productivity. Do you agree with the assumptions that the OBR has made in that regard?

Professor Chadha: Approximately half of our trade is with the European Union. Most models of trade think about trade as a function of geography and of the wealth or income of a country. We are in a world in which we have a high level of trade with countries that are close to us and, in global terms, fairly rich. The process we are now going through is going to lead to, if not exactly more costly trade, non-tariff barriers and other things that will compress trade to an extent. That seems to be a reasonable starting point to think about the process we are going through, leading to a lower value of trade with the European Union.

The next question is as to whether that should necessarily lead to a reduction in productivity. The link between productivity and trade is reasonably well-established in the economic literature. Something like a 20-point increase in trade seems to lead to a 5% increase in labour productivity, and these are very long-run estimates in the literature. Alongside that, we have had a longstanding productivity puzzle in the UK. I am sure we will come on to that a little later. There is a whole bunch of reasons, which could take up a whole evidence session for me to explain what they all are.

We cannot explain productivity terribly well, whether we are in the European Union or not, or indeed whether we are in the aftermath of the financial crisis or not. At the same time, to make a direct link to some compression of trade and productivity seems to us not to be the central way of thinking about things. It is more risk; it is more a possibility. There are lots of mechanisms by which we think trade will help. It leads to better specialisation, reallocation of resources, more efficient use and the ability to move to the frontier. But, right now, we would not necessarily want to make the links. In that sense, the institute, in its own work, has kept productivity separate from trade. The OBR has as well, and that is something we would agree with.

Q76 Catherine McKinnell: Robert Chote has told the Committee in the past that the link between productivity and trade is not well understood. Is



that how you would characterise it? You characterise it as a range of factors.

Professor Chadha: Unfortunately, economists are always going to say there is a range of factors. What is not well understood is productivity per se. As Ann said rightly, in a lot of models, it is a residual. When we try to understand it, it seems to be a result of a number of issues: the political economy settlement, the quality of institutions, education levels and the financial system. There is a whole range of things that help us to understand productivity. Trade may help us and, certainly for countries that previously had illiberal trade regimes and lack of structural reform, a move to more trade seems to be associated with higher levels of productivity.

For countries already at the frontier, the results may not be clear. In fact, trade in the short run may diminish productivity, as firms and jobs are replaced from one sector to another. We have done work at the institute that exactly identifies the impact on manufacturing jobs in the UK from increasing trade with China and A8 countries. In the very short run, it may be problematic for productivity, as resources get reallocated. In the long run, I remain agnostic.

Q77 **Catherine McKinnell:** Is it not possible to predict the impact of Brexit on productivity in the medium term?

Ann Pettifor: It is my view that there is no link whatsoever. I do not think there is a productivity puzzle. The reason why productivity is as weak as it is—and it is weak; the OBR is right about that—is because of the overemphasis on supply-side issues and the weakness of robust demand. The weakness of robust demand explains falling wages, the deflationary impact of the post-crisis period and weak productivity. If we were to increase demand and investment, you would find there was no productivity puzzle. I have just come from Vietnam, which has robust demand, high levels of productivity and growth rates of 6.3% to 7% per year. It is not a puzzle, really.

The real puzzle is why the OBR and most institutions focus so relentlessly on the supply side, and refuse to discuss or contemplate the weakness of demand, what can be done and the role that the Government are playing in reducing demand by contracting their spending and contracting investment. They are doing really deep cuts, and there are deep cuts forecast by the OBR. By doing so, they restrict demand even further than already is the case because of the impact in the post-crisis period on the private sector. There is very little demand for loans or for borrowing. Banks find it difficult to make loans. Because people are very nervous about applying for a loan, they cannot see customers coming through the door. That is a really important issue. The puzzle for me is why we have, since the post-Thatcher period, focused on supply-side issues—deregulation, trickle-down and tax cuts—and refused to focus on demand.



Q78 **Chair:** Do you think that productivity is being measured correctly? You have essentially said you agree with the OBR in terms of its productivity numbers. Some people make an argument that productivity is not being measured correctly.

Ann Pettifor: I think it has been measured correctly. I do not think that is the issue. The question is what causes it to be so weak. What has caused it to be so weak for such a long period, over the last 10 years, over the post-crisis period? We have argued all along that these were supply-side issues: "More deregulation, more tax cutting and more government contraction, please. Productivity will somehow be boosted". It has not happened, yet we pursue those supply-side measures relentlessly.

Professor Chadha: On the measurement question, we have done quite a bit of work trying to understand the extent to which mis-measurement of the service sector and the digital economy may have contributed to the productivity puzzle. Our best guess at the institute is that around a quarter to a third of the shortfall in productivity might be well explained by what we might generally call new economy measures. That is a footnote to the answer.

Q79 **Catherine McKinnell:** Ann, you have already mentioned the OECD report. In that, it was suggested that authorities should introduce productivity-enhancing measures to try to increase investment in growth, particularly if the weak forecast continues post Brexit. We know your views on it already, Ann, but I wondered if there was any divergence among the panel on these issues.

Paul Johnson: On how to improve productivity?

Catherine McKinnell: Do you agree with the OECD's assessment and proposals for increasing productivity?

Paul Johnson: I am afraid I have not seen the OECD's proposals.

Ann Pettifor: The OECD is very clear about the low levels of investment and the importance of investment to increasing productivity. Catherine Mann, the chief economist there, is very clear about that, but the lessons do not seem to be learned here.

Professor Chadha: Productivity itself could be an inquiry.

Catherine McKinnell: We will hopefully come back to productivity later in this session.

Professor Chadha: There are clearly a number of issues that have driven the weakness of productivity. Part of it is to do with the globalisation of labour and the pool of labour available to us. The low levels of investment—which, again, are mis-measured; there is physical investment and intangible investment, both of which we are not measuring very well—probably contributed to the low levels of



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productivity. Getting that investment up is to some extent the responsibility of government, but it is also the responsibility of the private sector and relates to the impairment of the financial sector. Where I agree, but not fully, with Ann is this question about demand. What really matters is uncertainty, beliefs about the future and optimism, rather than demand per se. The Government have a role in dealing with offsetting uncertainty and making plans that offset private-sector uncertainty. That is a slightly different way of thinking about what the Government do, rather than just injecting demand into the system.

Q80 Catherine McKinnell: That is the premise of my question. In the context of Brexit in particular, what more should the Government be doing? What concerns are there on the horizon for Brexit, in terms of its impact on productivity? You have already identified uncertainty and lack of investment. Are there additional risk factors relating to Brexit surrounding that? You have touched on migration. One of the key issues in advance of Brexit is the promise of reducing net immigration to the tens of thousands. If that is achieved, what are the risk factors for the economy in that regard, as well as in terms of productivity?

Professor Chadha: Recently, an interesting picture has been emerging about the regional and even constituency-level impact of underinvestment, lack of R&D and the risks from falling FDI in different parts of the country. You want the Government to think very carefully about those areas at the regional level, because we are getting a good idea of which places might be most affected by leaving the European Union, and which places have been most affected by the globalisation shock. We would like government policy to confront that directly. Whether and how we leave the European Union is almost an additional question. We now have a clear measure of some of the problems at the regional level, and that is where we would like to see it approached.

Q81 Mr Jack: Can I turn your attention to the divorce bill?

Chair: It is topical today.

Mr Jack: It is. I will come to that in a minute. The OBR has not made any allowance in the forecast for a Brexit divorce bill or any ongoing contributions to the EU budget during a transitional period. First, do you think this is a sensible approach for it to take?

Paul Johnson: It has not banked the £8 billion a year or so net contribution either. In a sense, you can think of that as perhaps evening out over this period. It rather plaintively says here, "We wrote to the Government and asked what their policy was, and they wrote back and said, 'Read Mrs May's speech'". It is working in a bit of a blind alley, in terms of the information that it has. Equally, it is pretty easy to bung £40 billion on to the debt, in terms of what the impact might be.

Professor Chadha: I would agree. It is very much constrained by the information that is available. Any money that may come back it assumes



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will be recycled back into expenditure, and anything else is therefore a risk factor.

Mr Jack: I am going to pick up on Mrs May's speech in a second.

Ann Pettifor: It makes a mockery of the fiscal rule. The £3 billion set aside and the social housing adjustments that were made make a mockery of the fiscal rule. The Government must be able to find the money and the finance in the event of such a shock happening. If we were going to war, £40 billion or £60 billion would not be insurmountable, given that we have a developed monetary system, a central bank and so on. No, there has not been provision, but that is really about the weakness of the Government in facing reality in relation to the EU negotiations.

Paul Johnson: It is worth repeating that, at the moment, the £8 billion per year net contribution is assumed to be recycled into spending. You can think of the £40 billion as five years of that. Given the assumptions of a relatively smooth transition and so on, and given that growth forecasts have been brought down as a result of Brexit, you can think of those numbers being there in some sense. But it is another fiscal risk to the downside.

Q82 **Mr Jack:** You mentioned Mrs May's speech. In her Florence speech, she said, "I do not want our partners to fear that they will need to pay more or receive less over the remainder of the current budget plan as a result of our decision to leave". Would you agree that it is now firm government policy, at the very least, to contribute to the 2014-20 multiannual financial framework, assuming that negotiations proceed amicably? How else would you interpret the statement by the Prime Minister?

Paul Johnson: That sounds like a reasonable interpretation.

Q83 **Mr Jack:** Yes, good. It has been reported today by the BBC that the figure the EU's strategy cabinet sub-committee has come up with in principle for a divorce bill is £44 billion. That is including contributions to the EU budget during transition. If such a bill is to be paid over the financial period, how significantly will that impact on the fiscal outlook?

Paul Johnson: Part of that is a set of money that would have been paid over the next few years, had we stayed within the EU. The big issue here remains the impact on growth going forward. If we were in a world in which leaving the EU had no economic impact and we were paying £8 billion a year in, economically, paying £40 billion up front would be a win, because, after the fifth year, we would be saving every year.

Q84 **Mr Jack:** Should it be up front? Should it be a lump sum or in instalments?

Paul Johnson: I have no view about how it should be paid.

Q85 **Mr Jack:** What about if you were negotiating?



Paul Johnson: The point is that one can focus on whether it is £30 billion, £40 billion or £50 billion, but what matters vastly more is the impact on growth. If the impact on growth is zero, paying £40 billion to get out is an economic win. If the impact on growth is negative, which it almost certainly will be, the future savings will be a lot less than the £40 billion we paid up front, so it will be a net cost. The £40 billion is one number within this, but what really matters in the end is the impact of leaving on growth. If you believe it has no impact on growth, the £40 billion is a good deal. If you think it will have a negative impact on growth, we will lose and, the more we give up front, the more we will lose.

Ann Pettifor: If you think it is going to have a negative impact on growth and, at the same time, you make no effort to expand the domestic economy—the domestic cake, if you like—it really will be disastrous.

Mr Jack: This goes back to your demand argument a moment ago.

Ann Pettifor: It is about the Government playing a role in compensating for any loss of growth brought about by the Brexit process by expanding the British economic cake, GDP, and doing that by deliberately intervening and investing in the economy.

Q86 **Mr Jack:** Does that involve increasing the Government's debt?

Ann Pettifor: It involves increasing the Government's borrowing, which is entirely affordable. The Government at the moment are borrowing at negative rates of interest. By increasing the borrowing and expanding the cake, if the investment is aimed at employment, all it will do is increase tax revenues for the payment of the borrowing. We know that has always been the way. The Government finance everything from borrowing, not from tax revenues, and hopefully generate the income from that borrowing and investment in the form of tax revenues, through increased employment and economic activity. That is what we should be doing. If we are exiting, facing a negative shock and contracting the economy, it is going to be a pretty rough time ahead.

Professor Chadha: To give a longer-term perspective on this, £40 billion is around 2% of GDP. Leaving the European Union or a divorce is a one-off event, so it is not something that we have to think about as a structural problem for the UK. Once we have left, we pay the bill and move on. There may be an advantage to thinking about doing this relatively quickly, rather than letting it drag on and lead to all kinds of uncertainty, and tying up limited administrative resources while we negotiate this particular bill over a very long time. As Paul and Ann have said, if these negotiations are prolonged, lead to uncertainty and delays in investment, affect confidence and lead to limited demand, the impact on the economy from that is much larger than a one-off bill of 2% of GDP.



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That is the perspective in the long run. Since the financial crisis, debt to GDP has gone from under 40% to around 90%. We are at peak debt now. We have kind of dealt with that, and we are probably at the peak debt moment where it will fall relative to GDP. In that context, 2% is not such a big story, it seems to me. That may sound heretical but, as a structural point, it is not something we should be too hung up about.

Q87 Mr Jack: I get that point. If you were in the negotiating team, would you pay in instalments over a number of years, to ensure things went smoothly through the transition period, rather than throwing all the money away up front and hoping everything else went to plan?

Professor Chadha: Fortunately, I am not the negotiator. Every negotiation depends upon everything else that is on the table and what incentives you want to provide for the counterparties to do the things that you want. There may be worlds in which it is appropriate to pay it over time, and worlds in which it is appropriate to write the cheque immediately. I have the same problem when I have builders at home; it is that kind of problem.

Ann Pettifor: I take a different view. It is really important for us to build good will with our European partners, because we are looking for a good trade deal down the line. I would pay up front.

Q88 Mr Jack: Have you ever run a business?

Ann Pettifor: I have indeed.

Mr Jack: So have I, and I like to get what I am paying for as I go along.

Ann Pettifor: Yes, but this is not a business; this is a political negotiation with 27 countries. We have managed to rile, annoy and unnerve them. This is the moment at which we try to build good will with those countries and establish some stability in the negotiations, in order to achieve something more in the later stages around trade.

Q89 Stewart Hosie: Paul, on the last page of the OBR forecast, it states that the UK accounts for 7.3% of the EU overseas aid budget in its own overseas development budget of 0.7% of GNI. If the UK stops contributing to the EU, it will have to replace this funding through additional spending if it is to meet its own legally binding targets. Can I check your understanding? Would that mean, of the current £10 billion or so in contributions to the EU, £1 billion will immediately have to be repurposed for the overseas aid budget?

Paul Johnson: Yes. That is my understanding of those numbers. I am not sure whether the 7% is the gross or the net. Broadly speaking, if the aid target remains the same, given the EU contribution has always been part of meeting that 0.7% target, it follows logically that additional money would need to go through the UK. Perhaps we will continue to pay it via the EU, through some negotiation; I do not know. Yes, that



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must logically follow. It may be that, when we come out, we decide that 0.6% rather than 0.7% is the right number.

- Q90 **Stewart Hosie:** I do not think it would be wise for any of us to second-guess what future government policy may be. Let me very briefly ask you all this. Does anyone believe that the public think they voted to leave the EU to require an increase in the UK's overseas aid budget by approximately a billion pounds? That is the consequence of this.

Paul Johnson: To be fair, it is not increasing the amount we would spend on overseas aid. It would simply be moving it from this pot to that pot.

- Q91 **Stewart Hosie:** Let me move on to Brexit costs themselves and the Budget. The Government announced an additional £3 billion of spend on Brexit, or more accurately Brexit preparation, the largest increase in spending other than in the NHS. Are you aware, Paul, of what the spending might be for?

Paul Johnson: We found no details of that. I do not know if either of my colleagues has found any details of that. One can only speculate, but, no, I have not seen anything written down that says what that would be spent on.

- Q92 **Stewart Hosie:** In terms of allowing the IFS, the national institute, the OBR or anyone else to assess this properly, given that it is the second largest single spending measure in the Budget, is it not important that we know what this money is actually to be used for?

Paul Johnson: Given that it is a new spending line, it would be. To be fair, we do not know precisely what the additional money for the NHS is going to go on, which hospitals or which particular things. In budgets, you do not always get huge amounts of detail when you are told that an extra billion is going on health, education or what have you. In this case, we do not even know which departments it will be spent through.

- Q93 **Stewart Hosie:** That is the key point, absolutely right. This Committee has also heard from the Chancellor that the additional spending on Brexit does not require the reopening of departmental spending plans from the spending review because the money that is required will come from the reserves. Do you agree with the Chancellor's assessment of that?

Paul Johnson: I do not understand the statement, because it is in the costs here, which suggests it is additional money that was not previously set aside. I do not follow that.

- Q94 **Stewart Hosie:** He would be wrong, then, to say that it will come from reserves, given that, as you say, it is additional and new spending.

Paul Johnson: It is clearly in the Budget measures here as an additional £1.5 billion per year on top of what was previously planned.

- Q95 **Stewart Hosie:** I am just wondering what that does in terms of the fiscal



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outlook. It is not a huge amount, but it is £3 billion. It is not exactly a drop in the ocean.

Paul Johnson: Over the two years, when you have an extra £1.5 billion, it makes the borrowing £1.5 billion more than it otherwise would have been.

Q96 **Stewart Hosie:** Let me move on slightly. In the forecast, the OBR has drawn attention to underspends against departmental plans of £4.6 billion. It states, "The large underspend happened because, unusually, the Treasury did not exhaust its current reserves". What do you think caused those underspends in each department?

Paul Johnson: I do not know the details of the underspends. It is clearly the case that, again, there is an asymmetry here, in that departments feel they absolutely cannot go a penny over their budgets, and that creates an incentive to remain a bit under. It is quite surprising, and it has been true throughout the period since 2010 that we have seen underspends, to the extent that the OBR has started to build underspends into its forecasts, and these have been bigger than forecast. In a period of very strong contraction, it is surprising that those underspends have continued. We knew in the monthly public finances up to November that spending was coming in a bit behind forecast. I had not expected them to build in that scale of underspend.

Q97 **Stewart Hosie:** Underspends of that quantum will have a measurable impact on GDP. Given that growth forecasts have been marked down, do you not agree that it seems foolish that the spending departments are unable to spend when we need to consume that cash, in order, frankly, to buy some growth?

Paul Johnson: Irrespective of the impact on growth, given the constraints on the health service, the immigration service and so on, I find it quite surprising that there is that scale of underspend, because it will clearly impact on the quality of the public services being delivered.

Q98 **Stewart Hosie:** Does the scale of the underspend suggest that future fiscal tightening might be more achievable than others may have suspected it could have been?

Paul Johnson: This is why I find it quite surprising. We know that there are significant problems in the prison system, for example. The health service is struggling. We are at the point where public pay has finally reached its pre-crisis level relative to private pay and is falling underneath. There are problems in social care. My sense is that, over the period up to maybe a couple of years ago, the spending cuts were delivered with less difficulty than I and colleagues thought they would be back in 2010-11. Over the last two years, you can see the pressure that this is putting on different parts of public services, and that is on top of whatever you might think the appropriate level of welfare spending is. I do not take this as evidence that it is going to be easy to continue with the planned cuts.



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Q99 **Stewart Hosie:** Let me ask a final question that relates to the point you made about pay. Do you believe it would be easier for the departments to lift the cap on public sector pay, given they have these structural underspends now in place, even if there was not a formal lifting of the cap?

Paul Johnson: Only if they think those underspends are structural. My understanding is that the Chancellor has given a green light to think about more than 1%, but without providing any additional money other than for some parts of the health service. That is clearly going to be a pretty tough decision for a set of departments juggling the different trade-offs.

Professor Chadha: It is very interesting that there is underspend. It is not something that I have looked at. Before deciding what to do with it, we would try to understand what has caused it. Has it genuinely been departments holding on to money for a reserve-type reason, or has it been that demands on departments have not been as they were previously anticipated? Is it something to do with the structure of employment that has led to fewer calls on welfare, or does the way that the welfare cap has been arranged in the past mean money has not been spent? Before deciding what to do, one would try to understand in which departments and which areas the underspend has been caused, and whether it should lead to some change in the way that they spend things. I do not think we have enough of that analysis here today to make a statement.

Q100 **Stephen Hammond:** Good afternoon. Thank you for coming to give evidence. Could we return to the productivity puzzle issue? Call it what you will. As you said, Professor Chadha, it might take up the whole session but, as my Chairman is going to allow me only 15 minutes at the very most, I have five or six questions. Perhaps I can address my first two questions to you, Professor Chadha and Mr Johnson, only because I think Ms Pettifor has answered them in her response to my colleague a moment ago.

If you look at the perturbations in long-term productivity, they started in about 2004. Since the financial crisis, we have seen long-term productivity issues and declines in growth. On that basis, are the problems besetting the UK purely structural in nature? How much would you attribute to the demand side's cyclical nature? Can you give a balance between the two?

Professor Chadha: I will try my best. The other thing to say, when thinking about productivity, is that our productivity performance has lagged behind our European partners throughout most of the post-war period. It is a sad fact that we were behind the productivity growth that we saw on the mainland of Europe in the 1950s and 1960s as well. In that sense, it has been a structural problem of the UK for a while. Admittedly, there was some form of catch-up in the 1980s and 1990s, but, since the middle of the first decade of the 21st century,



productivity—let us call it labour productivity, for the sake of argument—seems to have lagged behind our main trading partners, but also behind whatever trend there was in the past. Even though we were performing less well than our partners, we have performed less well even than that subsequently.

There must be both a structural and a demand-side explanation. There must be both. Something that has been in place for 10 or 15 years we would start to think of as structural. The question is what has gone wrong in the way that we are managing our economy that has not led to the return of productivity to previous levels. This autumn, most people analysing the macro economy have come to the view that we are going to have permanently or at least persistently low levels of productivity. That reduction in the supply-side capacity of the economy is something that the OBR is picking up in its forecasts. That has been the major reason for its downgrading in its revisions.

What are the causes? Of course, they are structural and they are demand. Let us run through. The globalisation shock has increased the global pool of labour, and that has tended to put downward pressure on manufacturing wages. In UK terms, that tends to reduce what looks like productivity in manufacturing and therefore wages in the manufacturing sector. We have talked about the mis-measurement point.

Stephen Hammond: I would like to come back to that in a moment.

Professor Chadha: It is interesting that the slowdown coincides with the increasing use of digital and IT equipment, and the burgeoning service sector in the UK, which we are not measuring terribly well.

There have been factors exacerbating this since the start of the financial crisis. With the low interest rate regime, banks have been able to allow firms that would otherwise, with the debts they had, have gone bankrupt to remain in business. They have been able to service their large debts at low interest rates, and that means capital has not necessarily been reallocated to new firms. That argument is subtle and complicated, because it depends on whether you think old firms, by doing, are more productive than young firms that have new ideas. Depending on your view as to which firms drive productivity, the zombie firm argument, as it has been called, may or may not help us understand level of productivity.

Q101 **Stephen Hammond:** It is interesting you pick up on that point, which we have had discussions in previous sessions about. You also pick up on the point, and there are a couple of US economic academic papers suggesting this, that increases in technology are accompanying productivity growth falls, which would seem to be counterintuitive.

Professor Chadha: There are a number of points there. First, we may not be measuring our output properly. Our inflation measures may not be dealing with the fact that a large amount of our consumption basket is free, so we are overestimating inflation and underestimating output. As a



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result of that, we are underestimating productivity. I have already said that that probably contributes to about a third of the puzzle.

At the same time, the lack of new firms and the fact that the firms that are in place are servicing existing debts mean there has been limited increase in investment in tangible capital in the last 10 or 15 years, particularly in the last 10 years, since the financial crisis. That is a direct input into the measurement of labour productivity. Capital augments labour productivity. If firms are not investing in capital, they have been producing a certain amount of output by hiring more workers, so they have been taking on workers instead. That means that the level of capital that every worker has to deal with is less than it would otherwise be. In fact, capital per worker has been contracting in the last four years, which has also contributed to lower level of productivity. If you have less capital to work with, you will probably, although not necessarily, be less productive than you would otherwise.

Paul Johnson: I do not have a great deal to add to that.

Q102 **Stephen Hammond:** If you do not, as I am fairly time constrained, I am going to jump my second question and come to my third question. If you look at the OBR's forecast for productivity growth—0.7% for 2018, 1.2% for 2022, deviating from 2.2%, which is clearly the long-term rate—it is a long way away in terms of the forecasting by the Bank and the average of other economists. When we saw Stephen Nickell, in his last appearance with us, he said it would be a big call to argue that long-run trend levels of productivity growth have changed dramatically or will change of the next 50 years. Do you think the OBR's forecast is as likely to undershoot as it is to overshoot? Is there a systemic pessimism inside the OBR?

Professor Chadha: People who have been forecasting a return to productivity for the last 10 years have been burnt by the fact that the outturns have been lower than they have seen in the past. Ann hinted at this earlier on when she said both the Treasury and the OBR have tended to over-predict output in the year in which they first made the forecast in the budget. That is the consistent phenomenon in the last 10 years. It is very much related to the fact that productivity has not returned to the previous levels that people like Stephen Nickell thought that it would.

One of the reasons for interest rates to move from 0.25% to 0.5% is that the growth slowdown was seen to be a contraction in capacity, not a reduction in demand. The Bank also has a view that capacity has fallen. The national institute has taken that view, as have the OECD and the IMF. It seems to us there is a clear emergence of supply-side constraints in advanced economies. It seems sensible for us to factor those in when we are planning into the future. If we make that the central case, we are prepared to be wrong. It would be wonderful if productivity returned, because it would give tax receipts and mean more people were in work at higher wages, which would certainly help the economy. In terms of



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appropriate planning for the future, adjusting the forecasts of growth in capacity downwards seems to be the sensible thing to do.

Ann Pettifor: Mr Hammond, you are absolutely right to talk about systemic pessimism. It is worse than that; it is systemic defeatism. You are right that it exists across the spectrum of institutions and the economy, from the IMF through to the Bank and the Treasury: there is something inherently wrong the economy and they do not know what it is, but it is the economy's fault that the economy is weak. I find that reasoning bizarre, but also very bad, because the effect of it is that we have done nothing to improve productivity, and the situation has got worse every year. Now we are saying it is going to get worse for the next 10 or 20 years, and we might as well all lie down and accept this defeatist approach. I do not accept that. I do not think that is right.

Stephen Hammond: I will come on to measures in a moment, but I hear that.

Paul Johnson: I have sort of forgotten what the question was now.

Q103 **Stephen Hammond:** I agree; it was quite a long time ago. I was basically asking if you think the OBR's forecasts, on this particular matter only, are as likely to undershoot as overshoot.

Paul Johnson: In the end, this is a judgment. Art, rather than science, would be a way of describing what the OBR has done. You can see that pretty clearly. It has basically put a line halfway between what has happened and what it thought before. It is just this judgment: is there any reason to think we are permanently dropping from 2.2%? Perhaps not, but we have had 10 years of 0.3%, so it would seem rather optimistic to assume we will jump straight back up. My take is that it has lost patience with its own over-optimism and decided to bring it down, largely for the reasons that Jagjit described. Therefore, yes, they are as likely to be on the optimistic as on the pessimistic side.

Q104 **Stephen Hammond:** To the issue of whether we sit back and do nothing, the Chancellor has put in a number of budget measures, some of which are spending on skills, R&D, infrastructure, housing inside the national productivity infrastructure investment plan. The other thing, of course, is that the OBR book talks about participation rates and the problem of an ageing population, and he has put some specific measures in the budget in terms of the national retraining partnership. Do you think that those are the right things? What would you have done differently?

Paul Johnson: It is the right set of things. None of them is particularly huge, but increasing infrastructure investment and R&D investment, in the long run, is the right thing to do. As we have pointed out, investment spending is rising just to its highest level for quite some time, as a fraction of national income. It might have been helpful to be clear that it was on a trajectory to an even higher level, because we remain behind



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many countries in terms of the quality of our infrastructure and the quantity of investment in it.

I am sceptical of the idea that one could ramp it up a great deal more quickly. I was in the Treasury in the early 2000s when investment spending was rising. Literally, the underspends were multiple billions every year, because it could not get out of the door, and quite a lot of what got out of the door was not terribly well spent. We spent much too much time asking whether the right answer is 2.5% or 3% of GDP, and nowhere near enough time asking what exactly was the right set of things to spend this on. That said, you could spend 3% of GDP rather than 2.5% extremely effectively, in a way that has a long-term positive impact.

The housing market changes are small, but in the right direction. Getting more homes and houses in fast-growing parts of the country will help. That does not necessarily help the imbalances between the regions, which we have not talked about. Where we are sitting is one of the most productive parts of Europe. Much of the rest of the UK is among the least productive parts of Europe. You cannot think about this just at a national level; you have to think about this at a regional level, which was not really part of what was there.

The third leg of this is the education and training system. There is an obsession with higher education and student finance, at the expense of thinking about further education and training, and governments of both persuasions have consistently failed to sort that out. T-levels might be a move in that direction. The Apprenticeship Levy is not working at the moment; hopefully it will. My sense is that the structural problems are much bigger than that.

Professor Chadha: I completely agree with Paul, as usual. The aggregate numbers are worrisome. Investment is around 10% of GDP. R&D expenditure is well under 2%. There has to be a move towards higher aggregates, but aggregates by themselves are not necessarily effective. That is where really hard work is needed to think about the regions and areas that need attention. It needs a micro-level analysis, rather than money out of the Treasury door in the way that Paul described. We need to think very carefully about that.

I would add communications, broadband and transport. The education points are very well known. We have quadrupled the number of people going to university, but are we necessarily meeting the structural educational demands of firms in the country? I am not sure we are doing that very well.

One point we have missed is the financial sector. New firms and start-ups need access to capital. Is our financial sector doing a good enough job in providing those new firms with the capital that they need? As an economy, we are lending four times more to our households through banks than we are to firms. That seems to me the wrong way



round. That is something we need to think very hard about in terms of allocating savings, whether they are in this country, in the pension funds, in the households or from abroad, into the firms and the people with ideas in this country. It is something that we are not doing well enough.

Ann Pettifor: I do not think, if grants were once again restored to local government, it would face any problems in spending on all the wonderful services that we, as a civilisation, have got used to, but are losing very fast. There is the security threat we face from climate change. We desperately need to do something about the energy inefficiency of our buildings. We need massive investment to make them more energy efficient—that is domestic investment—and an increase in domestic employment and the use of even domestic materials to make us more energy secure. There is an awful lot of spending that could be done there, and very quickly. There is not a shortage of outlets for spending.

Q105 **Stephen Hammond:** Can I ask two quick questions about the labour market? I want to return to your mis-calculation point, Professor Chadha. It was quite interesting, because last year this Committee heard similar evidence. Lots of people said there were mis-measurement problems on the productivity side. Has that issue grown because of the scale of the gig economy and, therefore, failure to measure that as part of the labour market?

Professor Chadha: The labour market is another form of puzzle. We have what looks like full employment and, just to be clear, even at full employment there can be some unemployment, as long as people continue to search for jobs. There is an issue as to why that has not pushed up wages in the way that we would normally expect. It is a question of whether we have considerably more flexibility in our economy and people moving in and out of hours, rather than the number of jobs that they have. We do not have a full handle on that in the economy at the moment. It is something we need to understand considerably better than we do. I have a feeling that there is a puzzle there for us to address.

Q106 **Stephen Hammond:** We had Sir Jon Cunliffe in front of us last week and we talked a bit about the nature and potential shape changes in the Phillips Curve, which brings us on to equilibrium rates of unemployment, which you spoke about. We have seen the Bank of England reduce its equilibrium rate of unemployment. I wonder if we could have the panel's view on the nature of the relationship at the moment, as reflected in the Phillips Curve. Does the Bank have the equilibrium rate of unemployment about right at 4.5%?

Professor Chadha: There are a number of equilibrium ideas in economics: the natural rate of unemployment, the equilibrium exchange rate, the equilibrium interest rate. They are all in our models. It is measured with so much uncertainty and I am incredibly nervous about putting a dot or a particular number next to it. I think of it more as a range than anything else. The range is probably somewhere between 3%



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and 5%. Even then, it is interesting that, if we are at some notion of equilibrium such that everyone who wants to find a job can find a job within an appropriate amount of search time, that is the way one should think about the definition. The question then is why that is not leading to upward pressure on wages. Why are wages still so stable? Even though, in the last few months, we have seen inflation explanations in the median household nudge up to 2.8% or more, there still does not seem to be pressure on wages. It tells me, at a very disaggregated level, we do not understand the new labour market as well as we should. That is something we will have to do much more work on.

Ann Pettifor: It shows that the Phillips Curve is no longer relevant or useful. I have never thought that it was useful. When it was used so much in the 1970s, it was used effectively to blame the unions for the rise in inflation, when in fact the real cause of inflation in the 1970s was the deregulation of credit and finance, and the fact of too much money chasing too few goods and services. The unions no doubt played a role in exacerbating that inflation, by demanding wage increases to match the rate of inflation. The causal issue is not the link between employment and inflation, but the link between easy credit and inflation.

Q107 **Stephen Hammond:** What is your current view on the equilibrium rate of unemployment? Do you not have a view?

Ann Pettifor: For me, 4.5% is not full employment. A lot of the new employment, including in the gig economy, is insecure, often unskilled and precarious work, and not generating the tax revenues that the Government need.

Paul Johnson: I vaguely remember learning about the Phillips Curve 30 years ago, and even then we were told it was dead.

Stephen Hammond: I remember economics lessons on the same subject.

Paul Johnson: There has been a change in the relationship between employment levels and wage pressures, which is down to a whole series of things, including issues to do with deregulation of the labour market and much weaker trade unions, which has an impact on wage pressure and the power that workers have in negotiating with their employers. There is quite a big pool of labour, both nationally and internationally, which is probably pushing wages down, particularly at the bottom end.

It is also true, what Ann was saying about a lot of this work being part time. For the first time ever, we are seeing a significant fraction of low-skilled men working part time. That started through the 2000s and has continued until something like a fifth of low-skilled men now work part time. It was pretty much safe to say, 20 years ago, that if a man was in work he would be working full time. That is no longer the case. We do not entirely understand why that is.



You have the positives of this very flexible labour market, in the sense that we have very high levels of employment, and we are suffering the negatives, in the fact that most very low income is now in-work low income. That, it seems to me, is the key. If there is one focus for policy over the next decade, it is how you support workers who are not able to earn a living that is adequate through the market. Is that through minimum wages, tax credits, training and skills or intervention with firms? Getting the right answer to that is possibly the most important question that we face.

Q108 Chair: That leads me on very nicely. As you know, we are doing an inquiry on household finances. We have deliberately talked about finance in the broadest terms. I wondered whether any of you had any comments on the OBR forecast, particularly in relation to savings and the savings ratio, which has got to a near-term low. It is going to continue to fall, according to the OBR, and then to stabilise in cash terms near zero from 2020. Do you have any particular comments about what the OBR said about the savings ratio, and about household debt as well?

Professor Chadha: The household sector is another puzzle. In aggregate, the household sector is incredibly wealthy. It has assets of some £12 trillion, against aggregate debts of just under £2 trillion. That is a household net worth of £10 trillion, which is five times GDP. Yet clearly it is the distribution that matters. It is not distributed in a uniform manner, which means that a number of households are, as Paul and Ann have suggested, on the margin, where changes in interest rates or changes in real take-home pay will materially affect their ability to meet their debts. That may have systemic consequences.

What is then interesting is, despite that high level of aggregate wealth, the savings rate has been falling; the OBR has a number of around 2%, and it also has 2%, approximately, across their forecast horizon. That is something that is a big risk to the OBR's forecast. We would expect savings to increase. The institute's view is that savings are going to go up over time, not all the way to the historic levels of 7% or 8%, but at least to 4% or 5% over the forecast horizon. That is in part a consequence of changes in interest rates and also the need for people, as they understand, to have to have more private savings to deal with health and old age questions over time. We have a return to historic levels, which, over the forecast horizon, in our view would tend to lead to lower levels of GDP growth than the OBR has. The reason we do not have a lower level of GDP growth is that we have a much larger contribution from net trade, as a result of the exchange rate depreciation.

A risk to the OBR's forecast is indeed that savings do rebound, which we think is a clear possibility, and that is because, despite the aggregate wealth of the household sector, there are numbers of households who are going to have to build up their net assets over the forecast horizon.

Ann Pettifor: Can I just say that we have had these debates before the crisis, before 2000, when the savings rate in the United States, for



example, went negative? Economists argued then that households had assets of \$10 trillion and debts of only \$2 trillion. The problem is that households do not pay for their debts by selling their assets. They pay for it out of income, and real wages are now not set to return to their pre-crisis levels until 2025, according to the Resolution Foundation. Again, there is not a puzzle here. If we increased wages we might increase savings. It is not the value of the assets that matter here, because they cannot use the assets to pay down debts or outstanding obligations. For me, there is no puzzle; the thing to do is to increase wages.

Chair: I guess one would say that the Government have tried to do that with the National Living Wage and National Minimum Wage, but we will pick that up in individual inquiries.

Q109 **Wes Streeting:** Good afternoon. The Chancellor's fiscal mandate is to bring the cyclically adjusted borrowing below 2% of GDP by 2020-21. Given the rate at which we are chopping and changing these fiscal rules, I just wondered whether any of you felt that they have any use or credibility any longer.

Professor Chadha: There are two aspects to the fiscal rule: one is the adoption of a fiscal council, and that is the OBR providing an important disciplining device on the Treasury's plans. There is a sense in which the OBR is the producer of the forecast and the Treasury is the consumer and has to build its plans around the forecast. That is incredibly helpful.

The rules themselves, in terms of having a cyclically adjusted deficit target, are bordering on the ridiculous. Nobody is able to measure the business cycle in real time and tell you whether the economy is at trend, below trend or above trend; to have a cyclically adjusted deficit target therefore is a complete nonsense. It is not something that makes sense in any way whatsoever. If you want a target for the deficit, the Government should aim for a balance on the primary account before interest is paid. That is something that does not get adjusted because of the business cycle, and is something that is clearly measurable in terms of cash. The Government could, of course, decide to steer away from the primary deficit for the reasons of a large economic shock, or may decide to pay back debt in another form, but that kind of target makes a lot more sense than anything that is cyclically adjusted.

A supplementary target for wanting to reduce the level of public debt relative to GDP makes much more sense. It is important that public debt is shown to be controllable and that paths are adopted so that public debt goes back to what we might think of as a normal level. Normal levels in peacetime are under 50%. Where we currently stand is in no way normal, and if we do not plan for reductions relative to GDP and make that absolutely clear, what happens is that as time goes on, there are always chances of another negative shock hitting the economy, and at that time we are going to want the facility to issue debt to deal with that shock. If we have not planned for a reduction at the time when we can,



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we may find ourselves hitting the debt constraints that peripheral economies in Europe, for example, have hit in the recent past.

It is incredibly important that we plan for reductions in debt relative to GDP, but that can be achieved by planning for balance on the primary account and then letting the growth in nominal GDP itself take care of the debt-to-GDP ratio. That is a much better way of framing the fiscal plan, it seems to me, than what we currently have.

Ann Pettifor: First of all, can I say that I am against fiscal rules? I know both sides of the House support fiscal rules and I am unpopular with some of my friends in the Labour Party for being very critical. Fiscal rules were invented by Milton Friedman in the late 1940s. The most important rule for us to have in the economy is to build prosperity. That will then generate the income for reducing the debt. The macroeconomics of this is that Governments should spend to reduce the debt, and that is so contrary to the current ideology that people find it difficult to understand.

I wanted to also draw attention to President Clinton's attempt to reduce the deficit back in the late 1990s. The Treasury and the Fed in the United States predicted that, by I think 2012, there was going to be no government debt and there was going to be no deficit. This in itself was going to cause a major crisis in the financial sector, as Daniela Gabor has shown, which is namely that the finance sector is heavily dependent on sovereign debt to use as assets for collateral in capital markets. The Treasury and the Federal Reserve panicked at the very thought that they were going to pay down the debt and reduce the deficit. We really need to understand that there are implications for the whole economy, and particularly for the financial sector, the City of London, if we pursue these, as Jagjit calls them, ridiculous rules.

The third point I wanted to make was that a lot of the debt interest paid on government debt returns to taxpayers. About 25% is debt interest paid by the Bank of England, and the Bank of England, of course, is part of the Government, so it is money that the Government are circulating within the Government; it does not leave the Government, if you like. About 50% of it is to domestic investors—pension funds, insurance funds and that sort of thing. About 25% is interest paid to the rest of the world. The interest paid by the taxpayer to domestic investors—pension funds, insurance companies, banks and so on—is recycled back to taxpayers in the form of pension payments in the future, so this money is very well spent by the Government. It helps to fund our pensions and to support the finance sector.

Fiscal rules that are aimed at this rather ridiculous target of reducing the deficit to whatever number is the fashion seem to me to be threatening not just to the health of the economy as a whole, but also to the finance sector.

Q110 **Wes Streeting:** Paul, where do you come down on some of these



debates?

Paul Johnson: Governments need fiscal frameworks to work within for all sorts of reasons, partly to do with external certainty, so that the world knows what you are trying to achieve, even if you do not get there; you can actually state what you are trying to achieve. It might be that you are trying to achieve 2% or 3% deficit, getting the debt down at some point or some fraction of spending as a fraction of GDP. A framework of some kind is important.

It is also, frankly, having worked there, quite important for the Treasury to give it some leverage over the rest of government, because the rest of the Government always wants more money, and if there is nothing that you can go back with and say that there is some kind of ceiling, then you just end up spending more money. That is genuinely an important part of why it is there, and also one of the reasons why in some sense I am less concerned about the precise nature of the wall than the fact that there is something there. You need the external clarity and the internal leverage.

Take Gordon Brown's golden rule as an example. He put it in place and he gamed it absurdly; we had the PFI nonsense and all this kind of stuff. However, it was still constraining, which was the intention. He probably knew very well, when he started, that he was constraining himself. In a sense, I think it is a self-constraint that Chancellors put on themselves for those reasons of intertemporal credibility.

What should the rules look like? In the end, you have to have in mind that you need something that is, in the long run, going to stabilise and bring down debt. That is the thing that matters in the long run. One of the worrying things about the forecasts, if we take the forecasts at face value, is that if real growth is slow and we are in a world of relatively low inflation, then you are in a world in which you need quite small deficits if you are going to be bringing debt down as a fraction of national income. That is very constraining, unless you can spend the money in a way that is effective enough to get GDP growing more quickly.

The last bit of your question was about whether, with it being fiddled around with so much, it has any value. There is the additional fiscal target in the Conservative manifesto, and repeated in the last Budget and this one, which is to get budget balance by the mid-2020s. If growth carries on as projected here, I do not think that will not happen, honestly. If growth is better then there is a good chance of it.

The other thing that we saw was the reclassification of housing associations, which gains the Chancellor about £5 billion a year. That is not a real change. In a sense, he should probably have moved his target to 1.75% of GDP borrowing, but I do not think that was ever going to happen, frankly, and whether it is 1.75%, 2% or 2.25% does not really make much difference, so he has made use of that little bonus.



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Ann Pettifor: If I could come back, I just want to say very clearly that I am also concerned that we should balance the public finances, that they should be healthy and that they should be stable. Back in 2007, public debt was about 40% of GDP; that was the average, and has been across time the average, of debt to GDP. In 2010, we wrote a paper called “The economic consequences of Mr Osborne”, and we predicted that if there was to be fiscal contraction, the public debt would rise. Sure enough, here we are, 10 years later, and the public debt is not 40% of GDP; it is 90% of GDP, despite all the constraints and the contraction that Paul has been talking about. It is not constraints that cause the debt to fall; it is constraints that have increased the debt, and it is spending that will cut the debt. That is really hard for people to get, but it is spending and increasing demand that will lower the debt. Until we learn that lesson, we are going to carry on and the debt will continue to rise. The OBR predicts the cake is going to shrink and the share of debt is going to rise. We have had 10 years of this hell. Are we going to have another 10 years of it, on the basis of constraint?

Wes Streeting: You have really anticipated the direction of travel with my questions.

Kit Malthouse: What a surprise.

Wes Streeting: It does not matter where you sit on the political spectrum. Wherever you sit on the political spectrum, it is hard to argue that the fiscal rules we have seen put in place—that being the fiscal rules in the broadest sense, or specific rules like the benefits cap—have been put there primarily for political reasons, to either do virtue-signalling to the public about what you intend to do, or virtue-signalling to try to wrong-foot your political opponents. That is what George Osborne’s caps were largely about, whether you are talking about the fiscal rule or the welfare cap.

Chair: It is not an Opposition Day Debate.

Q111 **Wes Streeting:** Yes, sorry. I am not going to give way. Turning to the welfare cap, Paul, the welfare cap has been reset again, based on the OBR’s latest spending forecast. It is not going to be formally assessed against the cap until 2020-21, by which point the 2017 forecast is going to be irrelevant. In practical terms, what are the benefits of a welfare cap, and is the current cap fit for purpose in terms of obtaining those benefits, if there are any?

Paul Johnson: I do not think there is much value in the welfare cap as it is currently designed. There was a good reason for thinking about something like a welfare cap, because there was a lack of control, if you like, over this demand-led spending. If you are sitting in the Treasury, you are controlling the amounts that go on schools, the health service and so on, and you have the DWP and it just looks like something you cannot control at all, so you essentially put a process in place that has a cap, which says, “If it looks like we are going to reach that, we are going to be forced to do something by the political system that is going to hold



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us to account because we have put that cap there". That seems to me perfectly reasonable. Again, it is about providing self-discipline with some external constraint. That seems reasonable.

Where we have ended up, as you say, is it keeps getting reset, and it is not going to be assessed until after the next election. That seems largely to lose its point. If what the Government want to achieve is to constrain their own behaviour in some sense, then it probably needs to rethink this. If it is now just wanting to kick it into the long grass and have something that is not going to get in the way, that is probably where they have got to.

Professor Chadha: Coming back on the welfare cap and also on things like the triple lock, there can be times when it is appropriate for a Government to set themselves particular expenditure constraints as a fraction of what they want to spend their money on. However, over time they might evolve; the nature of the shocks hitting the economy or the impact that particular policies have had in different sector may require those to be addressed. In a sense, over the long run, these things do not make a lot of sense, and Governments have to rethink the fractions that they are spending on people, because we just do not know how the structure of the economy will change and how people will be affected.

I want to very briefly come back on a couple of fiscal points that were made earlier on. There is a lot of talk about the downgraded productivity meaning the fiscal position is more problematic than it would have otherwise been without the downgrade. That is right but only to an extent. One of the reasons that productivity has been downgraded, or that we have seen low levels of productivity, is that employment has been high. Rather than fewer people producing more goods, we have more people producing more goods. That higher number of people in employment is hedging, to an extent, the fiscal costs of lower levels of productivity, so providing that the low productivity that we are expecting to see in the future is accompanied by continuing high levels of employment, it does not necessarily have the negative impact on the fiscal position that you might think. We have done quite a bit of work on that, to understand how that offsets some of the impact of lower productivity.

Going back to this point about the extent to which the increase in public debt has been a problem or a disaster, this is really where economics has difficulty in convincing people sometimes. The counterfactual of where the economy might otherwise have been is not entirely clear. The economy itself was arguably facing a world in which it was going to be difficult to recycle debt. Remember that as well as issuing new debt, every year the Government have debt that gets redeemed and needs to be sold again in financial markets. Over the next four or five years, about £500 billion of debt has to be recycled into financial markets, so it is incredibly important at all times that that facility is available. Even if we are at 90% of debt, the fact that we are continually able to issue



debt, whether it is nominal or index-linked, is an incredibly important option that the Government faces, and we should not undervalue that option and think that retaining that option is something that is not valuable. It is incredibly valuable.

Q112 Wes Streeting: I want to move on to the final issue, which you have already touched on in different ways, which is about some of the trickery, or what is described by the OBR as the “fiscal illusion” of reclassifying housing associations to the private sector. Paul, you mentioned this already. I just wondered, across the panel, if you agreed with the OBR’s description and whether you think the inclusion of the Bank of England’s term funding scheme in public sector net debt constitutes another fiscal illusion.

Finally, slightly tangentially but just to offset any accusation that I am being terribly partisan today, I am really bothered by the latest state-of-the-nation report from the Social Mobility Commission, and, Paul, I cannot think of who you had in mind when you were talking about the obsession with tuition fees. I know the IFS did an analysis of Labour’s manifesto during the general election. I was busy ringing undecided voters, so I cannot remember if you did distributional analysis of the parties’ manifestos collectively. If not, is that something the IFS might look to do, to see who would be the major beneficiaries of our parties’ tax and spending policies?

Professor Chadha: Clearly, if there are liabilities, wherever they sit, and ultimately the Government are behind them, they should be things that appear on the government balance sheet. For a long time, we have thought that thinking in terms of just the flows of deficits does not make a lot of sense. What we need is a snapshot of the Government’s assets and liabilities position, and if there are claims on the government balance sheet, from the PFI, from student loans or from housing associations, they should appear as such. The OBR has hinted at that, and it is something we would agree with. The construction of an appropriate balance sheet would be the way that we would want to think about government positions.

That might give a clearer picture, in fact, of the extent to which the Government are truly indebted against the assets that they hold. It is something that at the moment is very hard to construct, and it something I would like to see as an objective for Government.

Ann Pettifor: I agree.

Professor Chadha: At last

Chair: We do not want too much agreement. It makes for a boring session.

Paul Johnson: There are several questions in there. With the issue around the housing association reclassification, it really ought to give us pause, as Jagjit was suggesting, to look behind the details of the number.



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I cannot remember exactly what it was, but there was a small change in regulation that shifted something like £70 billion of debt from public sector to private sector. It only shifted into the public sector a couple of years ago, so this is just a return to the status quo ante in terms of how it is counted.

However, there is no sense in which the public sector would not feel that it was standing behind the housing association sector if something went horribly wrong. In any case, a very large fraction of the rents that are paid to housing associations are paid through the housing benefit system, so this is a fairly closed loop. That is why it is terribly important that we are not just focusing on the headline number, without looking in detail at all the other things where the public sector is on the hook. The whole of government accounts are published, which give you some of that over the long run, although again you have stuff in and out of the public sector. The OBR's long-term public finance forecasts are also helpful. We need to take all of that in the round. We spend much too much time on this one thing. It is very easy just to focus on individual numbers.

One of the other things that the OBR referred to was the "Augustinian" tendencies of the Government, in the sense of, "Make me pure, Lord, but not yet". Very clearly, this Budget, as with many others, has increased spending in the short run and promised cuts in the longer term. As I suggested earlier, I question the credibility of some of that, which is clearly designed to make the numbers look better four or five years out. The OBR has probably been as strong as it can be in saying that it doubts the credibility of that as well.

You asked a rather separate question about the distributional impact.

Wes Streeting: I had to sandwich them in because if I try to ask another round of questions, the Chair will cut me off.

Chair: You definitely would be cut off, yes.

Paul Johnson: To be honest with you, I cannot remember exactly what we did before the election, but I can certainly send you the link to what we did. In broad terms, if you look over the period since January 2010, we have had a set of tax and benefit policies that have hit the top 5% extremely hard and the bottom third hard, particularly the bottom quarter. The middle to upper-middle have been remarkably well protected over that period.

The big thing, which maybe you were alluding to in the Labour Party plans, was the impact of abolishing student fees; that is clearly a big giveaway to the highest earning graduates and of no value at all to the large majority of the population; it is of limited value to most graduates. You are always comparing on a baseline there. We talk a lot about distributional impacts. The fact that something is giving some money to rich people and taking it away from poor people is not necessarily bad—it



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depends on where you are starting from—but that would be the impact of the student fee abolition.

Q113 Kit Malthouse: I had some rather interesting questions but they have largely been asked by other people about forecasting. Essentially, as far as I can see it, the art of forecasting is shot, is it not? Brexit was the final nail in the coffin, with all those pre-Brexit forecasts that turned out to be total rubbish. Given that you have all broadly told us that the OBR's current forecast is almost certainly wrong, in terms of the public confidence that we are able to steer upon a path that we can broadly predict, it is not really there, is it?

Ann Pettifor: I would agree with you on that, but I do not think it is the forecasters—

Kit Malthouse: I do not want to put the three of you out of a job, but a large amount of it would be about forecasting and the art of forecasting.

Paul Johnson: I do not do any forecasting.

Ann Pettifor: You are right about the forecasting, but it is the basis on which the forecast is made. The real issue is the issue around the economics on which the forecast is based. In the case of the OBR, it is based on microeconomic reasoning. If you look at the OBR, it thinks, "How are we going to reduce the deficit? We are going to increase taxes and we are going to cut spending. If we increase taxes and cut spending, this is what is going to happen". If that is how you think about the Government's budget, you are thinking about it as if it were a household, a firm or even a local government. It is not any of those things, but that is how the OBR thinks about government spending. The OBR therefore cannot predict what is going to happen because it is not looking at the macro-economy and it is not using macroeconomic reasoning; it is using microeconomic reasoning. That is why the forecasting is so flawed.

Q114 Kit Malthouse: If you look at the fan charts that they produce, the range is massive, in terms of the historical error. It is something like 6%, plus or minus. On the current prediction, they are saying by 2022 we could either be negative 1.5% or positive 4.2%.

Professor Chadha: I want to just take step back. What is a forecast or projection for? Essentially it is for planning. It is for thinking about the future in a structured manner. Rather than just making something up, it is a way of ensuring that what you say about consumption is consistent with investment, it is consistent with the view on what the fiscal policy-maker is going to do, it is consistent with a particular view on the exchange rate, and if you say one country is going to be exporting more, it means another country is going to be importing more. It imposes a consistent framework.

What is very interesting in the dialogue in the last year and a half—I started at the institute just before the referendum—is that the institute produced two projections at that time. One was what would happen in



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the event of a "leave" vote and the other was what would happen in the event of a "remain" vote. The forecast in the event of a "leave" vote was that the exchange rate would fall by about 15%, there would be an inflation rate of around 3% or more this year, poorer households would suffer and, as 2017 went on, investment would fall as a result of uncertainty. That forecast was so accurate that we have not had to revise it until November this year. What I find remarkable is that the consensus or central case that orthodox economists were making as to the impact of leaving the European Union has been so profoundly correct, and yet, at the same time, there has been a narrative that the forecasters got it wrong, and I think that is because, in the run up to the referendum, the dialogue was dominated by people wanting to make the risk cases on either side.

A number of times this afternoon I have talked as clearly as I can about the difference between understanding a central case and talking about the risks. You are right to draw attention to a very broad range of risks in any forecast. There are a lot of stories or scenarios we might think of that might happen over time. What the bank does is try to encompass those scenarios in a consistent manner. If the output number is higher, that also has to mean the interest rate is higher, because the MPC is more likely to put interest rates up. That would also then mean the exchange rate is higher, so if output is still going to be higher, you have to ask yourself which bits of the economy are going to provide those extra numbers of output. It forces a consistency on the view.

The interesting point is about why it was that the narrative was dominated by the people who were exaggerating the risks on either side. That is not what we did at the institute, and it is not what most respectable forecasters did, and I find that really interesting.

Q115 Kit Malthouse: Fundamentally, then, if you are going to use forecasts for anything, presumably for forecasts like this from the OBR, the policy-maker objective should be to try to avoid that path. If you want growth a bit higher, this tells you that your objective is to prove the OBR wrong by trying to find some way to lift the line.

Paul Johnson: It is two-fold. What the OBR has done here is give its best honest, independent estimate of what will happen on current policy. It is incredibly important that policy-makers have a best independent, honest forecast of that. It is even more important that they understand where it comes from, and that they understand everything that Jagjit was talking about, about how that comes together and what the risks on either side of it are, and, as you say, what we do, particularly in the longer run, to shift that path.

What we do not want is what we have had in the past, which is the people making the policy also making the forecast and therefore being able to fudge the forecast to tell a different story about the policy. As I say, we absolutely do not do any forecasting at the IFS. It is much too difficult for us, but we do look at what the OBR is saying, what the Bank



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is saying and what NIESR is saying in terms of the short run. We also look at and understand the basics of the economic forecast that Jagjit was talking about: if you increase uncertainty, you will have a certain effect; if you increase the costs of trade, you will have a particular effect. Those kind of counterfactuals are much easier to get at than, "Growth will be 2% or 1.2% next year".

Q116 Kit Malthouse: Is it possible in the current structure, given the amount of information we have now, to make a similar historic mistake to the one made perhaps in 1988? Nigel Lawson misjudged the economy and it overheated as a result. He assumed it was slowing, it was actually accelerating, there was the 1988 giveaway Budget, and up it went, inflation through the roof. Interest rates then rocketed thereafter.

Professor Chadha: The problem with economics in real time is understanding whether what is going on is a demand or a supply shock. Clearly at that time, in 1988, the growth in the economy was demand-driven, but at the time the policy-makers thought it was a supply shock. In that sense, they decided to accommodate it. You are right: we have this problem all the time as the economy develops. Is it demand or is it supply? Your responses are very different. The wonderful thing you all want is a set of positive supply shocks, because they increase output, lower inflation and we all feel much better off as a result of that. What we have at the moment is a slowing economy. We have to try to understand the extent to which it is about supply. Is it productivity? Is it capacity?

Q117 Kit Malthouse: The forecasters are saying it is a slowing economy.

Professor Chadha: It is a revision, so what the OBR had last time was something in the upper-1s; it now has something in the lower-1s. It is an economy the growth rate for which is slowing.

Q118 Kit Malthouse: This is one of the issues. Ann, you raised a very interesting point about this collective defeatism. Is it possible to talk yourself into a slowdown, given that economics is 90% psychology? There is an unremitting media emphasis. If you Google "uncertainty", you will find millions of mentions of uncertainty across the media. Is it possible to talk yourself into a slowdown?

Ann Pettifor: Yes, it is possible, because the starting point is the wrong starting point, in economic terms. Your question is really important, because they have such an impact on the public and the real world, and so many of the forecasts around Brexit were, as Jagjit has said, extreme, but the Treasury was behind one lot, and then of course the Brexiters were behind the other. Both exaggerated the impact of trade, and net trade, as I said earlier, is a small part of GDP.

Q119 Kit Malthouse: Just on this point, the Bank of England has said to us in the past that when it does its forecasting, it does look at social media and the newspapers, and they look for words like "uncertainty", and it becomes an echo chamber of this overall sentiment, and yet there are



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some indicators in the economy. If you look at the City, job vacancy indexes in the City are well up on where they have been in the past. Some of the manufacturing sector is doing quite well. I have to profess to you—I declare an interest—that I have a business that lends into the small business sector, and we are not seeing any of this at all. When the CBI goes and does its index and it talks to all the senior managers, the senior managers have read the *FT*, seen the unremitting gloom and just reflected back to the CBI.

Professor Chadha: We can look at slowdowns in the past—1990, 2007-08 and previously 1981, if we go back in time—

Ann Pettifor: 2007-08 was not a slowdown. It was a global financial crisis.

Professor Chadha: Fine, but the economy slowed down.

Kit Malthouse: A rapid deceleration.

Professor Chadha: What I am trying to say is that the analysis of what we might call recessions or slowdowns is often that, in each of the previous expansions, risks were being built up, of different forms, and at some point, whatever point that is, we have realised that those risks have been built up, and the economy then has to adjust in a particular form. It might have to adjust through interest rate shocks, through an exchange rate jump or through 10 years of trying to reorient the economy away from the sector that caused the shock. If we are going to say that those kinds of recessions are driven by beliefs, in a way, that would suggest that the economy can run in a way that is separate to real activity—real choices, real jobs and real production. That is not the way that we really think the economy works, so if there is an event that triggers the change in beliefs or understanding of risks, that could then lead to the slowdown. It would be nothing more than us realising that those risks have been manifest, and that is very much what happened in 2007-08 and in the previous recessions as well.

Q120 **Kit Malthouse:** Or it could be that the risks are being exaggerated. As you say, the voices in this debate tend to be at either end of the normal curve. There is very little in the 80% or 90% sitting in the middle, talking and saying in calm terms about the way the economy should be going. Those are the voices that naturally the media pick up. I am not going to blame the media for this, but it becomes an echo chamber.

Both of you chaps, when Ann was talking about effectively what sounded to me like a reincarnation of Anthony Barber, were slightly pursing your lips, and her inflating demand—

Chair: Move on, Kit.

Ann Pettifor: Anthony Barber did not inflate demand; he inflated supply.

Kit Malthouse: You implied that it was a demand problem—



Ann Pettifor: It is a demand problem.

Kit Malthouse: And that you wanted to stimulate demand. My understanding of the Barber boom was that that was exactly what—

Ann Pettifor: No. The Barber boom was a supply-side shock—increased credit, increased deregulation.

Q121 **Kit Malthouse:** I am just interested in this notion of demand stimulation. Do you think that would be a useful thing?

Professor Chadha: We have discussed this a little bit, in the sense that we are aware that, at some aggregate levels, investment is below where we would like it to be, but we think doing things without carefully thinking about where the money should go, whether that is the private sector or the public sector, will not necessarily have the impact that we would otherwise want. Any further investment from the public sector or the private sector must fall into an economy that is able to receive it. One of the deep structural problems that we have is that the levels of productivity are value-added. They are not evenly spread throughout the country, so we do not necessarily want to invest in areas that are already above average. We have to think about structural reform that can help other areas. It has to be knitted together in quite a complex manner. Simply increasing expenditure without thinking about the structural reforms will not have the impact that we want.

Paul Johnson: I agree with that very much. We get lost in a rather sterile debate when we talk about “this many billion more” or “this many billion less”. For anything, the answer is vastly more complex than that, and it may well require more public investment in particular things or particular regions at particular times. If the Bank and the OBR are right—if they are right—and we are currently at capacity, then just bunging a bunch of money into the economy will not have the effect that we want. It may be that they are completely wrong, but they would have to be wrong about that for a significant increase in demand to be effective in the short run. In the long run, more public investment, more private investment and a bigger state is entirely consistent with a more successful economy, if you do it right.

Ann Pettifor: I was actually kicking myself for missing an opportunity there. I predicted in 2003 that there would be a global financial crisis in a book called *Real World Economic Outlook*, and then in 2006 I was beginning to panic about the fact that all my friends were taking out mortgages and debt and so on, and I published another book, which the publisher insisted on calling *The Coming First World Debt Crisis*, and I hated that title. The fact is that I was a lone voice then, and my forecast and my analysis was based on what I thought were real economic forces, not on chatter, not on social media but on real economic forces and, in particular, on the massive increase in credit and debt that was never going to be repaid; it seemed to be blindingly obvious, but there were very few other economists saying it. In fact, my book fell like a lead



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balloon. It was hardly read by anyone, but I am here today because of that book.

Q122 **Kit Malthouse:** Did you read Niall Ferguson saying in the *Sunday Times* that he also—

Ann Pettifor: Yes, he does claim to have done so, but let us not go down that route.

Q123 **Kit Malthouse:** It is interesting you should say that. I have to confess to you that in the year before—about 18 months before—my business all felt rather fizzy, so we de-gearred quite significantly. I looked foolish for about a year, and then suddenly—

Ann Pettifor: Exactly

Chair: When Her Majesty asked, “Why did no one warn us?” they should have come and asked members of the Committee, clearly, and some of our witnesses.

Q124 **Catherine McKinnell:** I have to confess that I heard you speak around that time, 2003, at Newcastle University on the very subject, so I should have been warning people as well.

I wanted to ask about local authority funding and the sustainability of it. The OBR’s forecast included a box highlighting that, in 2015-16 and 2016-17, English local authorities drew down their stock reserves by £400 million and £1.5 billion respectively, and that they expected the squeeze on local authority finances to prompt drawdowns much earlier than had been the case, but the corner does now seem to have been turned. Are you surprised at how long it has taken local authorities to draw down on reserves, given the political consolidation?

Paul Johnson: If you had asked me in 2010 or 2011, yes, I would have been surprised by that. I do not have any analytical answer, in a sense, beyond that, having spent quite a lot of time talking to people in local authorities in 2011 and 2012, at that time they were very confident that they could manage for two or three years. Talking to them more recently, it is very clear that they are extremely unconfident.

That is not an analytical response; that is simply from the fact that I, for various reasons, spend quite a bit of time with some of these people and their outlook has changed dramatically, and it has changed because their view was that there were significant savings that they could make early on. Their views now, as I see it, particularly in those areas that are responsible for adult social care, are that they are really struggling. If you look at the scale of the cuts and the increase in demand, that is hardly surprising.

It is genuinely hard, analytically, to tell at what point that problem is going to start to appear. We saw it in other areas—in the prisons three years ago, in social care a couple of years ago, and in the health service maybe we are just beginning to see it; in other bits of local government I



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think it is becoming increasingly evident. Of course, the Chancellor did make available additional funding in the March Budget through allowing increases in council tax, supposedly directly for social care, so there is something extra going in there. How hard it will in the end be, I do not know. It is interesting: the amount of additional reserves that they have added over the last four or five years is quite large relative to the amount that they have currently drawn down.

Q125 Catherine McKinnell: Presumably your response would be that these are reserves for day-to-day services; it is not sustainable in the long term.

Paul Johnson: It is obviously not sustainable in the long term. What the right level of reserves is across the local government sector I do not know. Clearly, because there were a number of years of net additions, they remain higher than they were a few years ago, so it is something that they can tide themselves over with for a while, but evidently it is not something that they can do forever.

Q126 Catherine McKinnell: Should we be concerned about local authority funding and what is happening there?

Paul Johnson: Yes. We know, as I say, that demands are growing, because the population is ageing and so on. We know that is creating problems for the health service through the way that social care is funded. We know that local government has had some of the biggest cuts of any bit of Government. As I said, that looked sustainable for a longer while than perhaps lots of people thought. It is looking less so now. It is difficult to tell how much extra is needed and when, but one really is going to need to keep a pretty sharp eye on how difficult this becomes. In social care, the Chancellor took the view in March that it needed an injection of additional money.

Q127 Catherine McKinnell: There are obviously different responses in different postcode areas. Do you want to come in on that, Jagjit, but also on the steps that local authorities are taking to improve their finances, by, for example, investing in commercial property? Do you have a view on that?

Professor Chadha: Reserves are there as contingencies against expenditures when income may not be available. Any local authority, depending upon its constituency of taxpayers and its expenditures, may have a different requirement for reserves over any year. I just do not know, from the analysis provided by the OBR, what is an appropriate level of reserves and what are the payments that local authorities have over the course of the year. That would require some analysis to think about local authorities, the way that they manage their expenditure and income patterns, and to think about an appropriate reserves management policy for them. I do not know whether that is something that has been done in the past or thought about. That would seem to me to be where you would want to go.



As Paul said, if reserves have gone up in the recent past and now they are going down, there may not fundamentally be a problem, but clearly, if there are plans to continue to draw them down, and at some point in the future reserves were not available, then you are going to get a world in which certain services will not be able to be supplied, which is going to be a severe problem for families and households living in certain areas. The way you manage that is to develop a reserves management policy, which, as you will know, all charities have to have, as do most firms and banks. If we have not got such a thing, that is something we should think about reasonably early.

Paul Johnson: You asked two specific questions. One is on the distribution. We know that the biggest cuts over the last seven or eight years have been in those areas that are most dependent on grants in the first place, which are, broadly speaking, the poorer and more deprived areas. They were getting a lot more from central Government and so the cuts to central Government have imposed a bigger proportionate cut on those areas.

You also asked about investment in commercial property. The reason, essentially, that councils are doing that is because they can borrow very cheaply and they are hoping for good returns. In that sense, they can outbid the private sector because they can borrow more cheaply than the private sector, so for each individual council you can see the commercial thinking behind that. Clearly, they are increasing their risk by doing that. The expected return for each individual council is positive and you can see why it is a rational decision. Some of them might get burnt if things go wrong. Whether this is sensible from a macroeconomic view, and a government-wide perspective, where the particular sets of borrowing rules, constraints and so on mean that the investment pops out at a small local council into a big shopping centre, I am rather less sure.

Q128 **Catherine McKinnell:** You mentioned the recent cash injection but also the social care precept that is supposed to be enabling local authorities to be able to afford the rising costs, but is there a risk at the moment that the need is outgrowing the ability to raise those funds through the precept, particularly on a postcode-by-postcode basis as well, in terms of the ability to actually generate that revenue through the precept?

Paul Johnson: The precept is not directly correlated with need.

Catherine McKinnell: No, but the ability to—

Paul Johnson: Exactly. We have done some work on this; I am afraid I forget the details, but clearly there are some local councils that cannot raise an awful lot from the precept because they have low-value properties and have a lot of need, and there will be other councils that it will work much better for, so there will be a distribution of outcomes, clearly.

Q129 **Catherine McKinnell:** Ultimately, it is not necessarily the answer to the



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growing problem of funding social care.

Paul Johnson: It is not going to be the answer in the long run, no. As I say, we have done some work on this that I can forward on. I forget the details, I am afraid.

Q130 **Catherine McKinnell:** I was going to press you a bit further on it, but if you could provide that work, that would be helpful. I was going to ask what more the Government should be doing in order to enable local authorities to be able to meet that growing demand.

Paul Johnson: There is a broader issue that we might see a Green Paper on at some point, I guess, in terms of making this whole system sustainable.

Q131 **Rushanara Ali:** I have some question on the equality impact assessment in the Budget and on universal credit. Starting with Mr Johnson, the Government did not publish an equality impact assessment alongside the Budget, and in 2011 the IFS said that it did not believe that a full gender impact assessment was possible. Is that still your view?

I will give you my questions in a block, because I am conscious of time. What do you think the barriers are that prevent the Government from producing such an analysis?

Paul Johnson: You clearly can provide some analysis of the gender impact of tax and benefit policies. You just have to be very careful about exactly how you interpret and present them. For example, suppose you were to raise the 40p or 45p rate of income tax, we know exactly the genders of the people who pay that on their incomes, and they will be overwhelmingly men. Does that mean it has no impact on the women to whom those men might be married? No, it does not, so you clearly need to put that in context. Equally, if you cut benefits for families or children, which are currently paid to the woman, will that have no effect to whom they are married? No, it will not.

If you are going to provide any kind of gender breakdown like that, you need to be very clear about those things where you are saying something about the individual to whom the money is being paid, but also about the family structure within which that individual is living, in order to get some kind of full picture. You can do both of those things and it would be relatively straightforward for Government to do that. They may feel that it is rather difficult to communicate it, but to do it for tax and benefits is not terribly hard.

Q132 **Rushanara Ali:** And yet they have a duty under the Equality Act, as part of the public sector equality duty. Are those the kind of things that they can provide assessments for, and are there other things that they could provide as part of that duty?

Paul Johnson: It is more difficult on the public spending side. If you are reducing or increasing spending on health or education, exactly who is going to be impacted is difficult to tell. There have been gender



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differences in the public sector workforce, which is actually becoming significantly more female. In that sense if you did a gender assessment of what has been happening in the public sector workforce, it would look like we have significantly increased feminisation of the workforce. Equally, therefore, if you are cutting pay in the public sector, that is going to have an effect on those groups. There are a bunch of individual things that you can do that tell you the difference in terms of individual men and individual women, but it is never going to be complete because there are a bunch of things where you cannot do that, and I repeat the point that it is important to take account of the family unit within which the man or the woman is living.

Ann Pettifor: You certainly can do it, as Paul says, and the Women's Budget Group has done it. It has come up with numbers that show exactly how women are impacted when it comes to the NHS, education, care and the family budget. It has done this work with the Joseph Rowntree Foundation and it has produced the numbers.

The more interesting point that it makes—and this comes to your point about the barriers to ensuring greater equality—is that the mind-set is that it is important for Government to invest in capital infrastructure, if you like, not in social infrastructure. It is arguing—I think correctly—that social infrastructure, which includes health, education and care, is almost as vital, if not as vital, as roads, rail and high-tech. I have to say that I think this is a weakness on both sides of the House. We think that jobs for the boys, in roads, rail or high-tech, are really important from an investment point of view, but where women work we are not really devoting the same amount of investment. Their point about there being capital infrastructure but also social infrastructure that has to be invested in is a really important one. The fact that we do not think like that is one of the barriers to achieving equality.

Q133 **Rushanara Ali:** That is interesting. Did you want to add anything on this point?

Professor Chadha: If we can measure it properly, it is a good addition to analysis and, if it is something that we want to do as a society, then we should put the correct resources in, produce a pilot and see what that gives us.

Q134 **Rushanara Ali:** How is it possible that Joseph Rowntree manages to get the Women's Budget Group team to do some of this work and yet the Government are saying that it is not so feasible? Is it a will issue? Is that what you are referring to? Is it a commitment issue as well?

Professor Chadha: I am afraid I have not read the Joseph Rowntree work but I am happy to say that I will and I can hopefully come back on that, but I have no answer immediately.

Paul Johnson: Clearly they can do some sort of sample. As I say, I do not think it is possible to do a full audit of this, and it is incredibly difficult



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to communicate it properly, but it is clearly possible to do what I have described, in terms of the amount of taxes and the amounts of benefits. The public services is significantly harder.

Q135 Rushanara Ali: In terms of other demographics—ethnic minorities as well—do you have any insights into this Budget? Are you familiar with any work that has been done on the impact on other ethnic groups alongside women, in terms of the implications of the Budget on distribution?

Ann Pettifor: I do not.

Paul Johnson: This Budget, to be fair, did not do very much. Distinguishing the impact on different groups is going to be quite hard.

Q136 Rushanara Ali: In the Women's Budget Group, there is a report that by 2020, 85% of lost income resulting from changes to the tax and benefit system will have fallen on women.

Paul Johnson: This cannot be about this Budget because there is not much in there, but this is one of the areas where you have to be very careful about that. The idea that that is impacting only on women as opposed to the family unit that they are in—I do not know whether the number is right or wrong, but you have to be very careful about how you describe that number.

Q137 Rushanara Ali: Turning on to another issue, which is related to childcare, the OBR stated that there has been far less take-up of tax-free childcare than it anticipated. The caseload is about 30,000, rather than 40,000. Is the take-up of childcare being prevented because of poor implementation of policy?

Paul Johnson: I am no expert on this, but my impression is that there are three things happening. The first is that it is being deliberately rolled out more slowly than originally intended, and the take-up relative to the original intention is much lower still. Secondly, there have been some administrative problems. Thirdly, we have ended up with such a complex array of ways of helping and subsidising people with childcare—everything from free or subsidised supply, through tax credits, through vouchers, through tax-free care, and it has been changing—that my guess and presumption is that people are just a bit lost, frankly.

Q138 Rushanara Ali: Which group is likely to be most lost and lose out the most, in your view?

Paul Johnson: I do not know. I have probably just told you everything I know about it, to be honest.

Q139 Rushanara Ali: Ann Pettifor, would you like to come in?

Ann Pettifor: I am afraid I am not really expert enough in this. I have to take the Women's Budget Group. It has been quite careful. It has said that it has shown that employed claimants will be, as a result of the



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changes to universal credit, £1,200 worse off, per year, by April 2021, the unemployed will be £500 worse off by 2021, and women on average will lose more than men.

To come to Paul's point about families, families with three children, with one earner, will be £3,891 worse off, and those with two earners will be £3,287 worse off. This is work done by the Joseph Rowntree Foundation and the Women's Budget Group. I am assuming it has been fairly rigorous. It is possible to calculate the impact on families, but I share your view that actually there is not the will to do so. I am afraid that there are too many chaps in economic think tanks.

Chair: That is a whole other inquiry.

Paul Johnson: The IFS is 50% female, including our senior team.

Ann Pettifor: I withdraw that comment immediately.

Q140 **Rushanara Ali:** We have two fine chaps with us today. There is a related point that I have found in my constituency work. If you are in work, you can have full-time childcare. If you are not in work—you are in training—you get part-time, and that is making it very difficult for women who have caring responsibilities with children and elders to make the transition into work, which is linked to the point we discussed earlier about employment and productivity. Do you have any reflections on whether you think this policy could be tweaked so that it captures this point about the transition through training into work?

Paul Johnson: I confess that is not a particular issue I have thought about.

Rushanara Ali: I am asking you to think on your feet.

Paul Johnson: It sounds reasonable.

Professor Chadha: Anything that reduces frictions in the labour market is something that we should support. Certainly, particularly for people who have had children and need training to get back to work, it seems to me critical that society should support them.

Ann Pettifor: It is really critical that women should not have to be looking after the elderly as well as the children, and that they should be able to get full-time work. Those are big macro issues; they are not micro issues. I do not know how you would tweak a policy to make it more adaptable to these very insecure part-time workers. With all the obligations that they have, that would be really difficult to do. It would be much better to change the whole picture.

Q141 **Rushanara Ali:** It is the restriction on having full-time childcare. If you are not in work over a certain number of hours, you cannot have full-time childcare. If you are trying to get on to training, you cannot do that very easily if you have small children. It is an unintended consequence.



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Turning to universal credit, the Chancellor announced changes in the length of waiting time, from six weeks to five, and some higher advance payments. Can you briefly outline the impact of these changes to spending in the future?

Paul Johnson: I can only tell you what it says in the red book, which is not a terribly large number; in fact, it is a slightly smaller number than we expected. That is partly because the upfront payments are loans, effectively. You get the money in the first month but then if you remain on the tax credit, on universal credit, you get less for the following 12 months. Rather than it being clawed back over six months, it is now going to be clawed back over 12, so the significant spending change is the waiting period going down from seven days to zero. That comes in at £200 million at its peak—I think that is the number—so in the context of universal credit changes, that is a pretty small number.

Q142 **Rushanara Ali:** In terms of some of the projections of increases in child poverty because of universal credit, universal credit is said to push up child poverty by 1 million by 2022. This recent change may help a little bit, but does anyone have any reflections on that?

Paul Johnson: The biggest impact of the benefit change on child poverty is the stopping of benefits for the third and subsequent children. That is by far the biggest impact.

Q143 **Rushanara Ali:** This policy will have an impact because the actual budget is going down, is it not? The actual amount being spent on benefits is still less than what it was previously, for universal credit.

Paul Johnson: There are two things. First, it really matters what the take-up of the benefit is. The hope and assumption is that the take-up will be significantly higher, and that will have a positive effect in reducing child poverty. Entitlement levels, on the other hand, will on average be significantly lower, particularly for lone parents, for two-earner couples, for those with assets and for the self-employed, whereas one-earner couples will gain on average, with different effects for different levels of income. The average entitlement will be lower, and that will clearly result in a higher number of children living on low incomes, which may or not be—but it may be—significantly offset by higher levels of take-up.

Q144 **Rushanara Ali:** It may, but you are not sure.

Paul Johnson: No, but that is one of the things that is an intended outcome of universal credit: that the take-up is higher than under the current system.

Chair: Thank you all very much indeed. Your time this afternoon has been very generous. It has been very helpful evidence. Paul, I think you are sending us further details on one matter. If there is anything else that occurs to you, please feel free to send it in. For this afternoon, thank you very much indeed.