House of Commons
Treasury Committee

Autumn Statement 2012

Seventh Report of Session 2012–13

Volume II

Oral and written evidence

Ordered by the House of Commons to be printed 22 January 2013

HC 818–II
Published on 30 January 2013
by authority of the House of Commons
London: The Stationery Office Limited
£12.00

The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies.

Current membership

Mr Andrew Tyrie MP *(Conservative, Chichester)* (Chairman)
Mark Garnier MP *(Conservative, Wyre Forest)*
Stewart Hosie MP *(Scottish National Party, Dundee East)*
Andrea Leadsom MP *(Conservative, South Northamptonshire)*
Mr Andy Love MP (*Labour, Edmonton*)
John Mann MP *(Labour, Bassetlaw)*
Mr Pat McFadden MP *(Labour, Wolverhampton South West)*
Mr George Mudie MP *(Labour, Leeds East)*
Mr Brooks Newmark MP *(Conservative, Braintree)*
Jesse Norman MP *(Conservative, Hereford and South Herefordshire)*
Teresa Pearce MP *(Labour, Erith and Thamesmead)*
David Ruffley MP, *(Conservative, Bury St Edmunds)*
John Thurso MP *(Liberal Democrat, Caithness, Sutherland, and Easter Ross)*

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publication

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/treascom.

The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in printed volume(s). Additional written evidence may be published on the internet only.

Committee staff

The current staff of the Committee are Chris Stanton (Clerk), Lydia Menzies (Second Clerk), Jay Sheth and Adam Wales (Senior Economists), Hansen Lu, Matthew Manning (on secondment from the FSA) and Duncan Richmond (on secondment from the NAO) (Committee Specialists), Steven Price (Senior Committee Assistant), Jo Cunningham and Lisa Stead (Committee Assistants) and James Abbott (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk

Witnesses

List of written evidence

Oral evidence

Taken before the Treasury Committee

on Tuesday 11 December 2012

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Andrea Leadsom
Mr Andy Love
Mr Pat McFadden
John Mann
Mr George Mudie
Mr Brooks Newmark
Jesse Norman
Teresa Pearce
Mr David Ruffley
John Thurso

Examination of Witnesses

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

Q1 Chair: I am sorry to keep you waiting for a few moments. We had a bit of private business to get through. Can I begin by asking you whether the Treasury in any way, directly or indirectly, has sought to or succeeded in influencing this forecast in ways you would have considered inappropriate?
Robert Chote: No.
Chair: The purpose of creating the OBR was to give the forecasts a stamp of independence. A second purpose was to give them a perhaps lower place in the firmament of credibility, that is people accepting realism about the limits of forecasting. How far do you think you have got in educating the public that forecasting is a pretty haphazard business?
Robert Chote: I think the cynical and obvious answer to that is, given the outturns for growth relative to what we said, we have probably done quite a good job in demonstrating the limitations of economic forecasting. The key thing is to underline the uncertainties that are around any forecast and for us to explain that nobody should bet the farm on a particular path being the definite outcome and, therefore, to explain how much it matters to the fiscal targets that we are ultimately here to police if the forecast turns out to be different in any one of a number of ways reflected in our sensitivities and scenarios.

Q2 Chair: Do you think that when the dust settles and we have another year or two of the Chote era at the OBR we are going to come to the conclusion that on the key variables, output, inflation and so on, your forecast is any better than the average of outside forecasters?
Robert Chote: I think the key point is the key variables and the reason we have been created is not things like growth and inflation. It is the budget deficit, public spending and tax revenues. That is what we are here to add value for because we don't have any additional information to that anybody else producing a macroeconomic forecast has.

Q3 Chair: So we might as well use the average of outside forecasters?
Robert Chote: The problem with using the average of outside forecasters, which I recommended back in 2009—
Chair: That is why I raised it.
Robert Chote: You will recall we discussed it when you took evidence on the structure of the OBR. The difficulty that has become more apparent to me subsequently is that we need a particular type of economic forecast to produce a bottom-up fiscal forecast that really is not out there to pluck off the shelf. For example, you want something that has a much more detailed breakdown of different categories on the income and expenditure side of GDP than most other forecasters would need for their purposes. You need something that extends over five years, you need to take a view on potential output and the output gap over five years, and many people don't. The other thing is that you need to be able to take into account the impact that measures will have on the fiscal forecast and that is quite hard to do if you are simply trying to bolt it on to a table you have plucked out of a compilation of independent forecasts.
Chair: Those are two very good points. We are going to be coming on to both of those in various ways in a few moments.

Q4 Teresa Pearce: Your GDP forecast doesn't take into account the effect of the Government's supply side reforms. Why not?
Robert Chote: In what sense doesn't it take them into account?
Teresa Pearce: You don't include it in your modelling. Is that right?
Robert Chote: We make an assessment of how we think potential GDP is likely to evolve over the five-year period. That is taking into account where data has been in the past and our assessment of any likely impact the policy measures are going to have on that. Judging at the best of times how potential GDP is likely to evolve is a pretty difficult task and you have seen the scale of the revisions that have happened subsequently to that. The various measures that we have taken into account in successive budgets and autumn statements generally haven't been large

enough to take us away from the view that over the long term there isn't much better that we can draw back on than to assume the potential GDP, the underlying supply potential of the economy is going to grow in the future in line with its performance in the past. Making a very small and precisely calibrated change to a number around which there is such uncertainty doesn't seem to make a great deal of sense.

Q5 Teresa Pearce: Isn't the point of a forecast to look at the uncertainties and make a forecast? If what you are saying is it is hard to take that into account because it is uncertain, that is the point of a forecast.
Robert Chote: Take planning reform for example, which would be an area of supply side reform that many people have called for for ages and would argue that that is likely to have long-term beneficial impacts and that is quite likely to be the case. But taking it from a view that you want to have a greater presumption in favour of development, how that is going to be implemented in practice is hard enough to judge when it is conflicting with the demands of localism in other areas. Precisely calibrating how that is likely to have an impact is a pretty heroic task.

Q6 Teresa Pearce: Are you saying that it would be far too complicated to try to do supplementary reports on those sort of supply side reforms?
Robert Chote: If we thought that there was a reform where there was a sufficiently robust evidence base that would take us away from our view that the most likely long-term path for potential GDP was as we have currently set it out then we would certainly take that on board. That has not been the case yet and I should say—coming back to the Chairman's first question—we have never been placed under any pressure to insert those sorts of judgments either.

Q7 Teresa Pearce: Which supply side reforms in the *Autumn Statement* do you think would have the greatest impact? You have mentioned planning there but have you looked at that at all?
Robert Chote: What we have focused on particularly is the impact of the budget scorecard measures, the ones that are isolated in the Treasury documentation. There you are focused principally on the demand side implications. The net giveaways and takeaways over most years of the forecast aren't particularly large so there is no dramatic change there. One change that you can argue is quasi supply and demand is the fact that we have increased the growth forecast by about 0.1 percentage points of GDP over the next couple of years, reflecting primarily the decision to increase capital spending. Many people would argue that relative to other forms of spending you might expect that capital spending is likely to have some supply side benefits as well. Again, I think they would be sufficiently small that calibrating them precisely would not be sensible but that would show up in outturn data over time.

Q8 Andrea Leadsom: Good morning. I would like to talk to you a bit about household consumption and specifically a couple of things. The Bank of England's *Financial Stability Report* says that the debt to income ratio has dropped from its peak of 170% in 2008 down to 149%, so household balance sheets are sort of improving. Then there is speculation from the Bank of England's *Inflation Report* that the Funding for Lending Scheme should ease credit availability for households. Do you anticipate in your forecasts that domestic consumption will increase? Is that going to improve growth levels in the economy and to what extent to you think that is likely?
Robert Chote: I will ask Steve to say a little bit about how we think about debt to income ratios and how useful that is as a guide to things. If I pick up the point about the FLS specifically, it is pretty hard to isolate the impact that the FLS is having on spreads and therefore feeding through to the real economy as distinct from other policies, for example at the European level, which have done the same sort of thing. What we have basically taken a judgment on is that the change in spreads that we have seen since the summer, to which presumably the FLS is contributing but also other developments as well, does have an impact of maybe up to 0.3% on the level of GDP by 2014, I think. You would certainly expect some of that to come through on the household side, and indeed there is reason to think that FLS benefits are more likely to show up in the mortgage market than they are in the SME market, for example.

Q9 Andrea Leadsom: Do you think it is already starting to show up? There have been some press reports of a frisson of competition for new mortgages. Do you think that that is starting to be the benefit of FLS or is too early to say?
Robert Chote: I think it is probably too early to quantify that. The Bank of England has been warning, I think, that as you start to roll out the data on this it is a bit dangerous to conclude either it is not working quickly enough or better than you expected on what we have at the moment. In terms of household consumption more broadly, leaving aside things like the FLS, a key issue here is how quickly we get back to the point at which household incomes are growing considerably more quickly than inflation again, which has been a puzzle and an important judgment in most of the forecasts we have done.

Q10 Andrea Leadsom: But you have said that they have started to rise higher than inflation. Is that a reasonable deduction, or perhaps it is not you saying that?
Robert Chote: I don't think so yet. Inflation has fallen so I think it depends whether you are looking as relative to the previous forecast or relative to previous years. Inflation has started to fall, which has reduced the squeeze somewhat, but we are anticipating that it is going to fall less quickly in the future than we previously thought because of the news on utility bills, on agricultural food prices, for example. You have a combination of the squeeze from inflation improving but not expected to improve as quickly as we had thought. Then there is also our view that as we have seen continued, persistent, weak productivity growth, that is likely to imply that nominal earnings, the cash value of wages and salaries, is not going to rise as

quickly as we previously anticipated. Steve, do you want to say anything about the debt to income issue?
Steve Nickell: Going back to the household balance sheets, speaking personally I think debt to income ratios are not very helpful as measures of household balance sheets, partly because debt to income ratios basically depend on the number of mortgages, and the number of mortgages has actually fallen and owner occupation rates have fallen. Under those circumstances the fact that there is slightly less mortgage debt relative to incomes would not be a surprise. Whether people think that is a good thing or not is another matter.

Q11 Andrea Leadsom: Can I try you with another question then, Professor Nickell? There is all this talk of zombie households and the fact that as the economy recovers and we see interest rates rise again it is going to be a disaster for private households. Could you comment on your views, your forecasts further out for the impact on households as the economy recovers?
Steve Nickell: On the household asset side, as you rightly say, people often say that when interest rates start to rise households are going to be in bad shape. First of all, of course, mortgage interest rates for quite a lot of people are not that low. Secondly, it generally seems to be the case that people can't pay their mortgages, fundamentally, if they lose their jobs. If interest rates start to rise and the economy is looking better fewer people are going to lose their jobs. So I don't see there is much of a time bomb sitting in the mortgage market. Up to now, of course, the bank losses in the UK mortgage markets have been absolutely minute compared to their losses in other areas.

Q12 Andrea Leadsom: Thank you. One very quick final question on a slightly different topic, and that is on the automatic stabilisers. The NIESR have said that, "Cutting welfare benefits deliberately negates, as a matter of policy, the operation of the automatic stabilisers; it is a reduction in flexibility not an increase". Do you accept that automatic stabilisers help to dampen the economy during booms and provide necessary stimulus during a downturn? Do you think that cutting welfare benefits is going to harm the economy or help it?
Robert Chote: The automatic stabilisers work in that way. Any discretionary policy measure that you take—it doesn't need to be on benefits, it could be on tax measures or other categories of spending—could either augment the impact of the automatic stabilisers or partially offset it. If you look at the bottom line of the scorecard that the Treasury has, it doesn't make a colossal amount of difference over the first four years of that, so I wouldn't be too worried about it. The other point to make is that the size of the automatic stabilisers depends, roughly speaking, on public spending as a share of GDP and how progressive the tax and welfare system is. Just because they are automatic doesn't mean that they are in any sense optimal or designed to achieve a particular desirable dampening effect, as you described it. It is a kind of accident that falls out from society's other preferences about spending and how redistributive it wants to be. Sorry, that was a longer answer than you wanted.

Q13 Chair: So it depends on one's estimate of the output gap?
Robert Chote: No, absolutely. How much of it you then attribute to the automatic stabilisers—
Chair: So how long is a piece of string?
Robert Chote: Indeed, yes.

Q14 John Mann: Good morning. You are very wrong on net trade. Why?
Robert Chote: That is a good question. It is partly because the international environment and export markets have been performing less strongly than we anticipated back in March and at this time last year and partly I suspect because of what has happened to the exchange rate. But, as we highlight here, it does appear that export performance has deteriorated by more than you would anticipate, adding those two factors together, for which I don't think we have a particularly good explanation. Something we need to be aware of is that this sort of puzzle was present a couple of years ago and we were all asking why has export performance not picked up, given the scale of the depreciation. The Office for National Statistics turned around shortly afterwards and said that it had shown up over the previous two years in the data in revision. So we need to be slightly careful about assuming that this story will remain exactly as it is in the data, but to some degree there remains an unexplained element.

Q15 John Mann: I understand the puzzle. What I don't understand is the change that you have made therefore.
Robert Chote: Do you think it is too big or too small?
John Mann: Well, I am asking you. You have changed your assumptions but I can't see what the validity of you making a change is.
Robert Chote: For example, we were expecting this time last year GDP to be broadly flat over the period between then and now. If you try to explain why we have had the double dip, why GDP has fallen in a way that we, and indeed others, did not expect, where it shows up in the forecasts is through net exports. Investment is slightly weaker, although we have had subsequent revisions that have pushed that back up again. Consumer spending has been roughly as expected. Government spending has delivered slightly more positive news than expected. So you are left, basically, with the net trade story. In part it is reflecting the fact that that is what the data has been showing us about what has happened over the last nine months to a year.

Q16 John Mann: By deduction. What assumption have you built in until 2017 of increases in energy prices?
Robert Chote: We generally assume that oil prices move in line with the futures curves and we have an assumption about what gas prices do relative to oil prices, based on those forecasts.

Q17 John Mann: What is your assumption on domestic energy prices?
Robert Chote: We have another increase in for next year, bigger than normal but smaller than last year. We basically have an assumption that most people are going to push them up by about 9% or so, which is roughly where everybody is—
John Mann: Each year?
Robert Chote: No, in the latest—because we were doing the forecast before all the energy announcements had been made during this round.
John Mann: No, over the next six years.
Robert Chote: In future they continue to go up but not as dramatically as they have been.
John Mann: By 9% each year for each of the next six years?
Graham Parker: No. I can't remember the exact details but we have another above general inflation rise for the end of 2013 but then I think we are not assuming any above normal inflation increases.
Steve Nickell: Based on the projection of the basic oil and gas prices. For utilities prices you have got the basic oil and gas price and then you have the extra stuff. We have had some extra stuff this year and we forecast some extra stuff next year but beyond that we have not made any specific allowance in our forecasts for more extra stuff.

Q18 John Mann: That is clear. Have you made any changes to assumptions on net migration?
Robert Chote: No, we have stuck with the ONS's low migration variant, which we have been using for ages.

Q19 John Mann: Have you made any assumptions in relation to local tax increases, primarily local government and fire and police authorities, over these six years?
Robert Chote: In terms of the council tax assumption, I think Graham may be able to help me on that. I think it is in line with inflation after a year or two.
Graham Parker: Yes, but because of the referendum limit I think we are assuming just about 2.1%. We are assuming that once that kicks in most councils will probably have a council tax rise just below the referendum limit but some will go above it.
Robert Chote: In terms of its fiscal impact, much of this washes out, of course, because it is self-financed expenditure so it appears on the tax side and is then offset by an equivalent number on the spending side.

Q20 John Mann: With those assumptions built in, you are predicating GDP growth to greatly increase by 2015–17, particularly predicated on an increase in private consumption. Where is the validity in that?
Robert Chote: It is a combination of the fact that the protracted weakness in productivity growth we assume at some point will start to reverse and therefore you will end up with stronger growth in nominal earnings, so the cash value of people's wages and salaries. We also have inflation falling, albeit less quickly than we anticipated, so the other blade of the scissors is cutting less sharply and you end up with real household disposable incomes growing more rapidly towards the end of the forecasts than they do at the beginning. That is the main reason for that.

Q21 John Mann: They are all very cautious assumptions based on high levels of predictability, but at the same time you have totally accepted, without hesitation, Government assumptions on, for example, tax revenue from Switzerland, on 4G. On the one hand you have behaved very cautiously. On the other hand you are accepting in your calculations what Treasury is telling you. How can you square those two things together?
Robert Chote: As you will recall from the original estimates that Ministers and HMRC made about the amount of money that Switzerland would raise, we have not accepted those original estimates and we have suggested that it would be more central to assume something lower, so that simply isn't true. On 4G, we have sought the publicly available information on what this is likely to raise. There was a study commissioned by Ofcom that is basically looking at the amounts of money raised from similar auctions in other countries. There was a PwC study doing a similar sort of thing, which suggested that £3.5 billion was about the right sum of money. I believe the Labour Party was suggesting how one might spend that sort of amount of money some while ago so I presume the number didn't come as an enormous surprise.

Q22 Mark Garnier: In the Bank of England quarterly *Inflation Report Q&A*—just talking about zombie companies—Spencer Dale noted that the number of companies that are making losses at the moment has increased quite dramatically since 2007 but the number of companies going out of business has shrunk quite dramatically. He then explains that has to do with monetary policy, the £375 billion of quantitative easing. But five and a half years into this super low interest rate environment, shouldn't we start to be a bit worried about zombie companies?
Robert Chote: It is certainly one of the issues that people have been highlighting as a potential explanation of the productivity puzzle and we refer to it in the box on that here. It is not just a story about monetary policy, it is also because wage growth is relatively weak. That is another absence of cost pressure there that has allowed some firms, arguably, to keep going for longer than expected. I think it is debatable to what extent it is the zombie firm explanation, i.e. not particularly productive or effective companies living longer than would normally anticipate versus potentially more successful and profitable companies not growing as quickly as they would in ideal circumstances. I think it is not just the zombie story. Ben Broadbent has made this argument in a couple of the speeches that he has done, that you have a misallocation of capital that could show up both in the weak firms and in some potentially strongly contributing firms not being able to contribute as much as we would like.

Q23 Mark Garnier: One of the issues about forbearance is the argument between good forbearance and bad forbearance. On the one hand you have good forbearance, which is where a company has a viable business model but is just trying to get over a hump in the road, and we all agree to that. Bad

forbearance is when the bank has a liability on its balance sheet to a company, trying to keep the company alive for the wrong reasons. Have you done any analysis into the level of bad forbearance within the banking system?
Robert Chote: We haven't looked at that specifically. Can you recall whether the Bank has done anything particularly?
Steve Nickell: We certainly haven't done anything on that.

Q24 Mark Garnier: Does that mean that you don't think it is a serious issue or does that mean it is just beyond your remit?
Robert Chote: We have taken on board the zombie firm story as a potential explanation. As I say, we have highlighted that on the productivity side. Distinguishing between those two particular reasons for it, we don't have the level of analysis and the micro-data to be able to judge that. I think the Bank has been looking more at firm level data and I presume that has shed some light on it, as would their agents' reports, but it is not something we have done.

Q25 Mark Garnier: There is an argument that goes with more pessimistic people that if you end up with a lot of these zombie companies around, a lot of false forbearance, you end up with a sort of Japanification of our economy. Do you think that is a possibility or do you think that is wildly wrong?
Robert Chote: It is hard to know the relative importance of all the various theories that people have put forward to explain a weak productivity performance, but if you look at the weak productivity performance it really is quite startling by historical standards. There are other countries that have a similar story and it is not as obvious, given what has happened to overall GDP, in the same way that it is here. Certainly we cite it as a potential reason why productivity has been as weak as it has but, as I say, this barrier on potentially more successful firms being able to grow as quickly as they might might be equally important.

Q26 Mark Garnier: Mrs Leadsom mentioned in terms of household debt that when interest rates start to rise that could cause a problem and, Professor Nickell, I think you said you didn't see it as being a huge problem. When it comes to businesses, do you think there is a potential risk to small businesses when interest rates start rising?
Robert Chote: Clearly in some cases, but it comes back to Steve's point of why would interest rates be rising in the first place. If they are rising because of the outlook for the economy and therefore for firms' profitability and revenue is rising then they could be going in parallel.

Q27 Mark Garnier: But we are in a super low interest rate environment. We talk about a low interest rate environment in the past and that would be 3% or 4%. We are now at base rates at 0.5%. I appreciate the yield curve is very steep at the short end but nonetheless we are in a very—
Robert Chote: Businesses are not generally being able to borrow at those sorts of levels.

Q28 Mark Garnier: Is it your opinion—and this is an important point—that it is a red herring that interest rates going up, back to a normal low interest environment, is not going to affect the economy because of the steepness of the yield curve?
Robert Chote: I wouldn't say a red herring. It is hard to draw an overall lesson from the circumstances of particular firms and how exposed they are to that relative to the upside they are likely to see from an improvement in demand for their products and services. Some firms are certainly likely to be in trouble as a consequence of that. Others will be more insulated by the fact that demand for their products is growing.
Steve Nickell: I think the area that is somewhat of a danger is commercial property where debt levels are very high and firms loaded on a lot of debt on developments in the time of the boom. That could cause a bit of a hangover if there is less forbearance or higher interest rates. I don't think this is going to be that serious a problem for the broad sweep of private sector companies, partly because the debts aren't that high and, since they can't borrow money at the moment, the smaller ones are not going to be overloaded with debt and the large ones have a huge cash pile.

Q29 Mark Garnier: My final question is on that particular point. There is a suggestion that a great deal of the money in the system has been caught up with these zombie companies, whether it is good forbearance or bad forbearance. A case has been made that one of the ways of increasing liquidity to smaller businesses is to take all this debt and put it into a bad bank. By bad bank, I don't mean the ones that went bust. I mean one that can look after bad assets and work out bad assets, thereby releasing liquidity to businesses who have better business plans but who can't get the financing. Do you think that is a viable proposition?
Robert Chote: It is not something that somebody has come to us and asked us to look at as a practical policy proposition so I couldn't give an informed answer on that.

Q30 Mr Ruffley: Mr Chote, some outside commentators have been rather rude about your—what they consider—convenient conclusion that we will see the cyclically adjusted current budget in surplus in 2016–17, meaning that it is more likely than not that the Chancellor will meet his fiscal mandate. What do you say to those critics who think your change of methodology, which you set out in your report, is convenient? Do you think it is unfair?
Robert Chote: I think it is. As you point out, what we are talking about here is whether the cyclically adjusted current balance is in surplus in 2017–18, which is the new—

Q31 Mr Ruffley: I think it is in surplus by 0.4% in 2016–17 and 0.9% in 2017–18, from memory.

Robert Chote: That is true, but the target date has rolled on since last time.

Q32 Mr Ruffley: No, exactly. So 2017–18 is the material one for the fiscal mandate, yes.
Robert Chote: The reason it is in surplus in 2017–18 in the target year is effectively because the Chancellor has chosen to extend the public spending cuts that were in place into 2016–17 through to 2017–18. That improves the structural position by 1.1% of GDP. As you pointed out, the surplus then is 0.9% of GDP, so it is that rolling forward of the spending cut that means you are still on course. The judgments you referred to methodologically, in a sense you can think of what would have happened if we had simply mechanistically done what we did in March versus the judgments that we have made on top of that, and actually the effect goes in the opposite direction from what you describe. It makes it harder for the Chancellor to hit the mandate rather than easier and that is because what matters is what you are assuming about the output gap in the target year, not in the current year. We have made an adjustment that says that the output gap is probably a little bit wider this year than our methodology would normally suggest but that is more than outweighed by a judgment move going in the opposite direction, which is that we think potential GDP is going to grow more slowly between now and the target date. So the judgments that we have made, rather than simply applying new data, make the Chancellor's job more difficult and not less.

Q33 Mr Ruffley: I wasn't associating myself with the idea that you had changed your methodology to make the Chancellor's life easier. Commentators have suggested that, but I just want to get on to this point—
Robert Chote: Yes. There are two effects and some people have just looked at the smaller one, which goes in one direction, and not the larger one.

Q34 Mr Ruffley: Quite, and I just want to unpack this because I think there is some ill-informed comment out there that this is making life easier for the Chancellor. On that point, could you talk us through what the other forecasters are saying about what the output gap might be in 2017–18? I don't want to lead the witness but that is a rebuttal to those who say you have done something a bit iffy.
Robert Chote: One problem is that there aren't that many forecasters who publish forecasts for the output gap.

Q35 Mr Ruffley: I was thinking about the National Institute and so on.
Robert Chote: They don't, for example. We ask them what their estimate of the current output gap is, which they graciously tell us, and we put that in our table for what it is now, but they don't publish their estimates, perhaps very sensibly, about where it is going to be in five years' time. In terms of where the output gap is now, we are in the middle of a wide range of between roughly one and five. We are three-ish. If you go further out then we tend to be more optimistic about the supply potential of the economy than the international forecasters, the Fund, the OECD and the Commission, but we are less so than, for example, Oxford Economics or Martin Wolf or Paul Krugman or people like this who would be at a different level.

Q36 Mr Ruffley: To what extent do you think the changes in the methodology that you use to calculate the output gap are overridden by any discretionary changes that the Chancellor might make? What is the balance between the two?
Robert Chote: If you think about the change in our view of the output gap, which is not simply the two judgments we have been discussing but also the application of the data as it is at the moment, that worsens the target measure by 0.9% of GDP, I think, at the end of the forecast. The Chancellor has overridden that by basically extending a 1.1% of GDP cut in public spending into the fifth year of the forecast because he has to make an assumption for the first time. In that sense it is the case that the policy is larger than the underlying forecast.

Q37 Mr Ruffley: In connection with the methodological change you say, on page 7, "Business and consumer surveys and other cyclical indicators would suggest an output gap of between 1.9 and 2.3 in the third quarter 2012. This would imply that the output gap had narrowed since the end of 2011 despite actual output being roughly flat over that period and much weaker than expected in March. This in turn would imply weakness in output over this period, imply it was structural and that trend total factor productivity had contracted." Then you say, "We find that difficult to accept. We do not think it is plausible that trend TFP has been negative over this period." Could you say quickly why you think it is implausible that trend factor productivity is negative? Are you looking at historical precedents here or—
Robert Chote: Trend TFP is essentially the underlying ability of the economy to put together inputs to make a unit of output, so the efficiency with which you do that. During the worst of the financial crisis it might be plausible to assume that you would get less efficient at that because of the degree of dislocation in the financial system, for example. The potential GDP growth has been weak subsequently. What we didn't find very plausible was to think there had been a sudden deterioration on the supply side over the period of the double dip when still not everything in the garden is by any means rosy in terms of the functioning of the financial system but it is not as though things have suddenly got dramatically worse.
Mr Ruffley: You didn't think it had contracted. Mr Parker, I may have misunderstood. Did you want to chip in on that point?
Graham Parker: No.
Mr Ruffley: Sorry, Mr Chote.
Robert Chote: That is basically the view. We have focused on this method of looking at business surveys and at earnings growth, but we also look at the other methodologies to see what that adds to the story. It is really taking what the business surveys are telling you and saying, "What would this imply if you look at it in a production function space?" and it didn't seem to us to be particularly plausible. That said, if we had used exactly the same methodology as we did in

March we would have said that the output gap in Q3 was 2.3. We have chosen here to think it is more likely than 2.7. Bluntly, whether it is somewhere between one and five is a difficult enough question let alone something over that small a difference. So I think one should not obscure the fact that there is much greater uncertainty, and always has been, about the level of the output gap. Even when Ken Clarke asked his panel of independent forecasters what the output gap was back in 1996, the largest and smallest estimates differed by 6% of GDP.

Chair: Significant changes.

Q38 Mr McFadden: How many OBR reports have there been now since the organisation was formed?

Robert Chote: Of these, five, I think.

Q39 Mr McFadden: How many times in those reports have growth forecasts been revised downwards relative to the previous report?

Robert Chote: We have had one upward revision in November 2010. The other ones have been downward.

Q40 Mr McFadden: So most times when a report comes out it revises downwards the growth forecast for the previous one?

Robert Chote: Yes.

Q41 Mr McFadden: Let's look at the growth forecasts going forward and this issue of the output gap that David Ruffley was asking you about. Simon Wells of HSBC says that in your latest report you say that the amount of slack in the economy, the output gap, is now assumed to be considerably larger than in your March projections. I want to follow up on your answers a minute ago, because you were saying we have at the beginning of the forecast period but not at the end, but he says, "In fact, it assumes that in 2016 the economy will be operating at 2.5% below potential versus just 0.5% in March and the output gap is considerably wider throughout the forecast. We believe this is a huge leap of faith. Indeed, in order to reach today's projections for the output gap the OBR has overridden its normal method, which would not have indicated such a wide gap." What is your response to that?

Robert Chote: As I say, if you look at the combination of the two judgments that we have made on potential then they mean the potential GDP is lower at the end of the forecast horizon than before. Part of the reason for the widening of the output gap is that also we have revised the actual GDP growth forecast so you end up with a wider gap, and it is 1.7%, I think, if you go right to the very end of the forecast horizon. That is certainly not a feature that you would expect to see in forecasts in normal times where you would assume that the output gap would be closed within a five-year horizon. The question is what are the alternatives to assuming that there is still a large, persistently open output gap at the end of that period. There are four alternatives you have to choose from.

One is that story, a big output gap at the end. Ours is certainly larger than you would normally expect. It would be smaller than those people who say that we are overestimating the hit to supply from the financial crisis and so on, so there will be people further out in that particular direction. The other alternative is that you assume that economic growth is going to be a lot stronger over the next five years than we anticipate, which would close the output gap. Most people out there are not assuming that economic growth is going to be dramatically stronger than we assume, even those people who aren't, like us, constrained to assume current policy and could therefore assume that there might be additional monetary or fiscal stimulus. The third possibility is that you believe that the financial crisis has dealt an even bigger hit to the supply potential of the economy than we are assuming but, as we have discussed already, people are finding it hard enough to explain the hit to supply that most people think there is at the moment so adding even more to that would intensify that puzzle. The fourth possibility is that it is not the financial crisis per se that has hit the supply potential of the economy but that the trend growth in GDP was weaker prior to the crisis and people were consistently overestimating the potential growth of the GDP before it kicked off.

The IMF and the OECD have moved a little bit in that sort of direction, I think. The consequence for them is that you end up having to assume that output was really way above potential in 2007 and immediately beforehand. I think they now have 3%, 4% positive output gaps in 2007 or thereabouts and the behaviour of inflation and wages at the time doesn't suggest that was terribly plausible. I am afraid this is one of those cases that in whichever of the four places you stand an unsightly lump is going to appear in the carpet somewhere else. We think that making that sort of assumption about growth, that sort of assumption about what is called a PLOG, a persistently large output gap, is the best of the available alternatives.

Q42 Mr McFadden: The way that you talk about this is in a range of 1% to 5% of GDP and your reference back to Ken Clarke's council of economic advisors, your body language indicates that you think this is a very uncertain science. Is that a fair assumption?

Robert Chote: I hope my oral and verbal language gives that impression as well.

Q43 Mr McFadden: But yet it is critical to this fiscal rule, isn't it? Upon this extremely uncertain science rests the question that you are asked to answer in every one of these five or six reports so far, which is whether or not the Government is meeting its fiscal rule. What you are basically saying to us today is it is a little bit like putting your finger in the air and taking a guess.

Robert Chote: It is taking a judgment but being very clear about how uncertain that is. You are absolutely right, the question of judging potential GDP, judging the output gap—can't live with it, can't live without it. At one level it clearly makes sense to think about the impact of spare capacity so that you are content to have borrowing and budget deficits larger when the economy is relatively depressed. That makes sense in trying to think about what the appropriate policy setting is, but judging exactly what the output gap should be, as you rightly point out, is central to any

cyclically adjusted target, for example as we have, and now, of course, you have Eurozone countries being encouraged to stick structurally adjusted targets into their constitutions, I think. It is not clear that the empirical and analytical foundations are necessarily as strong as one would like.
Steve Nickell: We make it absolutely plain in our documents how we work out the output gap and it is my belief that what we use is very sensible. There are estimates in the output gap out there, in some of the more extreme ones, which I think are implausible personally. Although there is a wide degree of variability in what people say, I think in practice if you look at people who I would say use relatively sensible methods the gap is not as wide as one might think.

Q44 Mr McFadden: What we have on these fiscal rules is a supplementary rule, which is acknowledged to have been broken, and a primary rule, which we are being told today rests on the shakiest of foundations. I think that is not an unfair way to sum it up. My final question is what does this mean for our constituents in monetary terms? Mr Chote, you spoke about factoring in an extra year of austerity that added up to 1.1% of GDP. What does that mean in money terms for a contraction of public spending?
Robert Chote: 1.1% of GDP in today's price would be £17 billion or thereabouts. It will be more in 2017–18 because money and GDP will be different.

Q45 Mr McFadden: They are looking at an extra £17 billion or so of either spending cuts or tax rises to meet that?
Robert Chote: Yes. At the moment the assumption is that that comes on the spending side rather than on the tax side.

Q46 Mr Mudie: I think you poured scorn on financial journalists, which I think is pretty unfair but there you.
Robert Chote: I was one. I wouldn't pour scorn on them.

Q47 Mr Mudie: I think you were more respectable when you were a journalist than you are now. Chris Giles, well respected, of the *Financial Times* said you have torn up your methodology to come to the aid of the Chancellor. Could you answer that? Secondly, accepting your defence, which is understandable, that any forecast is a forecast, you have defended your output forecasts in the past. In fact, I looked at your March report and you demonstrated how middle of the field you were, how near to the consensus and so on. Why did you change it so quickly and did you not understand this would lead to accusations that, along with other things in this report, you are charging to the aid of the Chancellor?
Robert Chote: The first question is basically the same one that Mr Ruffley asked, which is just wrong. We made two judgments relative to the March methodology, one on the current size of the output gap, which marginally reduces the estimates of the expected structural current budget deficit, and a second judgment on potential GDP growth, which more than outweighs that and therefore means that, taking the two things together as one should, we have made the Chancellor's life more difficult rather easier. Was the second question why have we moved the forecast so much between March and now? It is basically we haven't done a forecast since—

Q48 Mr Mudie: No, not really. The second question was why did you move to a new methodology? What prompted you and why the sudden decision?
Robert Chote: Every time we come to do a forecast we look at the key judgments that we have to make and make the best central judgment that we can on the basis of the evidence we had. As you will recall, at your last gathering you were urging us to look at different ways of estimating the output gap, to come up with a richer picture than relying too heavily just on one method, looking at business surveys. We have looked at the method on business surveys, we have compared that to what that would imply if you were looking at a production function estimate of this, and we have concluded that it makes more sense to assume that the output gap is slightly larger now than a mechanistic application of that methodology was at the time. That makes 0.4% of GDP difference to the output gap, less than 0.3% of GDP difference to the structural budget deficit, and it is more than outweighed by the other fact going in the direction. I think if you take a representative rather than a selective view of the changes that we have made then you will see that that criticism doesn't stack up at all.

Q49 Mr Mudie: Somewhere in your report you name the new methodology. There is two individuals and it is—have you adopted someone else's?
Robert Chote: No. We are still focusing primarily on the use of the business surveys. That gives you a path for the output gap. What we have then said is if you look at that and see what that implies for the underlying efficiency with which you would expect the economy to be able to stick inputs together and get outputs, that would be implying what we think looks like a relatively implausible deterioration over the last few quarters. We have said for the time being we think, therefore, we should aim off slightly for that but we will continue to make the best judgment we can in every report. We lay it out in painful detail here so no one should say we are disguising this. People can agree or disagree with the analysis we put out.

Q50 Mr Mudie: Mr Chote, I am mistaken that there is no names mentioned and no methodology that you adopted? Fine. But even with your new system, did you test it against past figures, past performance?
Robert Chote: As you will recall, there is no outturn data for the output gap so you never have an outturn, because it is an estimated number rather than a measured one there is no—

Q51 Mr Mudie: No, but you have a new methodology. Have you tested it in past years or in the March or 2010, 2011 figures?
Robert Chote: In the previous ones we didn't have a sharp, unexpected, implied deterioration in trend TFP.

Q52 Mr Mudie: So the answer is no?
Robert Chote: A new puzzle has shown up and we have had to decide how to address that. It is because that puzzle has not arisen. Since the very depth of the recession when you might expect trend TFP to be full and significant, this hasn't arisen yet.

Q53 Mr Mudie: So the accusation of lack of transparency and, above all, lack of consistency sticks, because that would be the second one.
Robert Chote: No, it doesn't. It is not a lack of transparency. We have explained very clearly why we—

Q54 Mr Mudie: No, that was the first one. I said the second one, consistency. That is what the commentators are saying, "We don't know where on earth you are because you seem to change your mind and incredibly it has always coincided with what the Government would wish to have".
Robert Chote: It hasn't, and I have explained to you repeatedly that is a complete misrepresentation of what has happened. In terms of being consistent about these things, we try to explain why we have reached the judgments that we have. I spent many years giving evidence to this Committee, painfully pointing out what I used to call conviction forecasting, which is to stick to particular methods or views as they became increasingly implausible and then finally you have to turn around and admit that this is all very different and it comes as a huge shock. I would much rather be in a world in which we are coming to you every six months or thereabouts to say, "This is our best view of what we have said at the moment". If we start to pull back from saying what we think is our best professional judgment because we think somebody might be rude about us then we would not be doing you or anybody else a good service.

Q55 Mr Mudie: Could I ask you a different question? In view of your indication that there is a danger to future capacity, do you think that this lengthy period will cause structural damage to the economy?
Robert Chote: The lengthy period of the economy running below potential?
Mr Mudie: Yes.
Robert Chote: It is one of the reasons why we have assumed that trend GDP growth does not recover right back to the long-term rate that you have seen over the past 50 years over that horizon. Various people have tried to do studies estimating what impact on the level of potential you get from an output gap persisting for a long period of time. I am not sure you would want to place particular weight on those quantitative estimates but it is something we have highlighted as a possibility in the report.

Q56 Chair: A moment ago you were saying that you have come before this Committee over many years watching people trying to justify a particular approach that gets less and less plausible over time until finally Mother Hubbard's cupboard is seen to be bare. You don't think that is where we are heading on the output gap?
Robert Chote: With the concept generally?
Chair: With the fact that it is so crucial to estimating where we are in the cycle and therefore what the Government's fiscal response should be.
Robert Chote: It is uncertain. Steve is absolutely right to say that there are fringes where you think it really is implausible believing that it is out that far away. One thing that we report all the time, and that you can draw your conclusions from as well obviously, is how our estimate stacks up to other ones that are out there.

Q57 Chair: But you are telling us that Mother Hubbard's cupboard in this area is not bare yet and that in any case you don't have something else to replace it with. Is that correct, Mr Nickell?
Steve Nickell: I think so long as you judge the fiscal performance on a cyclically adjusted basis there is no alternative but to have an output gap estimate.
Chair: That is very helpful.

Q58 Mr Newmark: Robert Peston said last week, "Will the UK lose its AAA rating and does it matter?" What do you think the effects would be of the UK losing its AAA credit rating?
Robert Chote: It is not entirely clear that that would be providing any new information to the markets that they had not already managed to deduce from the information on which presumably the credit rating agencies would have drawn that conclusion. I think you have seen other countries suffer that and it has not had an obviously noticeable impact on market views. The notion of how sensible it is to view this as an estimate of a change in default risk when the notion of default risk for a country that basically can print its own currency is a slightly debateable premise to begin with.

Q59 Mr Newmark: Why even downgrade at all then? You could ask that question about the US. Why did they downgrade the US at all given, you are absolutely right, they can keep printing money for ever?
Robert Chote: You would have to ask the credit rating agencies what the rationale is for the judgments that they make.

Q60 Mr Newmark: Let's deal with the hypothetical still. If you thought it was probable that they would downgrade, would you attempt to incorporate the effects of a downgrade and any associated rise in borrowing costs in your forecasts?
Robert Chote: No. We basically take market expectations of interest rates, which presumably incorporate the market's expectations of what credit rating agencies might do and how other people might respond to it.

Q61 Mr Newmark: Have you had any conversations with the rating agencies at all?
Robert Chote: They come and talk to us normally some time after we have done our forecasts and ask us the same sort of questions you ask about them, but it is not our job to guide them in one direction or another. It is up to them to make their own decisions.

Q62 Mr Newmark: Do they provide you any interesting information? You say they ask the same questions that we provide but you tend to drill down a little bit more probably than we would because you have more time to drill down in terms of conversations with the rating agencies.
Robert Chote: No. They ask very similar questions such as what underlies your growth forecast, why do you think exports are going to do this, how confident are you of the output gap, and so on, so it is very similar. Obviously not as well informed and so on, but there we are.
Steve Nickell: I think they see themselves as passing judgment on the credibility of fiscal plans rather than simply measuring default risk. I think that is the way they see it themselves. That is the impression I get anyway, talking to them.

Q63 Mr Newmark: Do you think this is a bit of shutting the door after the horse has bolted that they are now suddenly focusing on all this where historically they never really would have bothered with sovereign risks like the US or the UK?
Steve Nickell: When that question is put to them they usually deny it. I can't speak for them.

Q64 Mr Newmark: What do you think explains the UK's low borrowing costs? Is it QE, is it the fact we are not in the Eurozone? What do you think explains our low borrowing costs today?
Robert Chote: Those would be two of them. The other one is expectations that future short-term interest rates are going to be relatively low as a consequence of a relatively weak economic outlook and at some level, obviously, the market's view of the credibility of fiscal policy in terms of dealing with the underlying problems in the public finances over some appropriate time horizon.

Q65 Mr Newmark: On the subject of credibility of public finances, I am sure, Robert, you will remember when the Conservatives were in opposition I focused a lot on the Government's balance sheet and wrote three papers for the Centre for Policy Studies on the state of our balance sheet, *The Price of Irresponsibility*, *The Hidden Debt Bombshell* and *Simply Red: The True State of Public Finances*. In those I focused on pension liabilities, PFI and I guess the cost of the bank bailouts. Have you been focusing on what we are still holding off balance sheet and does that give you concern at all?
Robert Chote: We tend to address this in the *Fiscal Sustainability Report* that comes out in July because that coincides with the publication of a new set of Whole of Government Accounts that are accounts for the sovereign effectively treated as a plc, which brings a lot more of the things you are describing here on balance sheet and therefore you are able to take account of those. For example, that gives you a net liabilities measure that includes public service pension liabilities, effectively assuming PFIs on balance sheet, and so on. That is useful up to a point. You always have the problem with any of these balance sheet measures that it always misses off the Government's largest financial asset, which is the present value of future tax receipts. The fact that we have an aggregate net liability on the WGA or negative public sector net worth or a large positive public sector net debt is something that is less catastrophic for a sovereign than it would be for a private sector entity because you have the present value of what the Government is able to take out of it in tax.

Q66 Chair: Do you think the assessment of the Government's performance against its fiscal mandate would be buttressed if PFI was also included in your own economic and fiscal outlook assessments rather than just in this very long-term project that you described a moment ago, the *Fiscal Sustainability Report*?
Robert Chote: The problem is that you really only get new data on that once a year, so it wouldn't be moving between—
Chair: Well, annually.
Robert Chote: Yes, exactly. So we do say at the time of the FSR if you were basically to have all capital commitments on balance sheet at the moment it would add 2.1% of GDP to public sector net debt.

Q67 Chair: Are you recommending that it should be added?
Robert Chote: In legislation you have told us it is not our job to say what the targets are. The chosen measure of public sector net debt doesn't include that. To be honest, the movement in the value of the PFI component from one forecast to another is probably relatively small to what is moving in the other bits of public sector net debt, but there is no reason in principle why you couldn't target a measure of public sector debt that included that rather than excluded it.

Q68 Chair: We reported on the PFI a while back and asked the Treasury to ask you to give a view on this specific point. Did they do that?
Robert Chote: I think you asked us to make sure that we regularly reported the answer to the question I have just answered, which is how much difference would it make. As I say, it is not for us to say what the target ought to be. You told us not to say what the target ought to be.

Q69 Chair: I will just have one more go. Did the Treasury come to you and ask you—
Robert Chote: Whether we thought the target ought to be changed in that way?
Chair: Yes.
Robert Chote: No.
Chair: An informative reply.

Q70 John Thurso: Can I ask you, first of all, about the new treatment for APF? When were you informed of that and have you had sufficient time to work it through?
Robert Chote: I think we were probably first advised that it was a possibility in mid-October, which did give us enough time to talk to the DMO and the Bank about how one might go about modelling this sort of thing. We said when it was announced that we felt that it was particularly important to look at the implications of this over the whole of QE so that what

was a genuine opportunity for greater transparency actually turned out to be that way. We have had our best stab at estimating what impact that would have on the fiscal variables. I am sure we will continue to look at that in future. But, yes, we were given enough time to do what we have been able to do here.

Q71 John Thurso: You come to the conclusion, broadly, that it is net beneficial to the tune of about £55 billion.
Robert Chote: Which as a share of GDP is very small by the end of this period.

Q72 John Thurso: Absolutely. We have had evidence from Professor Chadha and Jack Meaning from Kent who put the number at £35 billion. Can you talk me through where the differences are and why you think your number is correct?
Robert Chote: I think basically the two numbers are very much in the same ballpark. As a share of GDP, that is a pretty tiny difference. There is a significantly different assumption that does not make a great deal of difference to the answer to that question, which is that they assume that QE is withdrawn much more quickly than we do but, as we show in the scenarios that we have here and in our supplementary tables, when you start and how quickly you withdraw QE doesn't make a huge amount of difference to the endpoint. What does make a difference is whether gilt yields move in a way that is not currently reflected in market rates. I think the reason they have a slightly lower figure than we do is because they are assuming that gilt yields will move slightly more upward as a consequence of the announcement. We highlighted the alternative of add 200 basis points, which gets you to 15. So I think if they have 75 to 100 it is not entirely surprising that 35 is roughly halfway between 55 and 15.

Q73 John Thurso: You are absolutely right, of course. In terms of the totality of the whole thing, it is a relatively small number but it is reflective of a very big number in the overall mix of what is going on. To what extent do those numbers, if at all, assist or detract from the Government's targets for both the deficit and their fiscal plans?
Robert Chote: They don't make a great deal of difference. The impact on the mandate measure is very small indeed at the mandate horizon. There is an open question mark about how the Office for National Statistics will eventually choose to treat the payments that come from the APF to the Treasury. We have assumed that they do so in a way that doesn't affect the mandate measure. It is possible that they could decide that they do. Going forward into further years it would not make any difference to the analysis we have set out here, so to that extent it does not make an enormous difference. Similarly on the debt to GDP target, it doesn't make much difference in the new target year. It makes a bit more in the previous one, the year that was the target year last time we met.

Q74 John Thurso: There are those who have said this is a very handy change for the Chancellor because it allows him to meet targets that he might not otherwise have met. I think one of the opening paragraphs in your overview suggests that the £11 billion less than forecast in March primarily reflecting the decision to transfer balances from the Bank of England Asset Purchase Facility to the Exchequer did that. Is that comment—
Robert Chote: It doesn't make much difference to the targets. What it does do, which is one of the reasons why we felt it was very important to spell out the impact over the whole lifetime of QE, is that it reduces the headline budget deficit noticeably over the period up until monetary policy is assumed to start tightening and QE is assumed to start going back, which is over the next few years. Then the negative effect shows up thereafter. The aggregate effect at the end of the whole process is not enormous, but we felt it was important to point out that this was going to make a noticeable impact, if not on the targets, on the headline fiscal numbers that are rather different in the short term to the longer term.

Q75 John Thurso: Summing that up, what we are really saying is that across the piece it is a relatively small impact but taken in a particular small timeframe it can have quite a bit impact, so on a year it could have quite a big impact. Across the decade it will take, overall it is a small impact. Is that broadly what you are saying?
Robert Chote: Yes, that is broadly right. It is in a different direction over one period to the other period.

Q76 John Thurso: One last question. However you look at it, when you are getting into these numbers of billions they are relatively big ticket items. There is quite a range in this of big ticket items. With a plc when you look at a balance sheet or a P&L that has "before exceptionals" you start going, "I wonder what they are trying to hide here". To what extent are these numbers obscured by these big ticket items and make it difficult for you to look at the underlying trends, which is what we are really all interested in?
Robert Chote: You are referring to the package overall and things like APF, Bradford & Bingley, Royal Mail and so on?
John Thurso: A whole range of them, yes. The general question is are you—
Robert Chote: The document is 11 pages longer than it was last time, in part because we have had to spend rather more time explaining how much difference each of these things makes and what the position would look like if you took them out.

Q77 Mr Love: Can I come back to one of the big ticket items, the sale of 4G? You mentioned earlier on in answer to Mr Mann that you felt that the figure of £3.5 billion was reasonable, but the reserve price set by Ofcom was £1.3 billion, and a previous sale in Germany didn't raise anything like the resources that were expected of it. Why are you satisfied with £3.5 billion?
Robert Chote: Ofcom themselves would say that the reserve price is not a good guide to the receipts you would expect from this. As I say, what we basically did was to look to what publicly available information was out there, which is primarily drawing on an

analysis of how much similar auctions have raised in other countries. They are hard to compare exactly because they are not auctioning exactly the same bits of spectrum, but certainly £3.5 billion was around the number where these independent assessments—so they were not commissioned by the Government—were coming out. But needless to say there is, as ever, considerable uncertainty around what the number will be, but that seemed a reasonable—

Q78 Mr Love: There is even more uncertainty over the timing of this. It only starts on 11 December and yet it is timetabled to conclude in February-March. Are you happy with that, that this money will arrive in this financial year?
Robert Chote: There is a clear policy commitment to have the auction within the current financial year. There was, if you go back a few months, some debate. I won't go too much into it but there was some potential legal action that could have been in the way of the auction taking place because of some of the potential participants' views on it. We have been told that all the participants are basically happy to proceed on the basis that the Government is currently intending to. The policy decision is to do it this year and we would assume that the money comes in on that basis.

Q79 Mr Love: What is the impact on the borrowing profile if the £3.5 billion did not arrive?
Robert Chote: The borrowing would be £3.5 billion higher than otherwise it would have been.

Q80 Mr Love: Would the Government's net borrowing be higher this year than last year? Would it have any dramatic impact? There seemed to be some implication that the £3.5 billion was a very important figure for Government borrowing.
Robert Chote: If you look at net borrowing excluding what you have described as the big ticket items, it is falling between last year and this year by about £1 billion and a bit, and if you didn't have that £3.5 billion in there it would be rising a little bit. But as you know, we take a no measures forecast. We ask the Government what their measures are and we take that into account on top of it. It should be said that putting a lot of weight on a forecast that borrowing is going to fall or indeed rise by £1 billion between one year and the next is ignoring the uncertainty. The average forecasting error for the budget deficit one year ahead is about £15 billion to £16 billion, so I think the best conclusion is that borrowing is expected on an underlying basis to be broadly the same this year as it was last year.

Q81 Mr Love: That is the answer of an economist, if I may say so, rather than a politician.
Robert Chote: Well, I apologise for that.
Mr Love: Where borrowing is going is exceedingly important at a political level, because the Government has staked its reputation on borrowing reducing on a regular basis year to year. Presumably, from what you have said, this would not happen or would not be forecast to happen.
Robert Chote: Let's put it this way, I certainly wouldn't be staking my reputation on a £1 billion shift in the budget deficit from one year to the next. You only have to look at how much the estimate of the budget deficit changes in the months after the end of the fiscal year by typically considerably more than that up or down, so I think it will be a considerable period of time before we are confident in knowing whether the deficit rose or fell this year or not.

Q82 Mr Love: Talking about confidence, you did challenge the HMRC estimates of the tax liability that would accrue from Switzerland. What gives you confidence that your alternative has any greater validity than that of HMRC?
Robert Chote: You can imagine, given the nature of the people and the sums of money you are dealing with here, that that is a particularly uncertain estimate. You have to judge how much money do you think is out there, how is behaviour likely to respond in a whole variety of ways. I think our initial judgment that the original figure that had been cited in the public domain was a bit too high was primarily on our assessment that the actual amount of money out there was rather less, rather than a view that we had a particularly better idea of how people were likely to respond to the measure.
Graham Parker: It was the estimate for the total money of British nationals in Switzerland that we thought was a bit too top heavy.

Q83 Mr Love: Which was 40 billion, I think. I have the figure somewhere.
Robert Chote: I think that is one step later in the calculation. It is 100 to 80 and then—
Graham Parker: Yes, the original was 100 and we thought 80 was much more central.

Q84 Mr Love: Okay. I would like to ask one final question—I can't resist it—from a comment that Mr Nickell made earlier on about the output gap, and because it is cyclically adjusted it therefore has to eliminate the structural component, that you are tied to the output gap as a measure. Doesn't that, along with the ability of the Chancellor each five years just to add a little more austerity, mean that the fiscal mandate really has outlived its usefulness? In other words, rather than the output gap, saying that the fiscal mandate really has outlived its usefulness?
Robert Chote: Again, I am afraid you have told us in legislation that it is not our job to say what the right target is.

Q85 Mr Love: I am not asking you to come up with an alternative, I am asking you to criticise the existing—
Robert Chote: I think the key thing we have to do is that obviously we focus in chapter 5 on whether the target is more or less likely or not to be met in the target year, but we also point out what would have happened in the previous years as well. So if people are concerned about that, then you can also look at what we said about the probability that you are going to meet it in the year before and the year before that, and it is for markets, investors, voters, whoever, to

judge how excited they want to get about those sorts of things. The contra-argument is that by having this going forward, it is introducing a useful degree of flexibility and otherwise you might have had a more aggressive, upfront tightening. Again, not something on which we are supposed to take sides.
Mr Love: Maybe the credit reference agencies will.
Steve Nickell: I think focus on the actual mandate. My guess is that if one is thinking of financial markets and credibility, they look at the whole picture always and to them that is what counts. The specific mandate is just a bit of the whole picture.

Q86 Jesse Norman: You already testified in your earlier comments that essentially all the information about Britain's credit position is in the market at the moment, so I take it you would not have any problem at all with there being full disclosure of PFI liabilities on all balance sheets, rather than just on the Whole of Government Accounts? There would be no reaction from the markets, given that view.
Robert Chote: To the extent that the markets are looking at the information that is available elsewhere, I doubt that that would materially affect people's view.

Q87 Jesse Norman: That is helpful, thanks. On the Higgs boson of the output gap, I always think it is like the Higgs boson except with the single difference that we more or less know the Higgs boson exists, so we know what its physical properties are, whereas we have more—
Robert Chote: People congratulate Higgs as well, so I don't think—
Jesse Norman: That is true. I do sympathise with the desperate situation that the OBR is in, given the massive divergence of views, and indeed the respectful body between that says that no such thing has any genuine economic theoretical background at all. On page 39 of this excellent economic and fiscal outlook, you give us a whole wonderful piece of algebra describing the production function approach that you use.
Robert Chote: Not my comparative advantage, I hesitate to point out.

Q88 Jesse Norman: No, I understand, and this is to any member of the panel. But how relevant is this dancing on the head of a pin, given that we know that the expert forecasts out there are between 1% and 5% or 1% and 6%? Do you not think there is a danger that this may, in the course of explaining your position, obfuscate or give it a spurious technical authority that in fact it does not possess?
Robert Chote: This is always a trade-off between being transparent and therefore explaining why you have taken the view so that you can avoid the sort of misrepresentations or misunderstandings that occasionally occur, versus if you do that then everybody focuses very much on the detail here. The Bank of England, for example, gives less quantitative data detail in its inflation report forecast, I think partly because the Governor has taken the view that that distracts people's attention from the uncertainties around this. Given that we were set up to basically demonstrate that the forecast didn't include politically motivated wishful thinking, I think we need to err on the side of giving considerable quantitative detail of how we get to the central forecast and then to explain laboriously the fact that there is huge uncertainty and what difference it makes.

Q89 Jesse Norman: Or if you already have it, give it the requisite theoretical padding in support, was the other argument.
Robert Chote: But basically we need to show our working. That is the key thing.

Q90 Jesse Norman: Yes. Do you think that the way in which you have changed the output gap is increasing the potential for stagflation at the end of the forecast?
Robert Chote: I wouldn't say the way that we set the forecast out does that. What we basically have is a largish negative output gap at the end of the forecast horizon, which you would expect to be pulling down inflation because there is spare capacity in the economy there, and indeed we have a very small downward movement in inflation at the end of that period. But at the same time, you also have other factors going in the other direction, so the fact that growth will be above trend by then, unemployment will be falling by training, you might still have some margin rebuilding at that stage. So the output gap is pulling inflation down at that horizon but you have other factors going in the opposite direction.

Q91 Jesse Norman: That is helpful, thanks. In your comments earlier you said that UK yields remain low in part because of credibility of Government fiscal policy. Can you give some sense as to how much? Let me put it this way, is it 0%? Is 0% credibility to be given to that or you give it some weight?
Robert Chote: What is in the price clearly is the sum of the market's views of current policy. I did watch your entertaining exchange with Mr Portes—

Q92 Jesse Norman: I am pleased you support my position, Robert, but just to be perfectly clear, is it your view on this that the differential in yield cannot be explained wholly by low levels of economic activity?
Robert Chote: As I said, I think there are a number of factors there. The issue though is if there was to be a looser fiscal policy and yields were to be higher at the same time, I suspect you would be telling Mr Portes that was the consequence of a loss of credibility and he would be telling you it is because it was a successful way of boosting economic growth in the future and that therefore—

Q93 Jesse Norman: You will recall that I wasn't making an economic point, I was making a philosophical one. But let's come on to the question that raises, which is what is the optimal level of interest rates in the economy at the moment? It is a question for all three of you.
Robert Chote: The optimal level of interest rates at the moment? It is not our job, I think, to second guess where the Bank ought to be on this. We take the market's expectation of interest rates. As it happens,

we take the view that that is consistent with inflation being roughly around the Bank of England's target in the out years of the forecast. As I say, partly you have downward pressure from the output gap, other pressure from elsewhere, but I don't think it is our job to say whether the Bank is doing its job properly, but implicitly—

Q94 Jesse Norman: I wasn't really saying that. I was just saying don't you think interest rates are—
Robert Chote: Well, has the Bank set the interest rate at the optimal level combined with QE? It is the same sort of question.

Q95 Jesse Norman: Is there any scope for more QE, given the size of the output gap, more monetary—
Robert Chote: Again, having told us not to look at alternative policy scenarios, you are asking me whether the Bank of England should have some additional easing there.

Q96 Chair: Can we go back to this zero or not zero effect on long-term bond rates of the current fiscal position? You are saying that it is above zero, this negative effect?
Robert Chote: At the risk of wading into the same waters that Mr Norman and Mr Portes did, it does depend on what your counterfactual is. You need to have an alternative view of if fiscal policy was dramatically looser then markets might be considerably concerned about the fact that they weren't convinced that the public finances might be dealt with in a decent—

Q97 Chair: Let's put a number on it, say £100 billion looser.
Robert Chote: Yes. I am not going to predict what the market's response to a particular alternative fiscal policy would be.

Q98 Chair: No, I am not asking you for a number in response to that number, but would you consider that the sort of number that might trigger a weakening of credibility in the long bond market?
Robert Chote: I have no idea how the market would react.

Q99 Chair: It could go up or it could go down?
Robert Chote: It would depend very much on whether you were telling a convincing story about whether you had a short-term loosening but you were simultaneously convincing people that you were still going to deal with the long-term problem. As I say, how that sort of thing were to show up in gilt yields, some people would view it as something that has affected your view of credibility, some people would view it as something that affected your view of future growth and future short-term interest rates, so you couldn't distinguish the impact on yields clearly if it hadn't.
Chair: You deal with googlies just as effectively as you deal with long hops. Andrea Leadsom wants one last rejoinder and then we must wind up.

Q100 Andrea Leadsom: I wanted to press you a little bit further about Europe, because in the last two forecasts you and the Bank of England in their financial stability meetings have kind of chewed their lips and said, "This is all terrible, and what is going to happen" but both have studiously avoided forecasting what the outcomes are that may take place, which clearly you are not responsible for, but what impact that might have on the future for our economy. Specifically, Mervyn King was particularly keen to avoid speculating on what may happen in Europe and what that might do to the British economy. But could you not go a little further and speculate for us—or forecast, should I say—on the impact of particularly some of the European central banks' monetary policy operations like, for example, the long-term repo operations, and what that may do to the banking sector in Europe when that unwinds and what the impact may be on the British economy? You have effectively said, "Well, that is so difficult we are not even going to go there" but it may, of course, impact as and when it happens. Could you not be a little more punchy than that?
Robert Chote: No, I think, on a convincing empirical analytical basis. What we have tried to do is to say, looking at the combination of the European measures and the FLS, what we think the likely impact on the economy has been of what has happened to spreads over the period since the summer. We have also, as part of the reason for revising down our growth forecasts over the medium term, taken the view that we are not saying that a particular bad outcome is X% more likely than it was last time we did it but that there is good reason to assume that continuing anxiety about the long-term health and stability of the Eurozone will persist for a longer period. Recent developments in Italy don't seem entirely inconsistent with that sort of view. But again, telling a particular story about one of the numerous ways in which the Eurozone novella could progress I think is not—what we did do, as you will recall, is we used the OECD's scenario for a more unpleasant outcome and looked at that as a scenario in a couple of reports.

Q101 Andrea Leadsom: I was going to ask you are you going to be doing that kind of disaster scenario forecasting? Again, is it your intention to look at what happens in the event? You have downgraded your forecast for growth in the euro area. Are you doing a sort of, "If the picture for Europe significantly worsens", bearing in mind what a key trading partner it is for the UK? Are you doing any of that scenario forecasting?
Robert Chote: Certainly for the international forecasts, because we are a relatively small body, we are drawing on the analysis that people like the IMF and the OECD do, a much closer sort of evidence across a number of countries. We look at that and reach our own judgment about whether we think that looks right and might we adjust it somewhat. It is certainly possible that if something like that OECD study were to be done again that showed a particular scenario or scenarios for a certain set of economic outturns, we could look at what the fiscal implications of those would be, but I don't think that we would

think of ourselves as being particularly qualified to judge any better than anybody else what the particular twists and turns of this tale are likely to be.

Q102 Andrea Leadsom: If the OECD does it, then you will look at the implications for Britain and make that available to the TSC?

Robert Chote: I think it is certainly something that you consider doing, as we did, as a scenario last time but, as I say, the underlying picture in the central forecast here is that we assume that the sort of pervasive uncertainty and anxiety extends for rather longer than we had assumed in the previous one.

Chair: Thank you very much for coming to give evidence to us this morning. It was full of detail and very valuable for the work we will be doing on the *Autumn Statement.*

Robert Chote: Thank you very much indeed.

Wednesday 12 December 2012

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Andrea Leadsom
Mr Andy Love
Mr Pat McFadden
John Mann
Mr Brooks Newmark
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Simon Hayes**, Chief Economist, Barclays Capital, **Simon Wells**, Chief UK Economist, HSBC, and **Paul Mortimer-Lee**, Global Head, Market Economics, BNP Paribas, gave evidence.

Q103 Chair: Thank you very much, all three of you, for coming in. Perhaps I can begin with you, Mr Wells. Just a few quick questions on the OBR; how do you think they have been doing as a forecaster?
Simon Wells: Clearly forecasting is a very difficult thing. I thought the March forecasts were maybe a little optimistic.

Q104 Chair: Have they been doing any better or worse than you three, or about the same?
Simon Wells: We have the fortunate ability to revise our forecasts more frequently than they have. As I say, I think in March they were a little optimistic. I think this set of forecasts is much more realistic in terms of the near-term GDP forecast. They are doing a great service and being very transparent and very open about what they are saying.

Q105 Chair: I will invite others to come in on this question as well. Do you think that they are doing anything to flag up to a wider public—not specialists like you—the limitations of forecasting? Do you think the creation of the OBR has assisted with that, and do you think we are now in a more realistic place? After all, it wasn't long ago that politicians were lambasted the whole time for failing to deliver on the forecasts, which those who have been involved in forecasts know is a ludicrous notion. Have we been able to address that problem at all with the creation of the OBR?
Simon Wells: I think it is a very good step in the right direction. The creation of the OBR was a positive step. It does add a lot of credibility to the forecasts, and we have seen that they are not afraid of marking down their forecasts really quite sharply if that is what they think needs doing.

Q106 Chair: Have they managed to lower people's expectations about what these forecasts can deliver, Mr Mortimer-Lee?
Paul Mortimer-Lee: Maybe, yes. My view would be they are still inclined to be too optimistic, and I think that clearly shows in the forecast where wages accelerate but inflation decelerates, which, because of what they do with productivity, allows you to say there is still a big output gap at the end of the forecast that allows you strong consumption but no interference from nasty policy timing by the Bank of England. That looks like a little bit of wishful thinking. If I was the OBR, I would be quite worried about projecting growth debt over 100% of GDP, because that would probably prompt downgrades from at least some of the agencies.

Q107 Chair: Should that weigh with them?
Paul Mortimer-Lee: In terms of being wrong, being wrong in a too pessimistic direction may have adverse consequences here and now, whereas being wrong—

Q108 Chair: The asymmetry around the consequences shouldn't influence what you write in as your numbers, should it?
Paul Mortimer-Lee: Maybe it shouldn't, but my suspicion is it probably does.

Q109 Chair: You don't think that they are trying to get to what they think is the truth. They are being influenced by what they think the effect of what they might say will have on markets. Is that what you have just said?
Paul Mortimer-Lee: I think to some extent, yes. What is a forecast? In making a central forecast you have to think: is it central; there is likelihood of a risk to the downside as the upside equal. The other way of looking at it is: what are the costs and benefits of erring on either side? If you take account of the costs and benefits, then the costs of erring on the pessimistic side are rather more serious.

Q110 Chair: So you think their forecasts are inherently upwardly biased?
Paul Mortimer-Lee: Do I think that the next forecast is going to be revised down or up? I think it will be revised down.

Q111 Chair: That is a different question. It is a quite important point you have made. Are you saying that there is an inherent upwards bias in the forecasting?
Paul Mortimer-Lee: I suspect there is.

Q112 Chair: Are you saying that the cause of that is that the asymmetry of outcome drives the OBR to lower its institutional risk by increasing its forecasts?
Paul Mortimer-Lee: I think that would be quite natural and normal, even if it were only subconscious. I am not saying they are doing it on purpose, but subconsciously.

Q113 Chair: That is a very interesting thought. Do you support that view, Mr Hayes?
Simon Hayes: I don't, actually. I think what has happened over the last couple of years is the Chancellor came up with a debt reduction plan and some fiscal rules. Then in November last year the OBR completely changed its view of the underlying potential capacity of the economy and that had the effect of almost totally eliminating the headroom under the two fiscal rules. If the Chancellor had known that assessment, I think we would have had a different set of fiscal rules, so that took us to the edge of breaching these rules. We have now had the OBR revise down not just its real GDP forecasts quite substantially but also its forecast for the GDP deflator, so the nominal GDP forecast is very much lower as well, and that has led to the breach of the debt rule. I think if you were trying to be kind to the Chancellor, you may have done neither of those things and the fact that they have suggests to me that they are, by and large, reporting things as they see them and that the consequences are something for the Chancellor to deal with.
Chair: They are not subject to moral hazard, which is Mr Mortimer-Lee's point.

Q114 Mark Garnier: Mr Hayes, if I can start with you; can I talk about consumption? What is your estimate of household debt in the UK at the moment?
Simon Hayes: The household debt to income ratio peaked at more than 160%, and now it is down to about 140%, 145%. That still means it is quite high by international standards and by UK historical standards.

Q115 Mark Garnier: The last number I heard was about 1.46 trillion in total. You broadly agree with that level?
Simon Hayes: Yes.

Q116 Mark Garnier: Do you think that that is a massive sort of sea anchor on consumption by households?
Simon Hayes: I think that it could well be. The reason why I put the "could" in there is that we have seen this debt ratio fall over the last few years. I don't think that that is an indication of households actively paying down debt. I think it is more a macro consequence of banks deleveraging. Lending is not as free as it used to be so that you are getting a macro fall in ratio, but if households are worried about their debt levels I think that that is still a problem to be overcome. If we look at discretionary repayments of mortgages, for instance, that has fallen over the last few years. People don't repay their mortgage when they are worried about losing their jobs. Even though we have seen this fall in the debt ratio and people have said, "This is household deleveraging, this has been holding back demand", I think the reality is that is a problem that is still there.

Q117 Mark Garnier: You don't think it is deleveraging; you just think it is the household is not leveraging up any more?
Simon Hayes: The household is being forced to do it because the lenders are timing conditions. I don't think it reflects overt behaviour on the part of households to pay down debt levels. Perhaps if and when interest rates start to rise again that will become more of an issue and I think that is a reason to be cautious, when monetary policy is timed, about the pace at which that is done and the effect that that might have on demand.

Q118 Mark Garnier: Do you think it would be quite a profound effect on demand when interest rates start to go up?
Simon Hayes: The Bank of England is aware of this, and it is something that we need to take into account. I would have thought that that means that you are very cautious in terms of the pace of timing monetary policy to begin with, because you don't know quite how households are going to respond to this. I would see that as an important risk.

Q119 Mark Garnier: Does anybody have any clue of what is going to happen when interest rates start to go up? Everybody now talks about this being the new norm in terms of a low-interest-rate environment, and yet if you look back over many years this is not just low interest rates; this is super-low interest rates. A low-interest-rate environment is more like 3% of 4%, and a high interest rate is 15% or 17%. Nobody seems to have any clue as to what is going to happen when we start going back to a normal period. Presumably there is a risk—I see you nodding—that potentially we could flick back quite quickly to a low-interest-rate environment before we know what has happened. Do you think that is a possibility, or do you think that this is the new paradigm and we will be moving up from this level in quite a gentle way?
Simon Hayes: You see, for instance, the Bank of England's response to signs of rising interest rates that are not under its control, spreads rise, but with the Funding for Lending Scheme and also with more QE it has been keen to make sure that that rise doesn't happen for now. Of course once we get to a stage if interest rates are rising because the Bank of England wants them to rise. then that suggests that the overall economic outlook has actually improved.

Q120 Mark Garnier: Do you think households could sustain a rise in interest rates because the interest rates are coming as a result of—
Simon Hayes: Well, that would be the plan. That would be what the Bank of England would be hoping to engineer, I think.

Q121 Mark Garnier: Do you see any possibility that could not happen: that interest rates could rise without there being a pick-up in the economic environment?
Simon Hayes: Yes, for two reasons. One is what we have already seen; increased pressure in bank funding markets that puts up the pressure on spreads and the authorities will try to offset that, but how successful they are remains to be seen. I guess it seems a lot less likely that you would have the Bank of England raising interest rates to control inflation even though

the economy is so weak. That seems theoretically possible but rather unlikely.

Q122 Mark Garnier: Yes. Can I turn to the zombie banks, unless, Mr Wells, you want to add anything to that? On the idea of zombie banks and money that has been tied up in good forbearance versus bad forbearance, are you familiar with the argument that is going on about this? To what extent do you think there is quite a lot of bad forbearance where banks are continuing to lend money to companies that basically do not have a sound business model but are being kept alive in order to make sure it does not have an effect on the bank's balance sheet? Anybody can jump in.
Paul Mortimer-Lee: I think there is a clear risk of that. We have almost 50% of loans to corporates is on commercial real estate and 20% of that commercial real estate is subject to some form of forbearance. I really don't think that we have tackled the potential losses on commercial real estate. I think the banks are aware of that and that is constraining their ability to lend because they know there are losses coming down the road. To quote Mervyn King, "In judging whether the banks are adequately capitalised, we need to ensure that capital ratios do in fact provide an accurate picture of banks' health. At present there are good reasons to think that they do not". The Governor of the Bank of England and Andrew Bailey, the Deputy CO elect of the PRA, talked about we have to avoid becoming Japan. These gentlemen seem to think that we are becoming Japan and part of the reason is we have not tackled the problems of the banks for a variety of reasons for a long number of years, and I agree with them. If you look at the UK, the poor performance is not due to too rapid fiscal tightening. It is certainly not due to an overvalued exchange rate. What is it due to? It is due to a shrinkage in lending, particularly to the corporate sector.

Q123 Mark Garnier: I asked Robert Chote yesterday if he thought there was a possibility of a Japanification of the British economy and he said categorically no. Do you disagree with that?
Paul Mortimer-Lee: There are a number of aspects of Japanification; we have some of them. In my opinion, the failure to deal with the banks is one of those and by failing to deal with them adequately we run the risk of slow growth, downgrades for the Government, higher bond yields, more bad loans and dealing with the problem eventually after we have accumulated many more bad loans, and I think that is an appalling prospect.

Q124 Mark Garnier: You will be aware of the so-called interest rate swap mis-selling scandal that is brewing and bubbling over a bit at the moment. There are 40,000 businesses that have these potentially mis-sold interest rates swaps that will have potentially a very significant effect on banks' balance sheets, because of course the other side of an interest rate swap between the customer is the bank's balance sheet. It has been suggested to me that there quite a lot of businesses are in sort of zombie businesses because the banks are keeping them alive, because unwinding these interest rate swaps will be very expensive for the banks. Have any of you done any analysis on that?
Paul Mortimer-Lee: I don't have any colour to give on that.

Q125 Mark Garnier: You have not heard any rumours? Is there a solution to this? It has been suggested that potentially the Government could create a bad bank. When I say "bad bank" I don't mean another bad bank; I mean a bank for bad loans. Would that be a solution, to try to gather together all these potential bad forbearance loans into one sort of hospital bank, if you like?
Paul Mortimer-Lee: Yes, I think you do. You put them aside. It is not a bank; it is a management company. It looks just to manage those loans and it lets the residual good bank get on with looking for the opportunities for the future. In the UK we did exactly the opposite of this formula when with Lloyds we put the bad bank in with the good bank instead of taking the bad bank out and leaving a good bank.

Q126 Chair: How do you keep the good loan managers from going off with the good bank and leaving the hospital bank to be run by people who don't know how to get the best out of a weak portfolio?
Paul Mortimer-Lee: That is an issue, but it is an issue that has been dealt with in Germany, in Ireland and they are currently dealing with it in Spain. I don't think it is beyond the ingenuity of the UK financial sector to come up with managers who can achieve the same thing over a longer time period to work this out. The main thing is to leave the managers of the good bank to get on with lending to the real economy. How the bad assets are managed is really a separate problem. What we currently have, as Mr Garnier said, is the banks are constantly looking over their shoulders worrying about the mistakes of the past instead of worrying about the opportunities for the UK economy in the future, and we need to free them up from that burden.

Q127 Andrea Leadsom: I would like to ask you about QE, but first of all, just following on from Mr Garnier, Mr Mortimer-Lee, do you therefore think that, for example, the Lloyds-HBOS merger should be undone? Would you say that that would be a sensible thing to do with a bad bank?
Paul Mortimer-Lee: I wouldn't opine on individual banks. I think we need an independent assessment of where we are and what needs to be done. I am very worried about commercial real estate lending in particular, and I think a lot of that needs to be taken out of the banks, because I think it is holding them back. I think they know there are losses coming down the pike, and if you know there are losses coming down the pike, you don't want to make loans to new businesses today, because you know you are going to get squeezed for capital tomorrow at some stage.

Q128 Andrea Leadsom: Mr Hayes and Mr Wells, do either of you think that the Lloyds-HBOS merger should be undone at this point?

Simon Hayes: I completely agree with what Paul has just said. It seems to me the general principle is right. Specifically how you go about it—
Paul Mortimer-Lee: I would say when you look at the banks in which the state has a very large holding you have to ask why is the state not able to sell those holdings, and part of the reason is that the market thinks they don't know what they are buying.

Q129 Andrea Leadsom: Coming on to quantitative easing, the OBR has noted that, "The previous work of the Bank of England suggests that the initial purchases of £200 billion was equivalent to a 150 to 300 basis point cut in bank rate and may therefore have added around 1.5% to 2% to the level of GDP. However, it is possible that the marginal effect of subsequent purchases was slightly lower." To what extent do each of you think monetary policy is losing traction. Mr Hayes?
Simon Hayes: I think it has lost a lot of traction. I thought that was true over a year ago when they did QE2 in October last year, and I think it is probably even more the case now. This is not particularly to do with its capacity to keep Government bond yields low, for which I think it still is an important factor, but the extent to which that feeds through into actual spending by consumers and firms is very difficult to discern indeed. If the Bank of England announces another £50 billion of QE, I would not rush away and significantly revise our growth and inflation forecasts because of that.

Q130 Andrea Leadsom: Mr Wells, do you think the Bank of England should or could do another analysis? It did the original analysis that determined what it thought it had generated in terms of GDP growth. Do you think the Bank could or should do another review now of its more recent asset purchase?
Simon Wells: I think it becomes harder and harder, because as quantitative easing comes into market expectations the market tends to react in advance. Therefore, on the day of the announcement it is largely in the price, so the sort of event study that they did in the past I think becomes little bit more irrelevant. I think it is very difficult, but most people agree, and I agree, with Simon: is another £50 billion of gilt purchases from the Bank of England going to suddenly drive us to growth? I think that is very unlikely. Quantitative easing was a great response, an unprecedented response to an unprecedented policy outlook in 2009. It did its job. It avoided a depression, it avoided deflation, but we can't expect more and more money creation from the Bank of England just to fine-tune the economy and drive growth.

Q131 Andrea Leadsom: Were you worried, Mr Wells, about the fact that the Chancellor has taken the coupons from the Asset Purchase Facility, not so much that he took them but the impact in terms of the equivalent of doing another £37 billion of QE? Did that strike you as concerning, or what was your analysis of that?
Simon Wells: In one sense yes, and in one sense no. No, because when QE was first started it was never envisaged to get to this size, so I do think there is some merit in the argument that it was a bit daft in some ways to have this huge pool of income just being built up slightly off the Bank of England's balance sheet. That said, I think it was communicated rather clumsily. I think it should have been thought of well in advance of when it was done, because it could have perhaps been announced during a Bank of England inflation report and explained very clearly. As it was, the day after quite a big policy announcement, suddenly being announced and then the MPC saying, "Oh well, if we had wanted to offset it, we knew it was coming; we could have changed", I think was slightly unsatisfactory.

Q132 Andrea Leadsom: Mr Hayes, do you accept what the Bank of England has said, which is that that £37 billion is the equivalent of an extra £37 billion of QE? Do you also accept the independent members of the MPC saying, "Well, we fancied doing a bit more so in fact we were fine to be doing it, and, in spite of the fact we have never specifically chosen that number before, it has always been 25 or 50, we were coincidentally entirely happy with £37 billion"? Did that strike you as odd? Does it imply that the impact of QE is so negligible now as to not really warrant worrying about the extra £37 billion here and there?
Simon Hayes: On the maths, the maths is right; it is equivalent to an extra £37 billion. I think one problem with this move is that it has created a perception that although this was done with the knowledge of the MPC it may not have been done with its wholehearted support.

Q133 Andrea Leadsom: Although the MPC members did argue that they were minded to do some more QE after the fact.
Simon Hayes: Indeed, some of them did, and Spencer Dale today was saying that he felt it would have been excessive fine-tuning to have voted against it or to have voted for a countervailing moving in QE in order to offset it. I think that is probably right as well, but that in fact leads to the conclusion that you just drew, which is if this is fine-tuning, this £37 billion, that does suggest that it is not expected to have a very large effect. Even though it sounds like a large amount of money, in macroeconomic terms it is not seen to be such a powerful influence.

Q134 Andrea Leadsom: Mr Mortimer-Lee, would you deduce from that, if it is just fine-tuning to do a further £37 billion of QE, that possibly the impact of further QE is marginally negligible?
Paul Mortimer-Lee: I think we have had vastly diminishing returns in QE. It is a bit like British Rail with the wrong sort of snow on the lines. I think, to be honest, we have the wrong sort of QE. In the US when the Fed buys treasuries and lowers the Government bond yield it has a significant effect on the ability of the corporate sector to borrow because a lot of the intermediation is not through banks, it is through the bond market. In the UK that is exactly the opposite. The banks are the main sort of

intermediation, and really the Bank of England has made the Government's job a lot easier. It may initially have helped the economy, but in the recent rounds it clearly has not helped the private sector's availability to credit. I would love to see them switch to buying, as the Fed has been doing. The most recent round of QE is to buy mortgage-backed securities, and I think the Bank of England should do exactly the same thing, because our problem is credit availability. The Bank could buy packages of corporate loans, but, to be honest, there is a danger of them being given lemons by the banks because there is an asymmetric information problem. With mortgages it is a much more homogenous asset. If the Bank were to take on mortgage-backed securities, that would allow the banks more room, given their capital constraints, to lend to businesses. I think that would be much more helpful than QE in gilts.

Q135 Andrea Leadsom: Mr Wells and Mr Hayes, do either of you disagree with that? Would either of you not like to see the Bank of England lending more directly to the economy?
Simon Wells: I think there is a danger that we slip into a world where the Bank of England is expected to just buy everything and bail us out of what may be a tough period. But credit to the Bank; the Funding for Lending Scheme is designed to do this. You can take a mortgage book to the Bank and for a very small fee get funding from the Bank of England to do so; the same with corporate loans. The only difference between the FLS and them buying outright, as Paul suggested, is term and the Bank could always say, "The FLS was designed for four years, but things haven't picked up as we expected. We are going to roll it, or we are going to increase the term." So they have taken a step in that direction, I think.

Q136 Mr Newmark: Mr Mortimer-Lee has answered my question, which was on the US versus the UK. Thank you for answering that question.
Mr McFadden: I want to take you back to where the Chairman began with the OBR. Most of the reports have been downgrading their previous growth forecasts. We asked them about this yesterday and I think on all but one occasion since they were formed they have downgraded their previous growth forecast. I will start with you, Mr Wells. Why should we believe the current ones when the last four or five have been downgraded?
Simon Wells: That is a very good question. I think it is not just them, and it is not just the UK. If you look at the consensus, the average of economists' forecasts over the past decade, in the UK and the US we have been too optimistic about growth and inflation consistently for nearly a decade. I do think that their latest set of forecasts for this year and next are much closer to the averages and therefore seem much more reasonable than they did in March. So in that sense, as I said at the beginning, I do believe them. Where I still have some concerns is that if this 10-year trend towards over-optimism doesn't actually come good this time then their forecasts for the potential growth rate of the economy, and indeed the growth rates further out beyond 2015, will turn out to be too optimistic once again. I think there is clearly a big risk of that. Everyone hopes that the UK growth prospects will pick up, but you are quite right, it is not a given.

Q137 Mr McFadden: Even in the latest forecast, although it projects the size of the economy to be about 3.5% smaller overall at the end of the forecast period than they were forecasting even six months ago, which is a very large difference going forward, they are still forecasting a bounce-back to create 2.5%-plus in a few years. Do you believe there is still a trend rate of growth, or does the recent experience suggest that the concept of bouncing back to growth rates of that order is becoming outdated?
Simon Wells: In the decade to 2007 the UK experienced, if the official data is to be believed, something of a productivity miracle. Of the G7, we had the highest average growth rate of productivity. I think that was probably unsustainable. Therefore, I think we came into the crisis having been used to higher growth rates than perhaps were sustainable and certainly operating at a much higher level than was sustainable. I think what we have learnt over the past few years was the extent to which the economy was operating above where it could do in 2007. I believe Mr Chote touched on this yesterday as one of the four possible explanations for where the output gap is. I think we probably were above potential coming in and that means that we are less far below potential now and therefore we could well be looking at a period of slower growth.

Q138 Mr McFadden: If there is no long-term trend rate of growth of 2%-plus, which is always the assumption in these, that has huge policy implications for all of us, doesn't it?
Simon Wells: It certainly does. The IMF came out recently with a study that said it thought the trend rate of growth in Western economies was going to be below 2%. That clearly has huge implications, not just for the current round of austerity to 2018, but you will recall from the OBR's long-term fiscal projections that they released in July, before the latest catch-up to their forecast, that even if we get though the latest round of austerity intact for 2018, we have about a 10-year respite before the demographics and other structural aspects of the economy means the debt starts to soar off again into the stratosphere. So yes, it is a huge thing, and it is a debate that is not really happening.

Q139 Mr McFadden: Can I ask you about your comments on the output gap? You have been sceptical about the OBR's treatment of the output gap and the way that this relates to the Chancellor's first fiscal rule. Could you tell us why you are sceptical and what you believe would have happened to that rule if the OBR had treated the output gap in the same way as they have previously?
Simon Wells: The OBR did two things. They revised down, as we said, their projections for actual growth in the near term. They also revised down their projections for potential growth, and that does make meeting the fiscal mandate more challenging, but the fact is they revised down actual growth a lot more

than potential growth, therefore the output gap is wider. My understanding of what they do is that the amount of the fiscal deficit that goes into the cycle is a direct function of the size of the output gap, therefore the bigger the output gap the more of the deficit automatically unwinds through the future. The OBR have a usual set of models and on this occasion that would have pointed to an output gap of actually narrowing since March. In fact, they decided it was nearly a percentage point wider. But that is their judgment. I think you should always override a model if you don't think what it is saying is sensible, but it is yet again, I think, the fact that they should have revised the potential growth down further, things would have looked worse.[1] They have applied that judgment, and at the moment it is impossible to know who is right. Certainly it would make things harder if they put more of the recent weakness into potential rather than cyclical factors.

Q140 Mr McFadden: How meaningful is a fiscal target that can be continually rolled forward one year at every new budget or autumn statement and that rests on a concept, the output gap, which is open to so much debate and so much uncertainty? I don't want to put words in Robert Chote's mouth, but even yesterday he was pretty much acknowledging this was a very, very uncertain concept.
Simon Wells: It is probably better than no target.
Mr McFadden: That doesn't say an awful lot for it.
Simon Wells: It is a very difficult concept. When you missed the targets the rating agencies had already come out and said this does undermine Britain's fiscal credibility when targets are missed, but at least there is a plan. We are not the only Western economy shouldering big debt burdens, but not so many of them have such explicit plans to try to deal with it, the US being a great point in question.
Simon Hayes: I think on the point of cyclical adjustments and the output gap, one thing that you need to develop as an economist is a sense of what is a strong conviction forecast or estimate and what is a weak one. With the output gap it is never going to be strong. You are well aware of the difficulties with measuring it. What I mean is that any judgment or rule that you have that is based on it is also going to be quite weak. The answer is not to ditch it, I don't think, because it makes sense to cyclically adjust something but it is important that that is not the only thing that is guiding you. So I think it means that you need to have more than just one fiscal rule that depends on this sort of cyclical adjustment and also you need to talk about the public finances in a broader context, not just in the context of whether the OBR determines whether you have a more than 50% chance of meeting this rule or not. The wrong thing to do would be to put a lot of weight on it or to ditch it completely. We are in the middle, and we are having what I think are the appropriate discussions about the uncertainty that it brings with it.

Q141 Mr McFadden: A lot of weight is being put on it, because this is guiding the decisions about cuts in public expenditure and the magnitude of those going forward. I will give the last one to Mr Mortimer-Lee. If this is not the right fiscal framework, do you have any views as to what an alternative might be?
Paul Mortimer-Lee: The fiscal framework should be a guide to action and should constrain the Government's ability to come up with policies that suit the short term but not the long term. The rule helps to achieve that but it is not set in stone. We don't fall off the end of the earth if we go past it. I do not like the fact that the OBR's model said one thing and they decided to do something completely different. I do not like and I do not believe in the forecast of the sudden magical acceleration of productivity that means that the output gap stays wide despite growth picking up. To me it is just far too convenient for the Government finances.

Q142 Mr Love: Can I come on to the AAA rating? What would be the impact of losing the AAA rating? Mr Hayes, I will start with you.
Simon Hayes: In terms of borrowing costs, I think the likelihood is it would be quite small. If you look today at France, French Government bonds are trading relative to UK Government bonds. They are only a quarter of a percentage point higher in yield, so that is very small. If you add on the fact that some of it is already priced in, some expectations are already priced into UK Government bonds, and one could argue that because the UK isn't in the euro area and so on it would always trade a bit south of France, it really suggests that the likelihood of a leap in bond yields from a rating downgrade is negligible.

Q143 Mr Love: The two arguments that are made about an AAA rating are, first of all, the safe-haven argument and, secondly, underlying economic performance. On the balance of which it is that will crash if the credit rating is lost, which do you think is the most important? Mr Wells?
Simon Wells: The UK does and will always retain a lot of AAA characteristics. It has strong financial and political institutions; it has a flexible economy. None of those things will change. I agree with Simon; I don't think that there would be a huge loss of confidence in terms of the UK suddenly losing its safe haven status if we were downgraded by one notch. I think it wouldn't come as a huge surprise any more and the fact that the United States has been downgraded by one agency, and France has been downgraded as well is another reason. We might see an impact on sterling, the pound would probably kneejerk a little bit lower, but what happens thereafter I think would very much depend on what happened with our trading partners. If the eurozone suddenly

[1] **Note by Witness:** The OBR have a usual set of models that on this occasion would have pointed to the output gap actually narrowing since March. In fact, they decided it was nearly a percentage point wider. But that is their judgment. I think you should always override a model if you don't think what it is saying is sensible. But, yet again, I think it is the fact that they should have revised the potential growth rate down further and then the cyclically-adjusted fiscal position would have looked worse. They have applied that judgment, and at the moment it is impossible to know who is right. Certainly it would make things harder if they had assumed more of the recent weakness was due to potential rather than cyclical factors

looks uglier again, then sterling would probably recover. It is as much to do with what is going on elsewhere as going on here. It is all a relative sense.

Q144 Mr Love: Mr Mortimer-Lee, does it reflect at all our economic performance or is it based on, "We are better in a safe haven like the United Kingdom rather than in the eurozone or in other parts of the developed world"?
Paul Mortimer-Lee: The AAA rating to me doesn't matter that much. What matters is what the UK can borrow at and that we have the right policies. Having a label attached to us might be nice in some sense, but does it really matter? I don't think it does. I would agree that the cost to the UK might be about 25 basis points on borrowing costs of losing it, but we should do the right things for the right reasons and not just because the rating agencies will mark us down. The rating agencies have been shown to be extraordinarily fallible. They tend to follow the markets rather than to lead them and we should do the right thing for our reasons, and if the rating agencies downgrade us, so what, at the end of the day. We are not operating in the interests of the rating agencies; we are operating in the interests of the UK population, and it may be that the right policies do lead to a downgrade. We should do them nonetheless because they are the right policies.

Q145 Mr Love: I think that might be what the Chancellor will say when asked about this. Can I finally come back to you, Mr Hayes? You mentioned there is a pricing-in of longer-term bond yields, and Mr Mortimer-Lee mentioned the market signal that is already there. Is it likely that there will be a downgrade? Do you see a downgrade coming some time in 2013?
Simon Hayes: I think it is quite likely. There are two reviews coming up that we know of. Early in the year, probably January, Moody's is looking to revisit this, and in March I think Fitch are looking to review also. In particular as I understand it with Fitch, we are on negative outlook, and on their criteria that implies more than a 50% chance of a downgrade. That was instigated in February this year, I think, since when things have got worse. So it seems to me that things are moving clearly in that direction, and it wouldn't surprise me in the least bit if at some point over the next six months—

Q146 Mr Love: Do you think it ought to take into account the Budget, for which the date of 20 March was given yesterday?
Simon Hayes: I don't know. In terms of rating agencies' timing of events, the comment you get is that people expected the downgrade but they didn't guess the timing. They do tend to keep that close to their chests, although the fact that Fitch have said March might suggest that the Budget is something that they would wait to see.

Q147 Mr Love: Do the two of you agree with that? Yes.
Paul Mortimer-Lee: Fitch were originally going to opine on the UK in 2014. I doubt that they have moved it forward to 2013 in order to upgrade the UK.
Chair: Thank you very much indeed for coming in. It has been short, brisk and very informative and interesting. Thank you very much indeed. We will go straight on to the next panel, please.

Examination of Witnesses

Witnesses: **Lee Hopley**, Chief Economist, EEF, and **Professor Philip Booth**, Editorial and Programme Director, Institute of Economic Affairs, gave evidence.

Q148 Chair: Thank you very much for coming in. Can I begin by asking you, Mr Booth, whether you think that the OBR's forecasts are better than anybody else's?
Professor Booth: At the IEA we have a long history of critiquing in principle the whole idea of economic forecasting.
Chair: That is why I asked you.
Professor Booth: In that case, given that context, I suspect they are no better or worse than anybody else's. I think it is reasonable for economists to try to forecast with a comfortable degree of confidence when economic circumstances are really rather stable, but then I don't think those forecasts add very much value because it is generally fairly clear what is going to happen to the economy. Most forecasters have not predicted very well the economy when there has been huge instability, and the OBR is by no means any different from anybody else. Of course, it uses the Treasury models and as such—

Q149 Chair: What do you think about them?
Professor Booth: I am very sceptical of all forms of economic modelling, but, insofar as I do like economic modelling, I prefer models that have a greater degree of rigour in interpreting the supply side of the economy rather than being based upon projections of aggregate demand and so on, what might be called neoclassical modelling. There are a few people who model in that way in the City, but that is not the Treasury's philosophy at all.

Q150 Chair: Is there anything you want to contradict there?
Lee Hopley: No, I don't have anything to add on that question.

Q151 Mark Garnier: Professor Booth, what do you think the likelihood is that Britain will lose its AAA rating over the next year or so?
Professor Booth: I think it is more than 50%. Whether it matters is a different issue.

Q152 Mark Garnier: That was my next question. Why wouldn't it matter?

Professor Booth: If Britain loses its AAA rating, it is really a reflection of underlying problems rather than an event in itself. Credit rating agencies provide an opinion on Government debt and the credibility of the Government in terms of repaying its debt. People are able to form those opinions with or without rating agencies. The rating agency just offers one more opinion. It will create a lot of political hubbub, of course, but I don't think the downgrading event itself is particularly significant.

Q153 Mark Garnier: You don't think there will be any difference to the interest rates at all?
Professor Booth: There may be some but not huge and significant. The problems the UK Government faces over the next generation are already quite clear, and we don't need Standard and Poor's particularly to point them out.

Q154 Mark Garnier: Your answer was there is a 50:50 chance that it might be changed irrespective of what the Government does? It is just outside influences may affect it?
Professor Booth: Yes.

Q155 Mark Garnier: If the Government changes course, if it suddenly is persuaded to adopt a kind of so-called plan B, do you think that would be a genuine risk to our interest rates?
Professor Booth: It depends what plan B was. If plan B involved more Government spending and more Government borrowing or lower taxes then, yes, I think there would be a greater risk of a downgrading, and that would reflect a genuine underlying deterioration in the likely prospects of Government debt being repaid in full.

Q156 Mark Garnier: To be absolutely clear, if the Government were to take on more borrowing or to try to extend the repair of the public finances, then that would result in probably higher interest rates?
Professor Booth: Yes, it would. There is a question of degree here. The difference between the plans put forward by different parties is relatively small and would not affect the total national debt all that significantly. At the same time, even if you were an out-and-out Keynesian, it wouldn't make all that much difference to economic growth in the medium term either. If you are a real Keynesian and you want much, much, much more Government borrowing, it would have to be of a scale to make a difference to economic growth that really would endanger repayment of debt in the long term.

Q157 Mark Garnier: It would be very helpful if you could give us an idea of how big an increase in debt it would be to have any sort of Keynesian effect.
Professor Booth: I don't accept Keynesian effects in any case, so I am the wrong person to ask. I think the fiscal multiplier is pretty much zero.

Q158 Mark Garnier: Lee Hopley, do you have any thoughts on that?
Lee Hopley: I think if it was clear that the fiscal plan was shot to pieces, so there was no clear plan, things had deviated off track, and there wasn't the same degree of independent scrutiny of what the Government was doing, then I think that is clearly going to impact on how the markets view the UK and the price of Government borrowing.

Q159 Mark Garnier: Why do you think interest rates are so low?
Professor Booth: There are several factors. One is a reasonable credibility with regard to the Government's financial plans. Another is that the Bank of England owns 26% of UK Government debt as a result of quantitative easing. Another is the increase in appetite among pension funds and life insurance companies in particular to buy Government debt. This is partly regulatory driven, and to that extent I think it is extremely unfortunate, but it is also partly as a result of the ageing demographic of those organisations. It is also partly because the UK is seen as, relatively speaking, a safe haven, certainly compared with the eurozone, and the credit premiums for private sector lending compared with Government borrowing are also rather high. That is a negative reason or a rather unfortunate reason why Government borrowing costs are so low. It is because the risk of lending to the private sector is perceived to be quite high. There are several reasons all coming together to create a situation where index-linked gilt yields at many terms now are negative.

Q160 Mark Garnier: Over the next few years, first of all, the Government is going to be borrowing, it is going to be increasing the national debt by about £500 billion, which means it is going to be going into the markets trying to borrow £800 billion or £900 billion by the time it has repaid some of the debt coming back. At the same time it is reducing the cost of Government as a percentage of GDP from 48% two or three years ago down to 39.5%. Lee Hopley, you raised your eyebrows at that so I might come to you first. First of all, is it achievable and, secondly, is it too much?
Lee Hopley: I was raising my eyebrows because that is an incredibly difficult question and that is quite an ambitious target in terms of reducing public spending. This situation is no different. There is always an appetite to squeeze more efficiencies out of Government spending, reducing departmental budgets. I think there is a big question mark over that ambition.
Professor Booth: There are two things that could be done that would make the Government's job much easier. One is to make supply side reforms that would raise economic growth and productivity. Productivity growth is shockingly low at the moment. The OBR projections for Government borrowing—what has really caused the problems over the last couple of years is the reduction in forecast growth rather than the Government actually wavering from its course. Secondly, this may come from slightly left-field—
Mark Garnier: Left-field, or left-wing?
Professor Booth: Both left and right should applaud these sorts of measures, I think. A strategy for reducing poverty, dealing with inequality, poverty and so on by removing Government regulation that raises

the cost of living rather than just by continually increasing income transfers—I know there is going to be a slowdown in the rate of increase of income transfers—I think would make the Government's target rather easier to achieve together if there was proper radical welfare reform rather than just administrative changes to the way in which benefits are provided.

Q161 Chair: Which is what you reckon we are doing now?
Professor Booth: I don't think you are doing any of those three things nearly to the degree that you need to be, in particular with regard to welfare reform. The Universal Credit is welcome in some respects but it doesn't change the marginal withdrawal rates at all for the vast majority of people in receipt of welfare benefits. The messing around with child benefits at the higher end—there could be radical reform here that created transferrable tax allowances for those who are better off and some means-tested benefits for those who were worse off and an awful lot of money saved through such radical reform, I think.

Q162 Mr Newmark: I want to go back to your throwaway line at the beginning when you talked about credit agencies: that it wouldn't matter, Fitch is just one other opinion. I would argue that a rating agency making a downgrade has quite some weight in the market versus chief economists at a bank or something. I am not being critical; I am just curious that you slightly dismiss rating agencies now really having any credibility in the market. Do you think that their credibility has been shot because of what has happened in the past few years? I am curious as to what was driving that dismissive remark on a rating agency downgrade.
Professor Booth: I wasn't meaning that they were not credible, but there is obviously a fine line between AAA and AA+ or AAA and AAA-, and at some point you must cross that line. What I am saying is at the moment we are perhaps only just one side of that line and if there is a downgrading we are only just the other side of that line, and the fundamentals won't have changed all that much when the rating agency takes the decision to move from AAA to AAA-.

Q163 Mr Newmark: Are you looking at what has happened to the US or France, for example, who have had downgrades and there has been marginal impacts on their borrowing? I am trying to see the direction of travel you were going, that is all.
Professor Booth: Yes. It is the underlying fundamentals that are really the issue.

Q164 Mr Newmark: Obviously the big debate today is whether we should stick effectively with plan A, which is continuing on with cuts and so on, versus a plan B, which is really looking to the US. There are people like Danny Blanchflower out there who would argue that there is nothing wrong with printing more money, borrowing more money, running big deficits in order to really get growth going. Do you think that, given the structure of the UK economy, we could ever consider a plan B without, for example, it having a big impact on borrowing the way that some economists out there would argue, or should we really be sticking with plan A? Either of you can answer that one.
Lee Hopley: I think where we are currently there is value in sticking to the fiscal path that has been set out. There are a lot of risks from the perspective of the business community about significantly drifting from that level and the risks that the market would face if there was a significant move. The flipside of focusing on deficit reduction and public spending is what about growth, what is the economic strategy? That is where we hear considerably less. There was a plan for growth that was announced by the Chancellor at the 2011 budget that wasn't referred to at all in his *Autumn Statement*. So what are the priorities for the UK economy going forward, what kind of economy are we trying to build, what sort of growth are we looking for, and what sort of steps are the Government taking to deliver those ambitions as well as pressing ahead with getting on top of the public finances? I think those are the questions that really need to be brought into the debate as well.
Professor Booth: My reading of the evidence is that fiscal multipliers are very low indeed, if not zero, for countries that have open capital markets, floating exchange rates, and that is key when comparing the UK with the same debate within the eurozone, and also that are already highly—

Q165 Mr Newmark: A lot of these Keynesians out there look to the US and say to me, "Brooks, you are wrong, because look at the US, they are still printing loads of money, they are still borrowing loads of debt, they are still running huge deficits. Actually we can still do a little bit more of that". Ed Balls will stand at the despatch box and say effectively there is nothing wrong with borrowing more in a debt crisis.
Professor Booth: Historically the UK has a much lower trend growth rate than the US. The US recovery is extraordinarily anaemic by US standards. The UK recovery is extraordinarily anaemic by historical UK standards. I think one of the reasons for that is the step change in both countries in the level of Government spending as a proportion of national income, but that is a separate argument. If you unpick US Government borrowing figures, including looking at what the states are doing themselves, the records of the UK and US Governments are really not very different in terms of the borrowing pattern. The UK seems to have a rather better record in terms of job creation and employment than the US in the last few years, and the US has a somewhat better record with regard to growth. There is nothing particularly you can point to in the US model that says—

Q166 Mr Newmark: You could argue the US has maintained growth, because they continue to effectively subsidise the economy with printing money and borrowing money and so on. As soon as they went to a more sustainable deficit or they, let's say, cut the amount of debt that is growing, actually you perhaps wouldn't get as much growth.
Professor Booth: That is one point that is very important. Any fiscal stimulus at some stage has to be

reversed or it leads to higher interest payments and that reversal probably comes at exactly the wrong time. Secondly, if you do really unpick the US numbers, you don't find that they are borrowing large amounts more than the UK, if you look at the activity of the states as well as the Federal Government.

Q167 Mr Newmark: My last question has to do with Arthur Laffer. There is an argument out there that if you keep increasing taxes you end up collecting less tax, and we saw a little bit of that when the tax rate was increased from 40p to 50p. Do you see any argument whatsoever that we could be cutting taxes and that as a result of cutting those taxes we would collect more tax revenues. Where would you target that? Would it be at corporation tax, capital gains tax or income tax?
Professor Booth: I suspect at current levels it would not be the case that reducing any of the major taxes, which would bring in large amounts of revenue, would lead to increases in revenue. Capital gains tax may be an exception. Corporation tax may have been an exception but is now on its way down.

Q168 Chair: Income tax top rate?
Professor Booth: Income tax top rate—I suspect you are somewhere around the top of the Laffer curve, which is what the Treasury analysis suggests. I don't think it is where you want to be, but I suspect it is where you are.

Q169 John Thurso: Professor Booth, I will come to you first. The Government has announced a whole raft of supply-side measures, basically saying this is going to stimulate growth. Will those measures succeed? Have they done enough on the supply side? What, if anything, would you like to see done more?
Professor Booth: I don't think those measures are sufficient. I would like to see much greater planning liberalisation but also a principle of compensation introduced into the planning system so that you get a planning system that runs with the grain of people's preferences and runs with the grain of the market and so on. I would argue that both with regard to house building but also with regard to major infrastructure projects. I think the third one where an issue could probably be to some extent—

Q170 John Thurso: Just so I am straight, most people don't want these things so you say you pay them compensation and they just have them regardless?
Professor Booth: Absolutely, yes, to be straightforward. Secondly, there are two major sectors of the economy that traditionally have been highly productive in the UK—energy and financial services—where productivity has either declined or productivity growth has stopped altogether. In energy that is partly because of the winding down of the North Sea gas fields but it is also because we have an incoherent energy policy that does things like renewable obligations on top of carbon reduction targets on top of implicitly subsidising domestic fuel by not charging VAT on top of what we might get of tax relief for fracking and so on. In the financial sector, we have, rightly or wrongly—you could argue about whether this is a good thing—much higher capital requirements on banks, which is no doubt restraining their lending. I think it is really playing at a supply-side agenda. There is no one thing you can point to that has been really radical that has been done other than the reduction in corporation tax.

Q171 John Thurso: Anything on the demand side?
Professor Booth: No. I think supply creates its own demand, but it is worth pointing out at the level of aggregates that most economic studies suggest that an increase in Government spending of about 10% of GDP reduces the trend growth rate by 1%. So simply reducing Government spending as a proportion of national income back down to the 2006 levels, which is what George Osborne's ambition is by the end of the Parliament, should bring about benefits.

Q172 John Thurso: Lee Hopley, if I can come to you; the last time you were in front of us you made the point that you thought that SMEs were starved of credit. What do you think the situation is today, improved, worse, the same?
Lee Hopley: We have a regular credit condition survey across our membership, and we have seen some small signs of slow improvement in both the availability of new lines of credit and some improvement in the balances on cost of credit, although more companies say that credit is getting more expensive relative to it getting cheaper. So there is still an issue. We are only taking small steps from a very low base. I think there is a lot of other evidence out there that suggests a more worrying trend that small companies in particular are disengaging from the financial sector completely. They have a demand for credit, they have investment plans, but they don't want to go to their bank or external finance providers to get finance to fund those investment plans.

Q173 John Thurso: Just to be straight, when we are talking about small companies or SMEs, broadly speaking we are talking what level of enterprise value?
Lee Hopley: We would be looking at on an employment basis less than 100 employees, so turnover less than sort of £15 million.

Q174 John Thurso: But above the £500,000 and a couple of employees. They are sensible companies is what we are talking about?
Lee Hopley: Yes.

Q175 John Thurso: What impact has the Funding for Lending Scheme had?
Lee Hopley: I think it is very difficult to say at the moment. They don't disaggregate the data into household and business lending. We would assume that it would probably take a little bit longer to feed through into business lending. SME lending is more complex than the mortgage market. We are, however, hopeful that the banks will promote the different schemes available and that perhaps Government might even be a bit more vocal about the fact that lower

costs of funding should feed through into small-business lending.

Q176 John Thurso: One of the problems with all such schemes is that they take a certain amount of time to get traction to work through. This one has been around for a relatively short time. How long would you expect it to be before it was working if it was going to work? What is the decision point?
Lee Hopley: I think we would like to see more concrete signs of this having fed through towards the middle of next year. Going back to the National Loan Guarantee Scheme, which had a relatively short lifespan as it was, relatively quickly we were picking up anecdotal evidence that companies were benefiting from various offers from different finance providers through that scheme. We would like to be picking up the same kind of evidence as we move into the beginning of next year.

Q177 Mr McFadden: Lee, this is your opportunity for a lap of honour. Before the election the Chancellor said, "There is an investment allowance for small businesses that I think is complicating the system and small businesses would rather have more money to make their own decisions on where they invest". That was followed up after the election by cuts in investment allowances to fund the overall cut in corporation tax. At the *Autumn Statement* the Chancellor did a U-turn on this. Can I start by asking you to what degree has his U-turn met the objections that the EEF have been making about the original post-election stance?
Lee Hopley: It was a very welcome move. It was a significant increase in the Annual Investment Allowance. It comes at a time when there are lots of factors weighing down investment plans, so having a signal through the tax system that the UK is the right place to invest and now is the time to do it was welcome. Whether it is big enough to get decisions over the line I think is yet to be seen. We were looking for something more substantial than that.

Q178 Mr McFadden: What were you looking for? What were you asking for?
Lee Hopley: Our central ask was for a temporary increase to 100% for capital allowances for a two-year basis. That would have covered all investment. I know the Annual Investment Allowance as it stands—£250,000, as it will be from 1 January—says it covers over 99% of all companies. I think you still have to put that into the context of the amount of actual investment in the economy that that will cover. It is probably closer to 30% or 35%, but it will be a big cashflow benefit for companies who are investing within that range.

Q179 Mr McFadden: Just to clarify, that is because that last 1% or 2% are actually large companies that make large investments?
Lee Hopley: Yes, medium and large companies, so companies with a £25 million to £30 million turnover will maybe not be caught in that bracket.

Q180 Mr McFadden: You obviously welcome it but, as you say, it is hard to see what the effect will be. To what extent do you think it might be outweighed by the weak state of demand in the economy?
Lee Hopley: Investment in manufacturing is still considerably below its pre-recession peak, but we know from all our survey evidence that there is a real appetite to invest in new plant and equipment. That is the thing that is going to secure companies' competitiveness for the medium term. I think companies with significant investment plans will be looking beyond the demand outlook in the next three to six months when they make those decisions.

Q181 Mr McFadden: A summary of this is policy and rhetoric about supporting manufacturing and growing and exporting our way out of the current situation are more aligned now than they were before the Autumn Statement?
Lee Hopley: I think this is a helpful move. There is a strong focus on exports but we have to be making things competitively. So encouraging companies to do that through the tax system I think is a good move.

Q182 Andrea Leadsom: I would like to talk to you about quantitative easing. To what extent do either of you think that the transfer of the coupons on the gilts held by the Bank of England's Asset Purchase Facility undermines the MPC's independence? Professor Booth?
Professor Booth: There aren't many questions I give a lot of thought to without coming to clear conclusions, but this is one of them, so I am not sure that my answer is going to be all that helpful. I am relatively relaxed about it. The process really is if the Bank of England creates money and does so by buying Government bonds so there is more high-powered money created, then the Central Bank, or ultimately the Government, gets seigniorage from that. That is the whole point, rightly or wrongly, of having a nationalised Central Bank with legal tender currency and so on. That seigniorage comes in the form of reduced interest payments on Government debt, effectively a form of free Government borrowing, and the Government is essentially just taking the credit for that seigniorage. I am not saying it is necessarily the right thing to do but it is certainly not an outrageous thing to do. If changes in capital requirements on banks, changes on the economy in general had led to a step change in the required amount of high-powered money in the system then that would lead to a step reduction, not a change in flows but a step reduction, in the stock of Government borrowing through Government bonds because in effect the Government would be borrowing by raising the stock of high-powered money and this would benefit the Government for ever. If, on the other hand, you view quantitative easing as something that is very temporary and must at some stage be reversed, then I can understand why you would take the opposite view. It is one of those; one economist, two conclusions on this issue.

Q183 Andrea Leadsom: Yes, but I am really asking you that. Is quantitative easing something that you can

simply say is now a fact of life and therefore, as Lord Turner suggested, you could simply cancel those gilts outstanding and let us just forget about it, in other words a permanent debasement of our currency, or do you take the view that for the credibility of the Bank and the credibility of our economy this has to be unwound at some point?
Professor Booth: No, I don't think it necessarily has to be unwound. The Central Bank should determine monetary policy using both interest rates and quantitative easing in order to meet its inflation target. Time will tell whether or not it is necessary to reverse quantitative easing in order to meet that inflation target and if the shock to the banking system is permanent it is possible that the quantitative easing will not have to be reversed. If the shock to the banking system proves to be temporary and the banking system starts lending, and the money multiplier starts to rise again, then it is possible that quantitative easing will have to be reversed. But I think those decisions should be taken as time goes on and as the Bank of England is asked to take monthly monetary policy decisions.

Q184 Andrea Leadsom: What would your advice be to the Bank of England to do with the £7.7 billion of gilts that mature next year in 2013? Should they just be cancelled or should they be reissued? What should be their fate, and what will the impact be?
Professor Booth: I think the quantity of quantitative easing should be determined by monetary conditions, not when the gilts happen to mature. I would be happy for them to mature and be cancelled. If, on the other hand, monetary conditions were such that it was necessary to reverse quantitative easing in any case, it should be reversed regardless of whether or not the gilts are maturing.

Q185 Andrea Leadsom: That is very clear. Perhaps, Lee Hopley, you could give us your thoughts on, in that case, the impact of the transfer of the coupons to the Chancellor or to the Exchequer, as opposed to leaving them sitting in the Asset Purchase Facility. Is that therefore the Treasury undertaking monetary policy outside its own remit, or is it just as with cash management, and should the Monetary Policy Committee have allowed it to happen and then after the fact say, "Well, we didn't really mind, because it is really not a big deal"?
Lee Hopley: I will take others' assessment of this at face value. This is largely a cash management exercise. There were discussions between Treasury and the Bank of England, and the assessment of how the coupons were treated as far as public finance go by the OBR. I think I am happy to take that at face value.

Q186 Andrea Leadsom: But do you accept, as the Monetary Policy Committee said to us, that it is in effect another £37 billion of QE?
Lee Hopley: Absolutely. Yes, I agree with that.

Q187 Andrea Leadsom: So is there then an implication that further quantitative easing is now having a negligible effect if £37 billion can be just waved through as really just cash management?
Lee Hopley: I very much agree with the comments that the previous panel made on this issue regarding the more recent rounds of quantitative easing, relative to those carried out in 2009. The MPC minutes themselves in November pointed to some of the other factors that are weighing on output and demand that are probably making quantitative easing at this point less impactful that we saw previously.
Professor Booth: I should say I gave you a theoretical answer, but given the Bank of England's record with regard to the inflation target and my views about inflation in the future, I do think quantitative easing should begin to be reversed or interest rates should be raised. So I gave you a sort of theoretical answer, but I do think QE should begin to be reversed.
Chair: That is very helpful.

Q188 Andrea Leadsom: Should the target for the Monetary Policy Committee be changed and, if so, to what?
Chair: Just an easy one.
Professor Booth: Preference one would be a price level target and, preference two, either an inflation or a nominal GDP target. Funnily enough, the Bank of Canada has done a lot of work on price level targeting historically that the Bank of England was looking at—Rachel Lomax in particular—but the particular remarks I think you are referring to relate to discussion of a nominal GDP target rather than the price level target.
Chair: We will be seeing Mr Carney and we will be talking with him, no doubt, about GDP targeting and various other approaches. Is there anything you want to add, very quickly? Excellent; thank you very much indeed. We are running more or less to time. I am sorry that it was so brisk, but it was certainly again, as from the first session, informative. We go straight on with the IFS.

Examination of Witnesses

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

Q189 Chair: Paul Johnson, I do not want to give you any time to pour water. We have to get going. Do you think we need two forecasts, and do you think we need what amounts now to two budgets a year? Strip out the politics.
Paul Johnson: We might want to leave ourselves the opportunity for two forecasts.

Q190 Chair: I am not saying they should be forbidden; I am saying, do you need them?
Paul Johnson: It was probably not a bad thing that there was a PDR soon after Lehmans collapsed. What happened this year was where we have ended up, I think, is you have the big forecast happens just before with the Autumn Statement, because there is a nine-month gap between the Budget and Autumn Statement, and then only a three- or four-month gap between the Autumn Statement and the Budget. So the way that the current structure works is that big fiscal stuff, numbers, happen at the Autumn Statemen*t,* not at the Budget, which is slightly odd.

Q191 Chair: Do we need two bites at it a year?
Paul Johnson: On the whole, we probably need the opportunity, we probably shouldn't be taking it in the way that we are at the moment. In the Autumn Statement last week, there was an awful lot of stuff that had nothing to do with the fiscal numbers and you would very much normally have expected to see in the Budget.

Q192 Chair: Let's just take these one at a time. Do we need two forecasts a year?
Paul Johnson: Do we need two forecasts a year? I don't think there is any great need for two in a year.

Q193 Chair: Can we get rid of the word "great" or do you want to keep it? We would like some answers. Do we need two forecasts a year?
Paul Johnson: We could live with one.

Q194 Chair: Would you prefer one?
Paul Johnson: I don't think I have a very strong view about that. What do you think, Carl?
Carl Emmerson: I think the risk of having one a year is that if a lot of things change over an 11-month period, everyone will be saying the OBR's forecast is massively out of date.

Q195 Chair: That is the answer you first gave, which is you would like to keep the option. The question I am asking is: do we need two a year?
Paul Johnson: If you don't always have two a year and things do change, it looks a bit like you have an emergency additional one, so I think there is no problem with having two a year in that sense, but I don't think we should—

Q196 Chair: So most years we have a pretend one, and then now and again it is functional. Okay. Now, what about the Budget?
Paul Johnson: I don't think we need two budgets a year in the way that we have had this year, because we have had a whole bunch of stuff that has happened that has nothing to do with the change in the forecast.

Q197 Chair: So we should get back to downplaying the Autumn Statement, that is what you are saying, or downplaying the Budget?
Paul Johnson: The preference will be to say, "Look, we have an Autumn Statement and we have a budget. The budget is the fiscal event, and the Autumn Statement is not", which is, I still think, the formal view of the Government, or if they could say, "We have two budgets"—

Q198 Chair: We have moved a long way from that, haven't we?
Paul Johnson: We have moved a long way from where we are supposed to be.

Q199 Chair: Yes. I am just trying to clarify—it is hard work, this first question. Is the IFS view that we should get back to how it should be, or is the IFS view something else?
Paul Johnson: I think the IFS view is that we don't terribly mind, as long as the Government is clear about what it is doing.

Q200 Mr Newmark: There has been a lot of chatter, as you have heard, coming in over the past few months on getting a rating downgrade, and obviously we have seen it happen in the US, we have seen it happen in France. People sort of shrug their shoulders and say, "Does it mean much?" Do you think it will have an impact in the UK? Do you think it will have an impact on interest rates, or is it really it will just have an impact on the political classes at Westminster?
Paul Johnson: I think I would broadly agree with what I heard just now, which is that it is the underlying fundamentals that matter and the view of the rating agencies might reflect some small change in those and moving from one grading to another, and the markets presumably will respond to the underlying fundamentals. They know pretty much as much as the rating agencies do about an economy like the UK.

Q201 Mr Newmark: Do ratings agencies have any point nowadays, though? If you are saying that, you are saying that there are a bunch of clever people like yourselves out there all keeping an eye on what is going on; do they really have any function? If Fitch, Moody's and Standard & Poor's all downgrade, all the other smart economists out there are saying, "So what? We sort of knew it anyway", and the bond markets just won't shift at all?
Paul Johnson: I don't know whether the bond markets will shift at all, but I do think it is the underlying information that is going to drive people's behaviour and, as you have alluded to, when these things have changed in some other countries, it has not made much difference to returns. Whether that

will be the case in the UK, I can't predict for sure, but if Moody's or whoever changes next week or next month, it will not be because something has changed very much between this week and next month. It will be to do with the timing of their announcement.

Q202 Mr Newmark: Something will trigger it, won't it, or not? Do you think it is sort of intellectual drift and eventually things stack up and the final straw breaks the camel's back, but not the bond market, in terms of making and breaking decisions?
Paul Johnson: Two things happen. Things do stack up and straws break camels' backs, and great big things happen. At the moment, what we have seen for the last 18 months is things stacking up and gradually getting worse. Clearly what we saw in 2008 was a great big thing happen.

Q203 Mr Newmark: Why do you think the UK has such low borrowing costs?
Paul Johnson: There are a number of things clearly that determine borrowing costs and it is a combination of the alternative places the money can go, the strength of the economy and the credibility of the fiscal strategy being pursued by the Government and the underlying institutional factors and the length of the debt that is available. I think all of those things are playing a role in the very low rates that we are facing, and I wouldn't like to put a percentage role on each of those, but moving away from any of those—

Q204 Mr Newmark: I am going to push you a little bit, Carl—one of the two of you; you are sort of like twins—is it the Government's cuts, effectively, to use simple language, or is the Governor of the Bank of England just printing loads of money? What is really driving down these borrowing costs? Is it the credibility of the Government and the programme that it is pursuing or is it really more the Bank of England just keep printing more and more money and that is what is really keeping the cost of borrowing low?
Paul Johnson: It is both of those things.

Q205 Mr Newmark: I know it is both of those, but are you putting more weight on one side than the other?
Paul Johnson: As I said, it is additionally the kind of demand created by the weakness of other asset markets. You move any of those things and you have an increased chance that the return on gilts will increase.

Q206 Mr Newmark: So you think that when the Governor comes in, for example, it would be advisable that he keeps the printing presses going and keeps printing money? If he stopped that, your argument would be there is a risk of the cost of borrowing in the UK going up.
Paul Johnson: All of these things matter. I have no sense of the scale of the likely risk there.

Q207 Mr Newmark: That is why I have you here, because I would have thought you do have a sense. You have to have some view on this. Carl, you look like you want to say something.
Carl Emmerson: It is the whole package of what we are doing in this country, and if you change one part of it, it depends on whether the other parts respond as well, so I don't think—

Q208 Mr Newmark: But we have this big £200 billion of printing that went on that kickstarted things. What do you see as the marginal impact of more printing?
Carl Emmerson: I think that the decision about that printing was taken in the full knowledge of what the Government was doing, and therefore if the Government did something else, maybe there would have been a different amount of printing. So I do not know the answer to the question, if you change one thing in isolation.

Q209 Andrea Leadsom: Just further to the discussion about the printing money, quantitative easing, are you satisfied with Government and the OBR treatment of the transfer of the surplus from the APF?
Carl Emmerson: From the public finance point of view, the transfer does not change the long-run outlook for the UK public finances, so I think it would be better if we used measures of the fiscal aggregates that did not make the fiscal targets any easier or harder to meet. So I think what should have happened is the Treasury should have told the OBR to exclude this impact when it was assessing compliance with the fiscal targets. As it turned out, we are on course to miss the supplementary target regardless, and we are on course when we are meeting the fiscal mandate regardless, so it did not matter, but I think the Treasury should have told the OBR to exclude the impact of this when measuring compliance with the two fiscal targets.

Q210 Andrea Leadsom: Just for completeness, in your mind, would the same apply to the kind of contentious issues around the Royal Mail pension fund assets and the 4G licences and so on? Would you simply exclude all extras that were not necessarily part of the main budget, for either completeness or for transparency or just kind of neatness? What would you recommend by way of treatment of those extra items, which surely this must be one?
Carl Emmerson: The OBR has done a very good job of documenting exactly what impact each of these had, so you can calculate the fiscal aggregates that exclude those measures. The 4G licence sales make no real difference to either of the fiscal targets, so I do not think it really matters. The Royal Mail transfer, I think what does matter is the OBR provides the series with and without them, and they have done that and I am happy about that.

Q211 Andrea Leadsom: So what is the difference? Is it just the quantum, is it just the size of the number is bigger in the coupon transfer, or is it that it is a different type of financial transaction? What is it that makes you say that it should be excluded perhaps where 4G licences or Royal Mail pension impact should not be?

Carl Emmerson: I think we should always have the ability to strip the numbers out so we know why they are changing. I think the 4G licences in particular do not make either fiscal target harder or easier to meet in any meaningful sense.

Q212 Andrea Leadsom: Yes, but they could have done. Had the value been sort of £50 billion or something, it could have made a difference.
Carl Emmerson: But asset sales are always included off net investments, so I think if they were to make a difference—well, they were never going to make a difference on the fiscal mandate because it excludes investments. Then I guess ultimately I don't care that much about the supplementary target, because it doesn't have much good economic underpinning. It is very hard as an economist to say, "What should you do about the supplementary target?" when it does not seem to have sound economics behind it.

Q213 Andrea Leadsom: Can you give us your thoughts on the fiscal wisdom of the transfer of the coupons out of the Asset Purchase Facility? There has been some discussion about the fact that, in effect, you are taking in cash now that makes the public finances look better and, in fact, when you come to unwind quantitative easing, you will then have to borrow at a presumably higher rate, because by definition interest rates will have gone up in order to compensate. Is that all too theoretical, or what is the IFS's view on that?
Carl Emmerson: I think it is very welcome that OBR has published the impact, not just in the short run but in the complete duration of those gilts, so we know its best guess of the impact right across the full 20- to 25-year horizon, which is what really matters here.
Paul Johnson: I think that is an example of where the way we look at the public finances suffers from problems right across the piece, so the Royal Mail transfer, for example, makes things look better this year, but considerably worse going into the future, and a whole series of other things that one does now can create liabilities in the future that we are just not measuring. I think that the gilt transfer is simply an example of that if you just focus on the impact today you are going to miss what may be more important, which is the long-run impact.

Q214 Mr McFadden: Your distributional analysis said that it was those at the bottom and at the top that were squeezed the most by the measures in the Autumn Statement. If you take out the top decile completely, it is really quite skewed towards the bottom two or three deciles, isn't it?
Paul Johnson: If you take out the top decile entirely, then what was announced in the Autumn Statement*?* Some cuts to benefits—obviously that is going to impact the bottom third half of the population—some tax reductions, an increase in the personal allowance and a reduction in council tax and in petrol taxes that benefits people across the distribution, and the things that hit the people at the top, effectively a fall in the higher-rate allowance and a squeeze on pension allowances. In a sense the shape was entirely predictable before we ran the model, and it is exactly as you describe: the bottom third to half lose a bit, the middle or sort of the upper third gain a little bit, and the people in the top decile lose a bit more.

Q215 Mr McFadden: Can I ask you on a slightly different subject about your article in the *Financial Times* yesterday? You suggested that shares for a rights scheme that the Chancellor has advanced might be open to tax avoidance. Could you expand on that a little bit and say why you think people might be on to this?
Paul Johnson: What I was really trying to do in that article was draw attention to a number that is in the Autumn Statement documentation that suggests two kind of quite surprising things. The first thing is that in the main documentation, the cost runs to a maximum of £80 million in the final year. What the supplementary documentation suggests is that beyond the horizon it might rise to £1 billion. That is very uncertain because, as the OBR says, I think the words were something like, "This is uncertain because tax planning may account for a quarter of the cost in the documentation itself". The point I think is there is a significant amount of risk and uncertainty about this that was not apparent in the main documentation. This is one of a long line of tax changes made in some haste, where there is a possibility of regretting at leisure, because it creates potential opportunities for avoidance. The £1 billion number may be massively overblown, but I think it is a good example of the risks that are associated with this kind of policy.

Q216 Mr McFadden: Has anyone from the Treasury contacted you since your article was published to say that they thought you were wrong?
Paul Johnson: No.

Q217 John Thurso: Can I just ask you one quick question around fuel duty? You have a very helpful chart in your pack that shows what would have happened if the Government hadn't done anything, where fuel duty would be, where it would be prior to the Autumn Statement and where it was after the Autumn Statement. That shows broadly, if you take the top and the bottom, it is about £4.4 billion that Government is foregoing in annual revenue. How does that impact across the distribution between different people? How is that impacting on people, other than the obvious one of motorists are doing well and people without cars are not?
Paul Johnson: So those that are right at the bottom of the distribution are less likely to be motorists, so they will probably gain a bit less from this. Those further up the distribution, particularly those with more than one car, will gain a bit more. We haven't kind of broken this specific one out to look at the effect. It is one of the things that is resulting in those people in the sort of 5th to 9th decile gaining a little bit, so that is one of the things that is impacting on that.

Q218 John Thurso: One of the arguments that is put is that lower fuel duty leads to increased growth, and on the basis of that you would have expected either growth to be much stronger, or without that growth

would have been unbelievably weak. Does the assertion of growth linked to fuel duty stack up in the light of that evidence?
Paul Johnson: We are losing £4.5 billion in fuel duty. Given what has happened in various budgets in Autumn Statements, that has been made up in other areas. It may be that there is a slight difference between the impact on fuel duty in terms of growth as opposed to the impact on VAT or income tax or what have you, but the overall fiscal numbers have not changed, so my guess—and it would not be more than a guess—is that the impact is pretty marginal.

Q219 John Thurso: It is plain that if going up or down in fuel duty has an impact on growth, you would have to do it when you had no movement anywhere else. In other words, it was a one-off that had no counterbalancing movement anywhere else that was having a movement in a different direction.
Carl Emmerson: I think if we thought that fuel duty policy was something that really impacts on growth, the first thing we should do is try to be much clearer about where we want fuel duty to head in the long run and try to stick to that, rather than change fuel duty policy on a virtually continuous basis. I think that would be the biggest flaw we would see with current fuel policy.

Q220 John Thurso: What we really need is a longer-term strategy, because I cannot help, for example—as has been pointed out to me by other people—contrasting the fact that we have saved or we are saving just under £4 billion on welfare going forward and we have given away just over £4 billion on fuel duty. I know it is not apples and apples, but if you wanted to, you could make that comparison.
Paul Johnson: I think there is a more general point about what was in the Autumn Statement, that the set of changes, the tax cuts and spending increases, were almost exactly offset, so this was not a fiscal event in the sense of changing the net amount coming into the Exchequer. It was a fiscal event only in the sense of giving to some and taking from others, and that is one of the examples.

Q221 Mr Love: I don't know whether you have seen or heard the Prime Minister's Questions today, but the Leader of the Opposition asked the Prime Minister to confirm one of the releases by the IFS in relation to the average one-earner couple would be £534 a year worse off by 2015. Not only did the Prime Minister not confirm that—and I did not hear his words very clearly, it is not always available but it seemed to be something related to personal allowance—but he also mentioned it hadn't taken into account the introduction of Universal Credit up to 2015. How would you respond to the Prime Minister's response to the Leader of the Opposition?
Paul Johnson: There are obviously a lot of ways of looking at the distributional impact. We produced two sets of numbers last week. The first was the impact of all the changes announced at the Autumn Statement, what that will be when fully implemented in 2015, and so I think the number that you are referring to is that number. It is the number or it is the impact on families in 2015, once all of the changes announced in the Autumn Statement are put into place. That includes the small increase in the personal allowances that were announced last week. What we have heard about this, what we heard when we listened to at least the first bit of this, was the Prime Minister saying that our numbers did not take account of the increase in the personal allowances announced in the Budget, and that number doesn't include the increase in the personal allowance that was announced in the Budget. We produced another set of numbers in these charts that look at the full impact of the consolidation since January 2010 up through to what was announced last week, and that does include that, among everything else and including Universal Credit when you take it through to 2015.

Q222 Mr Love: So that £534 figure wouldn't include the Budget figure—
Paul Johnson: That is correct.
Mr Love:—but it would include a Universal Credit?
Carl Emmerson: It includes the cut to Universal Credit that was announced in last week's Autumn Statement, yes.

Q223 Mr Love: But just to be absolutely clear, the Prime Minister seemed to suggest there were some changes on the introduction of Universal Credit next year up to 2015 and suggested that they hadn't fully been taken into account. Would you agree or disagree with that?
Paul Johnson: There are two sets of things here. Our overall number, looking at the whole consolidation package, includes the introduction of Universal Credit. Our number, the £500 number, includes what was announced in the Autumn Statement, which was the announced reductions in Universal Credit, so the cut relative to what would have been in place had the Autumn Statement not been there. So again, that £500 number does not include the introduction of Universal Credit, but it does include the cuts that were announced.

Q224 Mr Love: I think we have that clearly on the record. Can I ask you to confirm—I don't think this was one of your figures, I think it came from the Resolution Foundation, but perhaps you would comment in some form—how many of the people affected by the changes in the Autumn Statement are in work and how many are on benefits? The suggested figure is 60% plus. Do you have any figures to confirm or reject that?
Paul Johnson: We have not looked at that particular figure but, to be honest, it is hardly surprising, given that the large majority of people are in work, and so the large majority of people affected are likely to be in work.

Q225 Mr Love: Just one final question then, since we are under the cosh here today, and that is your warning about the inconceivability of the cuts if you take them through to 2017–18. We are talking about a cut in quite a lot of Government departments, in the order of one-third. Would you care to comment on word "inconceivable"?

Paul Johnson: That was essentially about that the Chancellor announced the envelope through to 2017–18. He announced the 2015–16, what would happen to welfare, and he also announced that in that year the NHS would be protected once more. So if you take no more cuts in welfare and you take that the NHS continues and schools continue to be protected, that results in total cuts in the unprotected departments from 2010 of nearly a third. Some of those departments have already had cuts of more than 25%, so that is very difficult indeed.

Q226 Mr Love: So you are suggesting that even cuts in welfare or tax increases to—
Paul Johnson: The real point was to say if you exclude tax increases and the NHS and welfare from your calculations, that leaves you with a really extraordinary squeeze on the other sort of half. Basically, you are only looking at half of spending for really big changes, and the longer that carries on the less sustainable that looks.

Q227 Mark Garnier: A very quick question: first of all, how big a factor is complexity in tax avoidance? A short answer.
Paul Johnson: It is substantial.

Q228 Mark Garnier: That is good enough. Do you think the Government has done enough to address this problem of tax complexity?
Paul Johnson: I think it could do a considerable amount more.

Q229 Andrea Leadsom: Following from Mr Love's question, you said that your £534, the Prime Minister's point today, only includes measures in the Autumn Statement. What is the impact of measures if you take them from 2010 on the average working family?
Paul Johnson: That is quite a big number. If you take that same group for obvious reasons the number that has been chosen here, which is couples with children with one earner, who are the biggest losers in all of this, which is presumably why that is the number that is being kicked around, they are also the biggest losers over the whole period, and that comes to more like just over £3,000 a year on average. We have taken this from the beginning of the consolidation, so January 2010. That includes the tax increases in the Budget before this Government came in, and the average is clearly significantly driven by big losses among a minority of that group, including big losses at the top.

Q230 Jesse Norman: Mr Johnson, on the output gap, obviously there has been enormous changes not just to the numbers but to the way in which they have been calculated by the OBR. Do you think it is helpful to have changes like that to the methodology of calculating these things, particularly at such a politically sensitive time?
Paul Johnson: Calculation of the output gap is difficult, and it is one of the big difficulties associated with the specific formulation of the fiscal rules that the OBR is trying to judge against.

Q231 Jesse Norman: The whole project is often rather dubious, but the question is: is it a good idea to change your methodology when you know in advance it is going to have an enormous effect on fiscal policy?
Paul Johnson: In the end, they made a judgment on this, and in a sense their job is make a judgment on it. Their judgment was that if they hadn't changed that then you would have ended up with a level of output gap that they simply didn't believe because it was too small. You might ask whether that brings into question the kind of underlying model, but in the end, all of the macro forecasts make these kind of judgments.

Q232 Jesse Norman: Should they have consulted on the change in the methodology?
Carl Emmerson: I think the difficulty is that the methodology is to look at one model, look at another model, think about it and then come to a view, and so it is Robert Chote, Graham Parker and Steve Nickell's brains taking a view on the outcome of what those two models tell them.

Q233 Jesse Norman: That is helpful. The final question is given the size of the output gap in the intervening years, how much scope is there for more stimulus of our monetary policy, if that could be achieved?
Chair: That is a very good question.
Paul Johnson: To which I am not sure we have an answer.
Chair: But one of the key questions. You must have thought about it a bit, IFS?
Paul Johnson: We don't really often think about the scope for monetary stimulus, to be honest, at the IFS.

Q234 Jesse Norman: But you wouldn't deny the suggestion that it might be rather large, given the size of the output gap?
Chair: They want time out. Come back to us if you end up forming a view. Extremely helpful; again, like the other sessions, brief, but full of interesting information. Thank you very much indeed. We will go straight on to PFI.

Examination of Witnesses

Witnesses: **Dr Mark Hellowell**, Lecturer, School of Social and Political Science, University of Edinburgh, and **Professor Dieter Helm CBE**, University of Oxford, gave evidence.

Q235 Chair: I will begin with you, Professor Helm. Do you think PFI2 deals adequately with the problems of PFI1? To answer that perhaps it would be helpful to divide the problems of PFI1 into three—you might decide to do it in another way—the off-balance-sheet incentives for Departments to do PFI deals, which probably meant more deals were being pushed by Departments than they should have been, poor value for money in these deals that partly came from the fact that they were ripped off by clever private-sector providers, and related to that, the absence of, or inadequate, risk transfer.
Professor Helm: The first thing to say is that it would be hard to make the PFI worse, so it is hard to dispute that the steps that have been taken are in the right direction. Who wouldn't want to accelerate delivery, make service provision flexible and make it more transparent?

Q236 Chair: So it is motherhood and apple pie, is what you are saying?
Professor Helm: The particular details of how these transactions are done clearly matter and they can be done better, and between the lines of the proposal for PFI2, there are some bits in there that are better than what was there before. But the more important question to ask is does it deal with the structural critique of what PFI is, and your questions, your three points, go to that. This was invented as a giant off-balance sheet exercise driven by public accounts that are driven in cash terms. So prior to starting to think about how Government should contract for services is to ask the question, "Where is the balance sheet?" There is no national balance sheet. We do not have a balance sheet, infrastructure, assets or natural capital for human capital and so on, and therefore, since we have accounts in predominantly cash terms, PFI was invented as an exercise to do more borrowing than you otherwise would have done, but to put it on someone else's account so it didn't appear in the public accounts.

Q237 Chair: Given that we are not going to get human capital balance sheet accounting any time soon—and I know you have done an exceedingly good piece of work on it, Professor Helm, and I have looked at it, and many others have too—just taking PFI on its own terms, have they made it work much better on those three heads?
Professor Helm: The point about raising the fundamental issue is it goes to the heart of what constitutes the incentives on the players, the value for money and the risk transfer. All of this circulates around the cost of capital, and whether we are paying a premium for transferring political and regulatory risk on to the private sector without any commensurate benefit. In the sums involved, 1% change in the cost of capital swamps a hell of a lot of efficiency incentives. So that is why it is important. Of course in a world in which you have severe constraints on public expenditure, the incentives to put things off-balance sheet in these schemes remains and it is neither larger not necessarily smaller in what has been put together. The Government can co-finance, which gives greater scope. There are some contexts in which that improves the risk spreading, to have the Government as party to the frame, but the overarching issue would be to break up the risks in these projects between the construction risk, the operation risk and the guarantee of recovering your costs of investment. None of that has been separated, and in that sense, the core problems remain, and the value for money improvement will be marginal rather than substantive.
Mark Hellowell: I think in terms of the off-balance sheet question, that is fairly straightforward. The move from PFI to PFI2 or PF2 doesn't really do anything substantially different in terms of the accounting treatment, and therefore we still have the Budgetary incentive and the fiscal incentive to pursue private financing almost regardless of the sort of value for money merits of PFI.

Q238 Chair: So this control total or tack that is being proposed is a little—well, what value does that have?
Mark Hellowell: I think that does have some value in the sense that—
Chair: That must cap out the abuse of these incentives.
Mark Hellowell: I think it moderates the way that those incentives operate, but it does not remove the incentives. There is still an incentive to use private finance in order to leverage increase capital budgets for departments. There is still an incentive to use off-balance-sheet financing in order to make the level of national indebtedness look a little bit better than it really is, and so those kind of budgetary or fiscal incentives still remain. I do think though that it makes sense from a budgeting perspective to say if we are going to use these off-balance-sheet mechanisms, we want to have a good sense of how much of future current expenditure we are willing to earmark for this kind of thing.

Q239 Jesse Norman: Mr Hellowell, what are the relative costs of borrowing through PFI or PF2 now versus borrowing on the balance sheet?
Mark Hellowell: The cost of a conventional PFI scheme as of now, the weighted average cost of capital would be something like 8.5% to 9%, probably higher for a higher risk project, something out of the sort of mainstream accommodation sectors, healthcare and education and so forth. PF2 is almost certainly, at least in the short term, going to increase the WACC, the weighted average cost of capital, because—

Q240 Jesse Norman: Because of the higher equity component?
Mark Hellowell: Because of the higher equity component, so we might see—

Q241 Jesse Norman: But there will be a reduction in risk as well; that will take costs down a bit.
Mark Hellowell: I think in the longer term, we might see some moderation of both equity returns and

interest rates on debt. In the short term, I think that is very unlikely to emerge.

Q242 Jesse Norman: So that 8.5% versus what you said—
Mark Hellowell: At the moment, it is sort of 2%, 3%, yes.

Q243 Jesse Norman: For borrowing off-balance sheet, using either PFI or PF2, the Government is paying 8.5%, and if it is borrowing on the balance sheet, it is paying 2%, so it sounds like four times as much, is that right?
Mark Hellowell: That is right as of now. Obviously, the long-dated gilt rate fluctuates quite significantly over time, but as of right now, we are talking about, I think, 2.5% versus about 9%.
Jesse Norman: Okay, that is interesting.
Chair: Quite a big gap.

Q244 Jesse Norman: Yes, not an insignificant gap; I think it is worth pointing that out. We might come back to that later.
Centralisation of procurement, do you think the Government has gone far enough in trying to ensure centralisation, high-quality standards of procurement, contract management in the new scheme?
Mark Hellowell: We have not seen a huge amount of activity on that front yet. I think the principle of centralisation makes good sense. In the past the Government has been bad at using its market power effectively in terms of its relationship with the big industries that participate in PFI, so I think managing programmes of procurement at a central level, using human resources that exist at the central level to drive down the cost of projects and to negotiate more commercially, all of that makes sense. Of course, in general, PFI programmes have had a rhetoric of centralisation attached to them and that has always been the case. Building schools for the future, for example, was touted as a heavily, strongly centralised scheme, a strongly centralised programme of investment that had Partnership for Schools at the epicentre of the scheme, driving policy and also taking a role in negotiating projects. Did the centralisation happen and did it secure good and efficient prices? I think that is not so clear. Centralisation is quite difficult to achieve when you are dealing with local authorities, for example, that don't necessarily welcome that degree of centralisation.

Q245 Jesse Norman: That is helpful; thank you. You obviously have a particular expertise in the NHS. Have you detected resistance from the NHS to the realisation or recognition of savings on existing projects, that is to say possibly what you might call contractor capture within the NHS, where it turns out they are working for the PFI contractor rather than working for the public purse?
Mark Hellowell: I haven't seen a huge amount of evidence of that. My sense is that many of these deals are quite adversarial in the way that they operate, rather than that sort of cosy relationship.

Q246 Jesse Norman: That is helpful. Did you want to say anything on any of these things?
Professor Helm: I just wanted to comment on the gap between the cost of capital. The counterfactual, what you should ask if you are interested in value for money here is do you believe that the additional efficiency incentives, by having the private sector run a complete asset, is equal to 6% or 7% real? But the counterfactual is compared with, what? So you could say supposing instead the Government contracted for someone to build a hospital or a school and then separately contracted for them to run the operation. The efficiency incentives are all in the private sector, but the finance is not, so you have to get an enormous amount of extra efficiency gains from bundling the whole thing up together over and above that cost of capital difference by choosing to have the finance off-balance sheet rather than on the balance sheet.

Q247 Jesse Norman: To be clear, if you were able to achieve a 5% efficiency gain in the delivery of the service every year, you would still be paying 2% more than the on-balance sheet costs of these projects? By the way, 5% being essentially unachievable in the public services historically.
Professor Helm: But it is more than that. It is 5% more than the efficiency you would have if you had let a contract in the normal central purchasing way for building the hospital and you had let an operational contractor run that hospital. So it is not simply public versus private efficiency. The cost of capital effect is over the way it is financed. You can still have the efficiencies and have the Government contract for the building and contract separately for the operations, or indeed contract for the whole thing and provide the finance themselves.

Q248 Jesse Norman: So what are the actual numbers? Give me some sense of what the number differential would be using that methodology.
Professor Helm: I am not sure it is greater than normal. It seems to me it is very sensible to parcel out packages. There may be some circumstances where it is the right answer, but whether you should always want to give whole of life contracts, confusing these things together, particularly since if you take over a PFI contract, you may well probably sub-contract the operational stuff anyway to someone else. The answer is you need to persuade me it is greater than the norm. Sometimes it might be, but sometimes it might be less than the norm, so we are left with the choice between a conventional procurement mechanism and an off-balance mechanism. I am not sure whether the numbers are exactly right—but I think we would agree we can't get it exactly right—but if you are talking about 5%, 6% difference on a cost of capital and what are initially capital-intensive projects, this is an extraordinarily expensive price to pay for getting something off your Government balance sheet to make your deficit look different than it otherwise would have been. It doesn't make economic sense, is the answer.

Q249 Chair: Anything to add, Mr Hellowell, or would you disagree with that?

Mark Hellowell: No. I think the sort of back of the envelope calculation in relation to one of the big hospital deals now being procured in the north-west of England is a £279 million scheme, and looking at the net present value of the financing costs—

Chair: This is the Royal Liverpool scheme, isn't it? Yes.

Mark Hellowell: Indeed, and this was the additional cost of using private over public finance. It was something like £170 million in net present value terms. So that gives you a sense of the kind of efficiencies you need to secure throughout sourcing and bundling construction and operations through PFI.

Q250 John Thurso: Let me follow up on efficiencies perhaps with you, Mark. The Government claims that it has made £1.5 billion efficiency savings from the operational PFI savings programme in its document, *A New Approach to Public/Private Partnerships.* How robust is that number?

Mark Hellowell: I am sceptical about that number. To be honest, the amount of uncertainty that there must be around that number is quite significant, because this is a cash figure, a nominal figure, that you need to set against the nominal liability of something like £200 billion and, in fact, we are extremely uncertain about the validity of that £200 billion. We would have to understand that a £5 saving in, let's say, 2040 or 2050 is a very different thing to a £5 saving tomorrow. So the way that this number is constructed I think is mystifying rather clarifying.

Q251 John Thurso: I was about to say, it is a completely unhelpful number, isn't it?

Mark Hellowell: I do not think we have learned a huge amount from that number, no.

Q252 John Thurso: What should constitute a saving? If we are looking for savings, what should be a saving under this programme the Government have put forward?

Mark Hellowell: I think if we were going to look at savings, we would want to look at either an annual saving or we would want to look at a net present value, but even then, looking at sort of making a forecast of savings over a long period of time, it is going to be subject to a lot of uncertainty. I would also like to know what the definition of a saving is, because of course the cost of these projects increases year on year because of the link to inflation, so there is a link in the unitary charge to inflation. Of course, these unitary charges also fluctuate year on year according to performance criteria. So it can be quite difficult to say what the cost is going to be next year, never mind the cost in 10 years' time.

Q253 John Thurso: So if your estimate of the cost for next year was slightly greater than it might otherwise be, and you then came in at a lower number, that could constitute a saving?

Mark Hellowell: Yes. One reading of that would be that it is a saving. I think the other thing you can do obviously is you can reduce the scope of what you are buying, and you have to do that in a sort of bilateral monopoly environment in which you are not necessarily going to get a beneficial distribution of the gains from that renegotiation. Therefore, while you might be able to achieve sort of lower costs—not lower unit prices but lower costs—you might be putting at risk the value for money of the deal.

Q254 Chair: Do you have in front of you by any chance the Treasury's document that it has put out on PFI? Perhaps if you do, you could turn to page 18, where there is a convenient table comparing conventional procurement with PFI. Are you familiar with this table? Have you read through this before?

Mark Hellowell: Yes.

Chair: Do you think it is correct, broadly right? The reason I am asking these questions is of course the whole of Government's case for going ahead with this scheme rests really on the conclusions drawn in this table.

Professor Helm: The right answer to that question is the table doesn't include what you really want to know between the two, and that is exactly the discussion we have had, which is: what are the big ticket items here? The cost of capital is a big-ticket item. It does not compare the cost of capital on the left-hand column with the cost of capital on the right-hand column. If you leave that out- as we have already debated, this number is enormous- then the fact that there might be some differences in how the contracts are run between public procurement and the PFI is kind of important but subsidiary.

Q255 Chair: There seems to be one other important table—well, there is quite a lot of interesting information in this document, which I read yesterday, but I think it is important to start with 18, just to be clear on the pros and cons of the whole thing—at page 13, which is a summary of how PFI2, or PF2, as they call it, makes improvements on previous measures. Perhaps if we could just have a quick look at that, because it does set out pretty clearly what the Government is intending to do. I know we don't have a lot of time, but let us just go through these things and decide whether we think they add much, some of which we have touched on already. On equity, "Look to act as a minority public entity co-investor". How much difference do you think that will make?

Mark Hellowell: I think it makes a bit of a political difference. I think it gives some substance to the idea of a rebrand perhaps, in the sense that the public sector is now going to have a stake in the ownership of the project. I think its effect on the economics of PF2 is likely to be quite marginal. To some extent, it is difficult to answer at this point, because we don't know how much or what proportion of the equity the public sector is going to be investing. I suspect it is going to be quite a small figure, so I think we would see this as having more symbolic importance than economic substance.

Q256 Chair: I am only going to ask one of you to answer each of these, whoever happens to volunteer or catch my eye as I go through these things, but if either of you disagree fundamentally with the reply you have just heard, then speak up. But you do?

Professor Helm: I do disagree. I think this is the most significant bit, because as the public equity increases, so the cost of capital is changed. Secondly, if you are inside a deal rather than outside, particularly when it is more adversary, you have a lot more information. Finally, you do share in some of the upside, because if there is an equity gain on this, then there is some component of it, so I think—

Q257 Chair: So if the minority went to a majority, you would be quite happy, because then the cost of capital would be plummeting?
Professor Helm: It is project to project. The idea that all projects should have the same framework is wrong, there are some circumstances where it will not make any difference if there is a public equity stake, or it might be undesirable. There are other circumstances where the political and regulatory risk is such that it is larger in the project or you are much more uncertain about what the equity return of the project is going to be and therefore you want to have a component part. So I don't think there is a blanket answer to that, but I do think it is potentially significant.

Q258 Chair: I realise that we are doing this in great haste, but let's just have a look at accelerating delivery. If you look at the first dot, I think Government on the whole has tried to put the most important item in the first dot into the discussion. The first dot is, "Improving public sector procurement by strengthening the mandate of Infrastructure UK".
Professor Helm: I think that makes very little difference. The mandate of Infrastructure UK ought to be looked at for different reasons, but the idea that after all these years' experience that there is a kind of whiz on accelerated delivery that hasn't been thought of before or by tweaking the role of an institution will not make much difference, I find that questionable.

Q259 Chair: Let's move on to the next one: "Flexible service provision: to improve flexibility, transparency and efficiency of services. Soft services such as cleaning and catering will be removed from projects".
Mark Hellowell: Yes, that has been the practice for some time. I think back in about 2005 it was recognised that there was no real value in bundling these kind of services within the PFI contract, and you could get much keener pricing if you just outsourced these through different sorts of arrangements.

Q260 Chair: Okay. Then we go on to the next one, "To transform the approach taken to transparency, the Government will introduce a control total". We have already discussed that and you said that it will have nugatory value. If we move further down, "To improve value for money, there will be greater management of risk by the public sector, including the risk of additional capital expenditure arising from an unforeseeable general change in law, utilities costs, site contamination and insurance". What store do you set by that one?
Mark Hellowell: This is sensible in as far as it goes, but these are not significant elements of the cost.

Q261 Chair: We have discussed future debt finance, and then we end up at the bottom with a very important one, "Delivering of value for money: the Government will develop and consult on guidance that will replace the existing value for money assessment guidance". How do you feel about that one?
Professor Helm: It would be a good idea to improve the assessment. The question though is should the guidance cover the core substantive elements of the cost, including the cost of capital, or should it be the list on the table on page 18 and the comparison that is set out there? This comes back to my point that if you want to compare value for money it is the cost of capital, because you can have the competitive advantages in a number of different ways of doing these schemes. The issue is why are we paying such an enormous premium for the capital component, and if the answer is, "Because we can't do our balance sheet properly", or, "We wish to pretend that assets and liabilities shouldn't be properly reflected", my guess is that democracy has reached a rather expensive point.

Q262 Chair: All right. We have that point firmly on board from an earlier reply. There are some questions that a number of us would have liked to have asked you in particular, Professor Helm, about energy policy. Perhaps we will put those on a piece of paper and write to you about them, but in the meantime, Jesse Norman has a further rejoinder on PFI.
Jesse Norman: Just a very quick question on PFI to you, Professor Helm, which is presumably Government has taken the view that—and we know it has taken the view—it cannot increase public sector borrowing as it is, and therefore it is forced to use private sector alternatives. So isn't the importance of the qualification of this gap to set a threshold within Government as to what projects have a social return that might justify this extremely high cost of capital, and therefore worth undertaking, even though they can't be undertaken in the most effective and efficiently financed way?
Professor Helm: It is obviously the case that the higher the cost of capital, the greater the rationing off of projects, and you would hope that as a consequence, if there are certain projects they were not going to do otherwise, they are going to pick the ones with the highest return to cover the cost of capital. By the way, I think you also want to find the projects that are the least capital intensive, because that is where it bites.
But I do want to come back to this point about they can't do it by public borrowing. You have to think about it. First of all, physically could they borrow the money? The answer is yes. Does this affect the way they account for their deficit? Produce two sets of accounts, produce the existing accounts and then create next to it a balance sheet with liabilities and assets, because remember, if this is sensible, the Government is improving its financial position because it is acquiring an asset that is worth more than it cost it to build, and we had a any normal accounting system this would be a plus. If you make that transparent to the markets, my view is that is perfectly understandable. So you don't have to abandon current

accounting, you just do current accounting and then set this thing alongside.

Q263 Jesse Norman: You are sounding frighteningly close to the proposal of Mr Hellowell, so I would not dissent from that.
Chair: That has shaken several members of this Committee.
Jesse Norman: But the point would also be the kinds of projects that should be preferred under this arrangement, if you are not going to go down that route, are ones with low capital cost and high social return?
Professor Helm: It is not social return; it is low cost of capital versus current or OPEX costs, right? The more capital intensive it is, the more problematic it is.

Q264 Jesse Norman: No, you are right, but the reason you are going to build a school is not just because it has a capital cost of X, Y, Z. You are going to build it because it has a social return, an all things considered return that makes it sensible from your point of view.
Professor Helm: No, but we confuse two things. One is what is the balance between CAPEX and OPEX in the project? If you are using a high discount rate, you want to have as low CAPEX and high OPEX as you can. The separate issue is what is the return of these projects, including their social return? Obviously under any procurement system, you want to pick the ones with the highest return first and then work down the list. This rations off at one point, but in no procurement system would you prefer to choose projects with lower social returns before you pick ones with higher ones.

Q265 Jesse Norman: No, but this sets the bar at a different place.
Professor Helm: It is just as a rationing.

Q266 Mr Love: In a sense I am asking the question because I am a little confused. What I am trying to do is to understand the differences between PFI and PF2. You seem to be suggesting that in terms of balance sheet activity the incentives are still there, and certainly we are living through very difficult times so that is understandable. On value for money, you seem to be suggesting that increased costs for capital is likely to prejudice an improvement in value for money. Costs to the taxpayer, I am not sure what you are saying, but perhaps you could give me an understanding of where you think the benefits lie in moving from PFI to PF2.
Mark Hellowell: Obviously you would want to take into account the costs as well as the benefits. As I say, I think the short-term impact will be an increase in the weighted average cost of capital, because equity is expensive and they want to increase the proportion of equity in the capital structure. In the longer term, you might see, especially if the funding competitions for equity succeed, those equity rates of return coming down and if you succeed in getting institutional investors to lend on the debt side, then you might see a lower interest rate on debt, but you are relying on the market to respond in the way that it is hoped in order to drive down the—

Q267 Mr Love: There appear to be some market signals that are negative, from the comment that we have heard about PF2, in terms of whether the market will participate in the new system as much as—am I wrong in—
Professor Helm: Just for clarification, the cost of capital to the private finance provider within this new version is likely to be higher, because their risk has been increased, but because the public sector may be doing some of the investing at a lower cost of capital, the overall weighted average cost of capital may go up or go down, depending on the weighting of the public sector within that frame. I think that is very important.
In terms of whether people are going to invest in these things, if you just increase the private cost of capital, obviously you are rationing off some supply. But this goes now to the much bigger question, which is whether or not in the competing space, the pension fund monies in the utilities that have regulatory asset bases are a sound way of doing financing in private projects, if I can put it that way- and these PFIs, which is going to suck up the money more effectively and faster? The utility model is so vastly superior, using regulatory asset bases and at a lower cost of capital, and understood and more homogenous- it is more similar across the schemes- my guess in the competition—given that it is the utilities that are also going to go in the market for much larger financing going forward—they are going to have the prime shot at this. That leads to a point that if you really want to do PFI and you want to do these things with the private sector, we have a perfectly good model that we have worked out over 20 or 30 years that produced a very low cost of capital and that is the core utility model. That is what people should be thinking about here, rather than this whole of life individual CAPEX project-type approach.

Q268 Chair: The very last word goes to Mark Hellowell, if he has anything he wants to say.
Mark Hellowell: I think my strong sense is that in a sense, this is kind of an interim report, because very much the intention here is to say, "Okay, this is what we want to do. Now it is up to the market to go away and organise itself in a completely new way for equities coming from new sources, for institutional investors to start lending into this space in a way that they never have before". We still don't know as of now whether they will, and if they will not, then PF2 won't happen.
Chair: That is very, very helpful indeed. Thank you for coming in for this again brief but very important session. We are very grateful.

Thursday 13 December 2012

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Andrea Leadsom
Mr Andy Love
John Mann
Mr Pat McFadden
Mr George Mudie
Mr Brooks Newmark
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Rt Hon George Osborne**, MP, Chancellor of the Exchequer, HM Treasury, and **James Bowler**, Director for Strategy, Planning and Budget, HM Treasury, gave evidence

Q269 Chair: Chancellor, you are looking remarkably good on no sleep and an overnight negotiation in Europe, so we know what gets you going. I want to begin by asking you first of all to tell us how much resolution of the eurozone crisis matters to the British economy. What proportion of the downturn that has happened in the economy over the last two years could be attributed to it?

Mr Osborne: First of all, I am very grateful to you and members of this Committee for agreeing to move the hearing to this afternoon, and that is much appreciated. I should also introduce James Bowler, who is the Director of Budget in the Treasury and can also answer your questions.

The answer to your question is that the eurozone crisis has had a huge impact on the British economy and indeed many other Western economies. It is not the only thing that is affecting the British economy, of course, and we still are living with the aftershocks of the financial crisis and we were hit by the oil price increase as well across the world. In terms of attributing a number to it, first of all the OBR's analysis of the deterioration in the growth forecasts since the budget is that the weakness in the eurozone is the principal cause, indeed more than accounts for the downgrade of the forecast. There is an interesting observation: if trade to the eurozone had grown as fast as trade to the non-eurozone over the last year, then that would have added 1% to our GDP. But I would stress that the impact of the eurozone crisis is not just on trade, it is also on confidence and it is also on financial intermediation. But there is an illustration of the impact. It is something of course that Britain and other countries have to work with.

Q270 Chair: You have been out there all night part observing and part protecting Britain's position in some difficult negotiations. Perhaps you can tell us first of all how you protected Britain's position and then tell us whether you think that they have solved this.

Mr Osborne: I would say it is a significant moment for the European Union, first because the eurozone took a step towards a banking union by creating a single supervisory mechanism. They did not create common deposit protection, they did not create a common resolution fund, which are the other components of a fully-fledged banking union, but that is not to underestimate the very significant step they took last night in creating common supervision. I think it was also significant last night because the UK—and indeed other countries that are not joining the banking union—secured significant protections. I would highlight two, although there are others I could describe. The first is we have now this recognition that the interests of the outs must be protected as well as the interests of the ins, and we are going to have a double simple-majority voting system when it comes both to writing some of the technical financial regulation in the European Banking Authority, but also to things like dispute resolution. So we have this new double majority: a majority of ins is required, as well as a majority of outs, and that is significant.

We also have now written into European law—assuming this all becomes European law—a very clear non-discrimination article, which I know this Committee has been concerned about in the past. It is only one sentence, if you would allow me to read it out, "No action, proposal or policy of the European Central Bank shall directly or indirectly discriminate against any member state or group of member states as a venue for the provision of banking or financial services in any currency". That is a very significant non-discrimination clause because we are currently in legal dispute with the European Central Bank about some of their location policy.

So I would say what we saw last night is perhaps a model of what is going to happen in the future, which is that a core of eurozone members and other fellow travellers among the outs are going to integrate further. Britain is not going to be a part of that. We are not going to transfer more rights and powers to Brussels. Our interests are going to be protected and the interests of all 27 members through the single market are also going to be protected, and I think it will come to be seen as quite a significant moment when you look at broader development of European policy as well.

Q271 Chair: I just want to take you back to an earlier part of that reply—which is extremely interesting and we are grateful for it—and what you have said about the core components of the banking union. This banking union, if it is to be called that at all, seems to be missing the key features of any banking union. One is that there is a common resolution to the source of funding, and to sort out resolution, that is at least theoretically bottomless, and secondly, that there is

common deposit protection. Without that, how can a banking union be called a banking union?
Mr Osborne: I think we should not take away from the achievement last night of creating a common supervision. That is a difficult thing to have put together, and the eurozone have put it together. But I agree with you that it is not a fully-fledged banking union. The reason why this debate grew up was because of the weakness in some eurozone banking systems and a concern that your deposits were not safe in particular banks because could the sovereign stand behind those deposits, or a country could not bail out a bank because it did not have the money to do so. The view was that you had to create common deposit protection and common resolution. Those two elements were not agreed last night and of course they are the subject of much controversy within the eurozone. My sense, my personal view, is they will move in that direction over the coming years, that an important precondition of moving in that direction was having common supervision, because that provides some reassurance to the taxpayers of Germany and the Netherlands and Finland and the like that their money is at least spent in a way that is properly supervised. But they did not take that step last night and I think that is going to be the debate for the next two years.

Q272 Chair: From the markets' perspective, this is a binary issue, isn't it? Either the markets believe there is that protection and there is that guarantee coming from the central authority of the banking union or they do not. It is one or the other. Why should the markets believe for one moment that a run on Spanish banks, were one to take place, would get bailed out by the ECB as a consequence of what happened last night?
Mr Osborne: I think the markets can take some confidence that earlier this year the eurozone indicated their willingness to consider using the European Stability Mechanism bailout fund to stand behind the Spanish sovereign and through the Spanish sovereign, the Spanish banks, but of course there is a fierce debate in the eurozone about direct recapitalisation of banks. I think an important hurdle has been passed, however, because countries like Germany said, "We won't even entertain this question while there is not some form of common supervision." We now have that common supervision coming into place. But if you are telling me, Mr Tyrie, that more needs to be done to reassure people that the single currency is a stable currency zone and that banking problems can be dealt with, I agree with you. Of course we can point out where things have gone wrong and we do, but when something has gone right, I think British politicians should also acknowledge that, and I think we should acknowledge that last night they got something right.

Q273 Chair: But it is the absence of clarity about these issues, and it is the absence of credibility lying behind any putative guarantee that is blighting the eurozone, isn't it? You began your remarks by saying that there is this blight; the loss of credibility and a lack of confidence in the eurozone is a massive impediment to the UK economy. Although you are being polite about it, by the sound of it, because you have just come back from the conference, you seem to be telling me we do not really have a banking union and although some of the tools required to start working one up look as if they might now be possible, we are a long way from it. A moment ago, you just said, "Some years hence we might get towards it."
Mr Osborne: I think it will be some years before you have fully-fledged deposit protection, which by the way some member states would today question is required. My personal view is it will be some years before we have common deposit protection and common resolution. There are directives in the area that are going to be legislated for next year and they are making progress. If you are telling me it is too slow and has been over the last couple of years, I think most eurozone members would agree with that, and I would certainly agree with it, but they are making some progress and I think we should acknowledge that. Personally I would say a lot of this is a symptom of the problems in the eurozone, not a cause. The cause is a fundamental disparity between the competitiveness of different economies in the eurozone and that is playing itself out in a single currency, where they cannot externally devalue.

Q274 Chair: Let us move on and touch on another subject that is very much alive at the moment, which is in the wake of your appointment, which we will hold a hearing on. As you know, we will be holding a pre-appointment hearing with Dr Carney on 7 February, and in the wake of your decision, your announcement in the House of Commons, a number of remarks have surfaced—some from him—that he is dissatisfied with the inflation target and is considering money GDP targeting. Have you discussed this with Dr Carney?
Mr Osborne: First of all, I think Mark Carney is going to make an excellent Governor of the Bank, and I very much welcome the opportunity he is going to have to talk to you about his views about the British economy and British monetary policy in February. I am not going to speak for him today. It is right that he comes and talks to you about that.
The second thing I would say is that it is not that these remarks that you refer to have "come to light". He gave a speech. I welcome the fact that we have in Mark Carney someone who is leading international debate and opinion and I think that is a good thing for a future Governor to be doing.
The third thing is we have an inflation targeting regime that has served this country well and has provided stability. There is a debate about the future of monetary policy, not in the UK exclusively, but in many, many countries. You saw yesterday the Federal Reserve take action on indicating the future path for monetary policy and linking it to the unemployment rate, so there is a lot of innovative stuff happening around the world. In the UK, we have the Funding for Lending scheme, which in itself has been very innovative, and other countries have looked at it closely. So there is a debate going on. I am glad that the future Central Bank Governor of the United Kingdom is part of that debate. Of course any

decisions about the framework are decisions for the Government, a Government-accountable department.

Q275 Chair: Are you dissatisfied with the inflation target?
Mr Osborne: I would say it has served us well. That is the point I make, and I think therefore if you were to move away from it, you would want to be satisfied, and Parliament would want to be satisfied, that you were getting some very significant rewards in return for moving away from that.

Q276 Chair: You didn't answer my question, by the way, about whether you had discussed this Dr Carney.
Mr Osborne: I had lots of discussions with Dr Carney over the last year, including interviewing him for this job, but I think it is right that those conversations are private and I think it is right that he first explains to your Committee his views on the British economy and the future of British economic policy.

Q277 Chair: What difference would it have made if we had money GDP targeting over the last couple of years?
Mr Osborne: I regard that as a hypothetical question and I do not think Chancellors should speculate about different monetary policy regimes. I would make a broader point, which is whatever regime you have, you have to ask the prior question, "What is it that you would want the Monetary Policy Committee to be doing that they are not currently able to do because of their regime?" before you would consider changing the regime. If you cannot answer that question, then I would not change the regime. So I think there is a prior question. What is it that you want them to do that you think the inflation targeting regime that we currently have prevents them from doing? But it is totally to be expected after everything that has happened to the international economy, and indeed to the British economy, over the last four or five years that there is a debate about the future of monetary policy. What I regard to be my job and to be accountable to Parliament for is to determine that framework. In the meantime, we can make sure that we have fiscal policy that is credible and enables the Bank of England to do what it needs to do. But I have no plans to change the framework. There is a debate going on.

Q278 Chair: I know you do not like hypothetical questions, but if you did seek to change the framework, would you try and obtain cross-party support for it?
Mr Osborne: I think it was a good feature of the inflation targeting regime, that my understanding is that the Labour Party at the time was supportive of that development, originally under Norman Lamont, and personally I think my party made a mistake in voting against the Bank of England independence. I think we were right to criticise the decision to take away banking supervision from the Bank of England. We were wrong to oppose the granting of interest-rate decisions to the Bank of England. I would like to get cross-party consensus for all the things I do. I am realistic that that is not always going to be the case, but obviously for significant changes to the monetary policy framework it would always be better to have cross-party support.

Q279 Chair: You would acknowledge it is a somewhat curious state of affairs that it has taken intervention by the Canadian Central Bank Governor, albeit one is about to come over here, to stimulate this debate.
Mr Osborne: First of all, I do not think it is particularly surprising that people are paying close attention to the speeches and expressed views of the person who is going to be the next Governor of the Bank of England. Second, I would say if you look at some of the academic debate, if you look at some of our leading newspapers, they have been carrying quite a lot of commentary and discussion about monetary policy. I think it is one of those areas, it has to be said, where it would be a good thing for academia to lead the debate and governments to follow, rather than the other way round. I think that is certainly what happened with inflation targeting.

Q280 Mr Newmark: It is curious, given the crisis that we have had in this country and the traditional thinking, which has been inflation targeting, that you yourself were very creative in thinking out of the box in choosing someone like Mark Carney, who himself—as you know—is an A-graded Governor of his bank, and you have reached out to somebody outside of this country to go to someone like Mark Carney. Mark Carney himself says or implies that perhaps after 20 years or so, we have exhausted the concept of inflation targeting and maybe we need to think a little bit out of the box. I am just sort of curious that you say—or you imply in what you say—that the Treasury itself has not been thinking a little bit more laterally, a little bit more creatively in coming up with solutions other than inflation targeting.
Mr Osborne: The first thing I would say is, I think there has been plenty of creative and innovative policy-making in this country in the monetary space in the last few years, that we have interest rates that are at a level few would have ever expected; we have the quantitative easing programme; we have the Funding for Lending scheme. So the Bank of England—and indeed the Treasury, both under myself and under my predecessor—have engaged in a lot of thinking and innovation in this space. I obviously do not give a running commentary on all the discussions that take place in the Treasury, but I am very clear in public and in private to say that if you want to change the regime, you have to make a pretty strong case for doing so. I think it is very good that there is a debate taking place in this country and around the world and I think it is good that we have the next Governor of the Bank taking part in that debate.

Q281 Mr Newmark: It is quite a radical form of thinking, to do GDP targeting versus inflation targeting. First, you must have an opinion on this, and secondly I am assuming, having read Mr Carney's speech, and your team having read Mr Carney's speech, this certainly must have excited some thinking and discussion. Do you think it is a good idea or not? You have not really answered that question.

Mr Osborne: As I say, I don't think it is sensible for the current Finance Minister of a country to kind of openly speculate about the macro framework. I think it is right that there is a debate. If we were to make a change, we would come and tell you about that and seek parliamentary opinion on that. But as I say, there is a debate taking place and I think it is one of those areas where, to repeat myself, academia should be taking the lead and governments, if they want to, should follow.

Q282 Mr Newmark: Okay. You have said that we have tremendously low borrowing costs, in fact the lowest borrowing costs in our history. On the balance between quantitative easing effectively and your plan A, what do you see has been the main driver in keeping our borrowing costs so low?

Mr Osborne: I think the principal driver of why our rates are low compared to some other countries—and it is partly a relative game—is because of the credibility of the UK fiscal policy, so obviously a stated aim of QE is to make money cheaper, but I would say that between QE operations undertaken by the Bank, we have also maintained very low rates, and it is worth remembering that if those rates were to rise relative to other countries, that would have a huge impact on the UK economy and the cost of mortgages and the cost of doing business and be very damaging indeed. It is one of the things that some of the countries that I was sitting around the table with last night are wrestling with at the moment. I would say the credible fiscal policy anchors those low interest rates and enables our monetary authorities to undertake innovative monetary operations like QE, and indeed Funding for Lending and the like.

Q283 Mr Newmark: You talk about credible fiscal policies and that is something that you yourself had pushed as one of the main drivers of keeping our interest rates low, but I think when you look at the US, for example, the US has continued to print money. They have continued to run a huge debt. Their debt ceiling has blown over $14 trillion and is heading to $20 or $22 trillion, and they are running what I would view certainly as unsustainable deficits. Yet their borrowing costs are also incredibly low. I keep getting this argument back from my friends in the States saying, "You guys have to lighten up a little bit and maybe a little bit more borrowing isn't such a bad thing."

Mr Osborne: There are two things I would say to that. First of all, the US has a reserve currency—we do not have a reserve currency—and that gives them more latitude than any other country in the world. It is not a hypothetical to imagine what happens to a middle-sized or large European economy when they lose confidence in the bond markets, because we have seen it happen on our doorstep. When I first started in this job, people stood up and said, "It is ridiculous to compare Britain to Greece" and then suddenly it was not just Greece, it was Ireland and Portugal, and then Spain had problems and even Italy had problems. So we can see what happens. There is a debate in the US about how to reduce the deficit. There is not a debate in the US about whether to have a big stimulus or a plan B. They have a debate about the mix between tax and spending. That is taking place in the Congress at the moment and we all want them to resolve that this month. But even if you look at US fiscal policy over the last year or more, it has been mildly contractionary and quite a lot of the state governments have also been dealing with their deficits or shrinking their spending to avoid deficit. So in the US as well, I think there is a recognition they need to deal with their deficit and debt problems, and I do not see any significant body of opinion in the United States, certainly none that carries any weight in the US Congress or the White House, that is arguing for some big additional discretionary borrowing or stimulus.

Q284 Mr Newmark: But they are going to go over 50% above target. They are going to hit $20 or $22 trillion, which is a huge debt figure. So just then to go back to your point, the last bit, a focus on keeping borrowing costs down, effectively what you are saying, in the absence of the policy that you are pursuing—for example, flipping to plan B, which is the Shadow Chancellor's view that we need to borrow a little more to really get the economy going, and I think David Blanchflower believes the same thing—that then would impact the low borrowing costs that we have here that would impact mortgages and corporations that are borrowing. That would be your concern, effectively, of pursuing perhaps a little bit more loosening on the debt side.

Mr Osborne: It would threaten the UK fiscal credibility. I think the public would realise this would simply be deferred tax increases or further spending cuts, so I think it would probably not have any boost on confidence. What I would say I have noted in the last six to 12 months is that I do not hear a significant argument from the Opposition that there should be lots more borrowing or a plan B. They have gone pretty quiet on that. There is an argument about the composition of the consolidation, which no doubt we will come on and have, but you don't hear much about five-point plans or plan Bs anymore from the Opposition.

Mr Newmark: Okay, thank you.

Q285 John Thurso: Chancellor, can I ask you a little bit about your supply side measures? The OBR have not included these in forward growth figures, which is quite consistent with the majority of forecasters. When do you think we might expect to see some of these measures bearing fruit going forward?

Mr Osborne: They are supply side measures. They are designed to improve the structural competitiveness of the British economy. I am not attempting a fiscal stimulus. I am deliberately saying that that is the wrong thing to do. I want to see more roads and schools and the like built because I think that is right for the medium- to long-term performance of the British economy and that is why we are switching current to capital spending.

In terms of its impact, I think an interesting measure at the moment is how the UK is climbing up the league tables of competitive places in the world to do business, so we have climbed back into the top ten of the World Economic Forum list and I think we are now at number eight. So we are becoming a more and more competitive economy. I think that is a combination of supply side reforms to welfare, education, the tax system, the capital investment in key bits of economic infrastructure and the like.

Q286 John Thurso: Would you say there is a set of principles underlying those reforms?
Mr Osborne: I think the principles are that we are doing everything we can to make the UK the most competitive place in the world to come and do business, to invest and to grow a domestic business, and we benchmark ourselves against other major Western economies. For example, with the corporation tax rate, I am very clear that what we want to do is have the lowest corporation tax rate in the G7; make this a place where if you are an investor in Texas or Shanghai you say, "Have you noticed what the UK is doing on its corporate tax rate?" and if you are a domestic business, you are getting a competitive advantage as well against those you are competing with in other countries. So what I am trying to do is assist the private sector and make sure that the people seeking employment in the future have the right skills and the right education to make the best of their lives and make the biggest contribution to the British economy.

Q287 John Thurso: Do you think we could have moved faster on those?
Mr Osborne: I think everyone doing my job would always like roads to be built more quickly and buildings to go up more quickly, but we are willing the means, so we are changing the planning rules so that, yes, of course people can still have their objections heard, but they are heard more quickly. The Prime Minister set our plans at the CBI to dramatically increase the speed at which a road can be built in this country, so that again objections can be heard, but there is no reason why the whole thing has to take years. So I am for accelerating the pace of some of these changes.

Q288 John Thurso: Rest assured that if the Government in Scotland decides to deal with the A9, it would be welcomed with no objections anywhere.
Can I turn to the automatic stabilisers? Can I ask, first of all, do you accept that the automatic stabilisers do dampen the economy during booms and provide the necessary stimulus in a downturn?
Mr Osborne: Yes.

Q289 John Thurso: Jonathan Portes said to us that cutting welfare benefits negates, as a matter of policy, the operation of the automatic stabilisers; it is a reduction in flexibility, not an increase. Do you accept that?
Mr Osborne: No, I do not accept his analysis, because the scorecard is neutral across the period of the spending review and period of welfare benefits being underrated. So we are not—to use the crude language—taking money out of the economy. There is a deliberate policy over the next few years to circulate money from current spending into capital spending and so we are not diminishing in that sense the automatic stabilisers.

Q290 John Thurso: So it would be your expectation that the automatic stabilisers will continue to function much as they have in the past?
Mr Osborne: Obviously one of the central judgments of this Autumn Statement was not to chase the debt target, in other words, to accept that we had missed the debt target, and had we chased the debt target, that would have required significant cuts or tax rises over the next couple of years. I think that would have cut across the automatic stabilisers, because the OBR was telling us, "This is a cyclical deterioration in the forecast" and I didn't want to chase that cyclical deterioration. So I guess one of the absolute central judgments of this Autumn Statement has been to let the automatic stabilisers operate.
John Thurso: Thank you.

Q291 Andrea Leadsom: Chancellor, I would like to talk to you a bit about bank forbearance. In evidence to the Treasury Select Committee, the Governor of the Bank of England was describing how good forbearance is where a bank feels, "Look, this company does have a long-run future. Let's not put it in a difficult position now," but bad forbearance, on the other hand, is where the banks do not insist on repayment, not because they care about the customer, but because they are worried about the implications for their own balance sheet". Is that what is happening now? There has been all this talk of zombie companies. Do you believe that bad forbearance is in fact becoming a feature of our economy?
Mr Osborne: I think there is no doubt that the recovery from a financial crisis, the likes of which we have not seen in this country in any of our lifetimes, is having all sorts of impacts out there in the economy. One of them, which is one of the things the OBR examines, is what happens on credit intermediation and whether it is preventing strong firms expanding because they get cannot get a loan, and also because of the very low interest rates allowing so-called zombie companies to continue. The only question I would raise is it is quite difficult sometimes to tell the difference between a zombie and a good company that is just having a difficult period because the economy is weaker than anyone hoped. I am absolutely clear that trying to clear up the credit intermediation channels and get the bank system functioning normally is probably the most important or certainly one of the most important tasks I face. But I do think this whole area is one that is worthy of greater consideration. I think we should all, including the Treasury, be doing more work on how the recovery from the financial crisis has taken longer than people had hoped and what is the impact on company and household balance sheets.

Q292 Andrea Leadsom: So do you believe personally in the concept of destruction, where you let companies go to the wall because then you get better capital allocation as a result of that, so you might

suffer short-term pain, but you get long-run better capital allocation?
Mr Osborne: I have always thought it was a rather unattractive phrase. One of the things that we should welcome over the last couple of years, difficult as this period has been, has been the relatively strong performance of the job market and the fact that yesterday we had another fall in unemployment, another increase in employment. So those who advocate the sort of short, sharp shock that would lead to a load of companies closing and a lot of people being put out of work are not people that I would myself agree with. I don't think that is what the British economy needs at the moment.

Q293 Andrea Leadsom: I think most people would agree with you that it is not attractive to think of putting people out of work for the sake of the long run, which is unproven. But bearing mind the situation we find ourselves in, where undoubtedly productivity is unusually low, notwithstanding the relative good performance of the employment market, do you think there is a case for the Government to do more to create a bad bank/good bank scenario? When we were taking evidence I think it was the banks themselves that were saying it would be very advantageous to clear up some of the bad debts on bank balance sheets and allow the good bank to proceed. That old thing of privatising the losses or nationalising the losses and allowing the taxpayer to bear the bad debts so that the banks can proceed to lend freely. Is there a case for doing more of that, do you think?
Mr Osborne: We have some bad banks on our balance sheet, and indeed, one of things in the Autumn Statement was that Bradford & Bingley and Northern Rock Asset Management came on to the balance sheet. Although there is a superficial—and I don't mean that in a pejorative way—attractiveness to the bad bank/good bank idea, that is not the route that was pursued in 2008–09 when RBS was part-nationalised, and it was not the route pursued when HBOS was taken over by Lloyds. So I think the question four or five years later is do you go back into these banks, which have done a lot to shrink their bad assets and are continuing to do so, disrupt everything and try and rip out of RBS the bad assets, try and value them—which would take a long time, and the experience that the previous Government had of valuing assets with the Asset Protection Facility was not a particularly happy one—in order to achieve some gain in the future that you might have created this bad bank and taken these bad assets off RBS' balance sheet, or indeed, the old HBOS assets. I think it is very, very disruptive and I am not sure the gains outweigh the disruption.

Q294 Andrea Leadsom: Only six financial institutions have yet taken advantage of Funding for Lending, and there is, because of the lower risk weighting associated with mortgage lending, a tendency for those to have been towards the mortgage sector. Are you happy with that balance and with that relatively slow start? Do you have some concerns about that?
Mr Osborne: I am happy to write to the Committee if I have this wrong, but my understanding is many, many more institutions than six—several dozen—have participated in the Funding for Lending scheme, and so it has had a very strong take-up. One of the encouraging things again from the OBR analysis is that it is having an impact on the real economy. It is adding to GDP, it is bringing down the bank funding costs and we have published in the *Green Book,* if you look at the unsecured bond spreads, the impact that the FLS announcement has had, so that was a joint scheme between the Treasury and the Bank of England, and I think it has been working well.

Q295 Mr McFadden: I apologise for missing the beginning of the session, Chancellor, I was at my son's Nativity play. He was a shepherd.
Can you tell us, what is the cumulative total of extra borrowing in your plans now compared to the plans you announced in the budget after the election?
Mr Osborne: First of all, I never made it to shepherd. I played the triangle in my school nativity play.
I don't have that number before me, but I can write to you with it.

Q296 Mr McFadden: Would the figure of £212 billion sound right?
Mr Osborne: I don't have the number in front of me, so I will happily write to you with the number.

Q297 Mr McFadden: If someone had said to you in the summer of 2010, "In two years, your plans will include over £200 billion more of borrowing than you are now saying," how would you have described a plan like that?
Mr Osborne: I always knew in 2010 that we were facing a very difficult situation domestically. What of course subsequently happened was the impact of the international situation. But if I had known in 2010 that we were going to put in place a plan that commanded the confidence of bond investors and that in a period over the next 24 months we were going to see countries like Spain and Italy really struggle but the UK maintaining those low interest rates, I would have thought, "We are doing the right thing."

Q298 Mr McFadden: Do you not think it throws into some relief the discussion of borrowing, given that the plans have moved to that extent? £200 billion is a lot of money.
Mr Osborne: I would note that the Institute for Fiscal Studies have analysed the alternative proposal, which was Alistair Darling's plan, and said that would add a further £200 billion to any borrowing that we had undertaken. So I think you have to take into account the fact that between 2010 and now, every country has seen its growth forecast downgraded; every country has seen borrowing forecasts downgraded, because every country has been affected by the same international environment. I think it is also fair to say that in the United Kingdom, we face this additional challenge of the recovery from a very, very deep and destructive banking crisis.

Q299 Mr McFadden: There may be many reasons, but my central point is you do not dispute that you are borrowing in the order of £200 billion more in these plans than you said would be the case after the election?
Mr Osborne: I said I would write to you.

Q300 Mr Mudie: Mr Bowler, why can he not answer? He is the Director of Budgets. He must know that figure. If he does not, I think you should look for another Director of Budgets.
James Bowler: I don't have the cumulative figure to hand.
Mr Mudie: But you should know it.
James Bowler: But the Budget 2010 figures will show borrowing throughout the period. The Autumn Statement 2012 will show them. I have the fact that we were forecasting debt at 70% this year in the Budget 2010, and we are now forecasting at 75% of GDP in the Autumn Statement. That is primarily because of a difference in the OBR's growth forecast.

Q301 Mr McFadden: Let me give you another one, Chancellor, and see if you can do better on this. Turning to your welfare measures in the Autumn Statement, and this 1% cap on the uprating of working age benefits, the Resolution Foundation believe that around 60% of the real-terms cut associated with this will fall on working households. Would you accept that figure?
Mr Osborne: First of all, I accept that working households in receipt of benefits—and indeed, I have said this in the House early this week—will be affected by the decision to uprate tax credits at 1%, and indeed, we took a decision last year to freeze the working tax credit, and the Labour Government for many years froze the family element of the tax credits. If you look at 2015–16 and you look at the £3.7 billion of welfare savings, £1.4 billion comes from the tax credits upraising and around 70% of tax credit recipients are in work. But of course you cannot look at that measure in isolation because it sits alongside a big increase in the personal allowance, which means that on average, working families are £125 better off. So when you make these decisions, you take them in the round. I was aware of course that the personal allowance would help working families, by definition.

Q302 Mr McFadden: I am interested in your justification for this. You said in your statement, "Fairness is about being fair to the person who leaves home every morning to go out to work and sees their neighbour still asleep and the blinds or curtains drawn," or whatever it is and so on. You also said, "Over the last five years, those on out-of-work benefits have seen their incomes rise twice as fast as those in work." Given that we now know that a large proportion of the cuts you have announced will fall on working households, is it not the case that these households are suffering from a double whammy of the stagnating wages—which the whole economy is suffering from—and the real-terms tax credit cuts. When you say they are better off, the same foundation, the Resolution Foundation, believes that those in the bottom decile who are earning, I think, £12,000 a year or so, will be losing £3 a week. So they don't accept that your personal allowances outweigh the welfare cuts.
Mr Osborne: The first thing I would say is that all working people, and indeed, out-of-work people, are suffering from the aftershocks of a very deep recession and banking crisis and the fact that we were running a double-digit deficit. We have had to take very difficult decisions on VAT and lots of other measures, including benefits, that are not decisions you would want to take in better times.
Mr McFadden: I am trying to probe the effect of these.
Mr Osborne: So you have to make choices about what you do. We have had to increases taxes, so I increased VAT, completely opposed by the Opposition. I have also taken the decision to take child benefit away from the top 10% of families; opposed by the Opposition. That is not something they wanted to see happen. Now I have taken the decision to underrate out-of-work benefits and tax credits, again to try and get the budget deficit down and reduce the structural deficit and make sure that we have a state that the country can afford and that is fair to the person who is working and paying their taxes for that. But you take these measures in the round, and to help that working person, I have also increased the personal allowance that means that they, I say, are on average are £125 better off.

Q303 Mr McFadden: Are you then disputing the Resolution Foundation's accusation that taking into account both the personal allowances and the other measures in the Autumn Statement such as the welfare measures, the effect is for the bottom decile they lose £152 a year for the second-bottom decile, £146 a year, and for the third £136 a year? In other words, for lower income groups, even after the effect of the personal allowance, and many of them in work, the effect of your proposals is to bear down heavily on those incomes.
Mr Osborne: I do not have the Resolution Foundation numbers in front of me, but I would ask the question of them, have they included the total increase in the personal allowance next April, which is obviously going up very significantly, the largest increase in our history; have they taken into account the impact of the Universal Credit, which is going to provide more generous support for the lowest-income working families? I suspect they have done neither of those things, so they have made a selective calculation, but I would point out that overall, if you take the Autumn Statement measures, working households are, on average, £125 better off and average households in every decile are better off next year. These are difficult decisions. I am not claiming that in better times you would want to underrate welfare benefits, but when faced with a still very large budget deficit, when, as I say, you are doing it alongside things like VAT rises I think it is a perfectly fair way to try and save money and to make sure we have a state that we can afford. For those who do not support this they have to explain why it is fair to taxpayers that out-of-work benefits for example have gone up by 20% and earnings have gone up by 10%, but more to the point they have to

explain what else they would do. If you do not do this then you would have to confront deep cuts in education and in the National Health Service. If someone wants to get up and argue that is the right thing to do, that is the better balance, fine, then I can engage in that argument, but it is quite difficult to engage in an argument with people who literally oppose every single measure to deal with the deficit, who even oppose taking Child Benefit away from the top 10% of families.

I am happy to have the debate with someone who is prepared to engage in the tough choices that anyone doing my job would have to take at a time like this.

Q304 Mr McFadden: I am trying to explore the effect of your decisions. The time when you can debate what other decisions might be will certainly come.

Mr Osborne: It is here now. I agree with you about that.

Mr McFadden: We had the Institute for Fiscal Studies give us evidence yesterday and we asked them for the cumulative effect of the measures announced in all your Budgets and Autumn Statements since the election on a one-earner family with two children. They said it was over £3,000 a year reduction in that family's income. Do you accept that figure?

Mr Osborne: I certainly accept that the consolidation has borne on every quintile of society. I certainly accept that the whole population has had to contribute to dealing with the deficit. I did not see their evidence to you, but the IFS presentation last week was very striking. Chart after chart after chart showed that the richest were paying the most, not just in cash terms but as a proportion of their income. I thought the IFS nailed the argument that somehow the better off have got away with it, because the better off were paying more—more as a percentage of their income, more in cash as well. Those charts from the IFS I thought were pretty compelling.

Chair: I think we will leave it there.

Q305 Mark Garnier: Can I go back to Government debt? In response to Mr McFadden's question to you, I think we broadly speaking have accepted that we had run up debt in the region of around £200 billion, which is more than we were expecting, but can you just let us know how much we have increased Government debt since 2010, since you became Chancellor?

Mr Osborne: The cumulative increase?

Mark Garnier: Yes, absolutely.

Mr Osborne: It has gone from 69.8% to 74.7%.

Mark Garnier: But in cash terms, do you know?

Mr Osborne: I will give you the exact cash number.

Q306 Mark Garnier: The point I am trying to make is how much would it be if you had not done anything at all?

Mr Osborne: If we were continuing to run on an 11% budget deficit it would obviously be significantly higher, and I am happy to give you those numbers as well. It has also been the case that we have saved £32 billion, which is about the size of the Defence budget, on lower interest payments than were forecast in 2010. So that is also a significant saving for the British state and one of the things that we have to wrestle with is that one of our largest items of Government spending now is debt interest.

Q307 Mark Garnier: Which is pretty horrific. Can I ask a similar question about unemployment as well, because I believe unemployment in the public sector has gone up by somewhere in the region of 270,000 job losses but in the private sector employment has gone up by 1.2 million? Again, if you had done nothing in 2010 since gaining power, have you any idea what the employment figures would have been relative to each other?

Mr Osborne: I am not sure I can answer the counter-factual. I think job creation in the private sector has been aided by confidence that there is a stable fiscal policy and a stable macro policy underpinning the British economy and that has been very supportive.

Frankly, I think anyone who had been in Government during this period would have seen the numbers of people working in the public sector fall, because the wage bill was unaffordably high, but in general wage restraint both in the public sector and the private sector has helped keep the job losses in the public sector lower than they otherwise would have been. In the private sector it has enabled companies to be able to go out and hire more than we were forecasting. We have talked a lot about forecasts being worse than we have previously produced. The unemployment forecasts are of course significantly better in many respects and this year we have considerably exceeded the OBR forecasts for the fall in unemployment and the rise in employment, and of course yesterday we had very welcome news of a big fall in unemployment, a big rise in employment and a record fall in youth unemployment.

Q308 Mark Garnier: To what extent do you think it is your policies? And the other question, to what extent were you surprised by the fact that we have record employment and that we are as a country employing four people in the private sector to every one person who works in the public sector?

Mr Osborne: I am not surprised by the fact that if you can make your economy more competitive then businesses will become more competitive and be able to employ more people. There is no doubt that the OBR who do the forecasts have been surprised by the employment and unemployment forecasts and they provide an explanation of why that might be the case and there is this so-called puzzle of the unemployment numbers and the GDP numbers. I would just say that out there of course firms have had a difficult time but many firms remain in good shape. They are hiring people and keeping people on, and I think that is very welcome. It comes back to the discussion we were having earlier and I think firms are well-poised to take advantage of any global recovery.

Q309 Mark Garnier: In your statement you said that the OBR projects that the share of national income spent by the state will fall from almost 48% of GDP in 2009–10 to 39.5% by 2017–18. Is that coincidental

or is that your long-term intention, to try and get public expenditure below 40% of GDP?
Mr Osborne: I have never myself thought it was wise to have a GDP target for a percentage of national income spent by the state. There are plenty of people in politics who think there should be, so I do not mean any disrespect to them. I just think that it is better to think about the state you want and the state you are prepared to pay for, but you cannot help noticing that 39.5% or thereabouts has been the long-run average for the British state in recent decades. It was only when we started to diverge from that in the middle part of the last decade that some of the serious problems in our public finances emerged. As the IMF recently analysed, we went into the financial crisis with the largest structural deficit in the world, and that is a significant burden to carry into a crisis, let alone out of one.

Q310 Mark Garnier: Would it be your intention, going beyond 2017–18, should you continue to be the Chancellor of the Exchequer all those years out, to continue with having the state costing less than 40% of GDP? Again I appreciate your earlier point.
Mr Osborne: That is not the way around I would look at it. It is clearly the case that when we were spending close to 50% of national income, which is what we were doing when I came to office, that is totally unsustainable, and 40% or just shy of 40% is the long-run average. Broadly speaking, Governments have got themselves into trouble when they spend considerably less than that and they have got themselves into trouble when they spend considerably more than that. I would basically take the view that you should work out what you want and then see if you can afford that, and build it from the bottom up, rather than the top down, in that sense.

Q311 Mark Garnier: One final question, if I may, Chairman, on a small technicality of your statement. You chose not to cut spending further in order to meet your supplementary target. Does this suggest meeting the supplementary target was not as important as you originally claimed?
Mr Osborne: Of course I very much wanted to hit the target but then faced with a choice of taking £17 billion of cuts in a single year in order to hit the target and give myself the satisfaction of saying, “I have hit the target” compared to the impact that would have on the economy and the unnecessary pursuit of a static target because of a cyclical situation, faced with that choice I chose not to hit the target, aware that people would focus on that. Broadly speaking the reaction has been a very positive one and the debt target was put in place in 2010 alongside the fiscal mandate. The mandate is being met. The mandate is the cyclical target. The debt target was put in place to assure people that we were determined to deal with our deficit, which was something that I had to prove early on in the Government. We were a hung Parliament for the first time in our modern history. We had to prove that a Coalition Government could take difficult decisions. I think it helped, but then faced with this choice-—hit the target and potentially damage the economy in doing so, or miss the target and help the economy—I decided to help the economy.

Q312 Mr Mudie: Can I just give you some debt figures from your Budget book, as you and your Budget Director don’t seem to have them to hand? Public sector net debt 2010–11 £905 billion, following year £1.39 trillion, the following year £1.159 trillion and 2013–14 £1.272 trillion. Did you get that, Mr Bowler?
James Bowler: Thank you very much.
Mr Mudie: Then if I just give you some figures from Martin Wolf, an impeccable source—Mr McFadden is quite right. The latest forecast increased to £539 billion away from the original estimate of £322 billion, which Martin Wolf makes £217 billion extra borrowing, as he and other commentators say, with no sign of movement to our objectives after two years. I am sure you knew those figures. Can I just ask you—
Mr Osborne: Can I just say that I don’t accept there has been no sign of—
Mr Mudie: Are you asking the questions now?
Mr Osborne: I don’t accept there has been so sign of movement. The deficit has come down by 25%, we have cut the structural deficit more than any G7 country, and we have very low borrowing rates. So I would argue that that is significant progress.

Q313 Mr Mudie: The point is that after two and a half years we still have another five years to get to the target we should get to three years from now, not five years. Austerity has been extended at a cost of £270 billion.
Just on debt and just technically, and gently, you have accepted this afternoon you have missed a target, so the second part of the fiscal mandate is lost. You said it this afternoon.
Mr Osborne: The target—
Mr Mudie: Don’t backtrack.
Mr Osborne: No, I am not backtracking. We have missed the target, and I was very open about that in the speech and today.

Q314 Mr Mudie: Okay. This is all about the credibility of your targets and yourself as Chancellor. The basis for a fiscal mandate is, this is how you are going to be judged. The mistake you made, it seems, with debt, is you did not make it a roll forward, a five-year roll forward, and so you have to admit now that you are going to miss the target in the year 2015–16. So you are missing that, but you also are going to miss the deficit target, but because of a roll forward you are able to say, “Well, I still have my—” but how do you, genuinely, think that gives you credibility? You came to the country in 2010, you said the deficit had to be dealt with quickly, you would deal with it in five years—and I even have from the *Daily Telegraph*, front page, 6 December, your figures—and where are you now?
Mr Osborne: What does the headline say?
Mr Mudie: You don’t want to pay any attention to that, George. Let me ask the questions. You said it has to be done in five years. It has not been done in five years, because in five years you are well behind, and that is going on. That is the same as the debt. The

deficit is the same as the debt. Why do we accept the debt target we missed and the fiscal mandate is lost on that part and we are missing it on the other, but we amazingly say, "Oh well, five years from now"? If you borrowed money from a bank, £10,000 payable over five years, and two years in you said to the bank, "I'm not going to pay you off in three years' time, because we agreed five years, so it is five years from now," how long do you think you would stay in the bank manager's office?

Mr Osborne: A bank in that situation would take a look at the business that said, "It's going to take us longer," and say, "This is a sound business with good prospects and a good future, and we will go on lending it money." That is not a hypothetical situation for the UK economy, because every single week we are out there borrowing money to fund our public services and if for a moment the international community, the bank in your metaphor, decided, "You know what? The UK is not a going concern," we would pretty quickly find out about it. So there are plenty of banks that are accepting that companies are taking longer to pay off their debts. As I said in my statement it is taking longer, but when you look at the progress that we are making, the reduction in the deficit, the increase in jobs in our economy, the fact we are becoming more competitive, the fact that we are rebalancing our economy so that we are starting to export as we should have done many years ago to the big new markets in China, India, Indonesia and Brazil, the fact we are doing all those things—is it difficult? Yes, it is, but is it also absolutely necessary? Yes, it is, as well.

Q315 Mr Mudie: Those sound good soundbites, but out there the pain is growing, and that is the point. We were discussing automatic stabilisers. Your response to Mr Thurso and Mr McFadden on automatic stabilisers was, "Well, it was this business of the 1% on benefits. We are taking that 1% and we are transferring it over to capital spending." Well, the whole point, the cry for capital spending as a stimulus, is additional spending. Instead, you are doing the right thing maybe in too small a matter by putting £5 billion into construction and infrastructure, but you are taking it from people who need to spend it, want to spend it, and now cannot spend it. The two things balance themselves out.

Mr Osborne: I would say many western economies face a similar challenge and many western economies are advised to try and switch spending from current spending to capital spending, to try and invest in the economic infrastructure of the country. That is what we have sought to do and we are investing more as a percentage of our national income in this Parliament than we did over the average of the whole Labour period before us. We are doing that in a way that remains fiscally credible because we are not, as I say, undertaking a discretionary stimulus.

The other advantage of capital spending is that it is temporary, it is a one-off, it can be turned off, and current spending is more difficult, as we have all seen.

Q316 Mr Mudie: I have another matter to raise with you. Martin Wolf for example would ask you to consider temporary fiscal expansion on a major scale which was clearly accepted by the market to deal with problems, get people into work, get the economy stimulated, and that is what Mr McFadden was speaking about. You have spent and are spending £270 billion of additional borrowing not to put people into work, just because you are trying austerity rather than growth. That is our argument.

Mr Osborne: I don't accept that.

Mr Mudie: I thought you wanted an economic argument away from the five points?

Mr Osborne: I am happy to have the economic argument. I would say that by not chasing the debt target we have allowed the automatic stabilisers to operate and that is a sensible economic decision, in my view. That supports the economy in that sense, during a cyclical downturn. One of the things that we are doing is getting the structural deficit down. We are getting the underlying deficit that does not go away when the economy recovers.

Q317 Mr Mudie: All right. Can I just raise a more positive matter with you? You have announced in the budget the Business Bank starting from the spring. One immediate thing I would raise because we are in the Autumn Statement format is that I am disappointed it is only £50 billion in the first year in the Budget, because if it is going to help small businesses who are crying out for money £50 billion will go nowhere. That is the first thing that you might mull over.

The second thing is more important. I am interested if the Cabinet have had any real discussion about this, because the Business Secretary announced it a couple of days ago, and it appears to be that it is a bank where you borrow through the internet and you are put on to peer-to-peer lenders. In all the discussions we have had on the banking industry and retail banking we have all wanted face-to-face banking back for small and medium-sized businesses so that the bank manager knows his customers through bad and good. He knows them because he has met them, he knows the area, and so on. That is something the banks have moved away from.

If we are going to introduce a bank just for that, is there not an argument for, have you not discussed, and will you consider discussing, taking some of the RBS's divestment—not a great number, 300 or so, so a very small number—and starting regional business banks, with a few local ones where the region is too big, so that we can start having small businesses being able to go in and speak to a banker with access to resources? I don't even mind suggesting that, at the end of the day, as soon as it is sensible financially, you float them off. I don't want to see us as politicians running a bank. Is there any sense in that, and is there any suggestion that it might be considered?

Chair: If you can do a somewhat shorter reply than the question, we would all be grateful.

Mr Mudie: Just say yes.

Mr Osborne: I will say yes in this respect, which is that I think you are right that one of the things that went wrong was the loss of face-to-face banking, for small businesses and indeed also for individuals. To be fair to the banks, they are trying to recreate that.

When it comes to the Business Bank, we are not proposing to create a rival on the High Street to the other banks. Frankly, I do not think we would be allowed to anyway under state aid law and so on. What we are trying to do is reach those companies who the banking system is not supporting at the moment, to underpin lending to small and medium-sized businesses and to help, for example, restart the securitisation market. So we are putting £1 billion of public money into that. We are also bringing together the existing schemes, which can be a bit of an alphabet soup for businesses, and we are trying to help the non-bank channels of lending. Indeed, it sits alongside something called the Business Finance Partnership which we have also undertaken in this area. So it is a credit intervention, it is designed to help those small and medium sized businesses. It won't have a branch on every High Street in the way that you describe.

Mr Mudie: I did not ask for that.

Mr Osborne: I think it will help and support lending to small and medium-sized businesses. The trickiest area of economic policymaking in the aftermath of the financial crisis has been trying to return the banking system to health and get credit channels cleared and get lending going again. That has undoubtedly been the most difficult thing that both myself and my predecessor have confronted. I think we are making progress. I have talked about the Funding for Lending scheme but we still have further to go.

Q318 Chair: As you know, the Banking Commission is looking at these issues at the moment and half of its membership is around the table, the Commons half, at the moment. What is very quickly apparent is that of course even if the Business Bank is successful on its own terms and it is really an investment bank anyway, as you have obliquely pointed out, it is only going to make a very small contribution compared to what is required to sort this out. You would agree with that, would you not?

Mr Osborne: It sits alongside. I don't think it can be taken in isolation. The Funding for Lending scheme is an £80 billion scheme, but I think if we did not have the Business Bank or some intervention like it there are medium-sized businesses that would fall through the net. Looking for the big bang solution, I don't think it exists. It is a series of interventions, to clean up the banks that we have the shareholdings in and to return as quickly as possible some of those banks to the private sector, as we have done with the good part of Northern Rock, and to have these interventions through the non-bank channels for small and medium-sized businesses.

Q319 Chair: Just to be clear, under the definition which you have just said does not exist, the big bang solution, you would class, for example, the big bang of breaking up the existing part of your wholly-owned state banks as a big bang solution, would you not? I just wanted to be clear as to whether they are in any way on the agenda?

Mr Osborne: I don't think even if you broke up RBS I would describe that as the only solution.

Q320 Chair: Is that a big bang solution?

Mr Osborne: I think the problem with breaking up RBS that you have to confront, first of all RBS has shrunk, dramatically, its weak assets. Secondly, it is now shrinking its investment bank and making sure it is a less risky proposition. So the question you then have is, okay, do you want to break it up still further into several component parts? That would be a very complex operation. As you have seen with the sale of RBS branches, which Santander are not buying, it is not as if there is an enormous market out there for people who want to buy bank branches at the moment. So I would just say there are lots of problems with it. Although it sounds like a good idea, in the sense of, "Let's just break up the banks" when it comes to the practicalities of delivering it I think it makes you think twice.

Q321 Chair: So it is not on your agenda?

Mr Osborne: At the moment what we want and what the RBS management are seeking to do is to turn themselves from a universal bank with a very large investment bank into something much closer to a UK corporate bank that is supporting homeowners and businesses in the United Kingdom, and they are on track to doing that.

Chair: I could not spot whether that was yes or no.

Mr Osborne: I am glad.

Chair: Do you want to have another go?

Mr Osborne: I think if we had thought that breaking up RBS was a practical proposition then we would have done it. We have not done it.

Chair: Okay.

Q322 Mr Love: Chancellor, how significant would it be for the United Kingdom if it was to lose its AAA credit rating?

Mr Osborne: It would not be a good thing, but the majority of the rating agencies have us on negative outlook. You have seen what has happened to countries like the United States and France who have lost their AAA credit rating. We have the AAA rating. I would say it is one test, alongside others, and I guess the ultimate test is what you can borrow money at.

Q323 Mr Love: There is some contrast between what you have just said about the AAA rating and what you were saying all the way through since the 2010 General Election, when this was, if I may put it, something of a virility symbol. This was a reflection of the confidence that the markets had in your economic strategy. What has changed?

Mr Osborne: As I say the UK still has its AAA rating. Other countries have had theirs downgraded. I think the question in the General Election and the question two and a half years ago was is an incoming Government going to put in place a credible fiscal policy, because at the moment the country does not have one. That was the question being asked in early 2010. I think we have that policy. That is demonstrated by the fact that the bond spreads for the UK and Spain were the same on the day that I came into office and they are very different today. So you can see what has happened to other countries and there is a real benefit in the debt interest bill, the fact that we are spending £32 billion less than we thought we were going to on debt interest.

Q324 Mr Love: Is it a credible economic strategy that the economy will shrink this year? Is the market looking at that?
Mr Osborne: I have just been to a meeting of European Finance Ministers. There was not a single Finance Minister there who is not facing a weaker economic situation than they had hoped. Many economies in Europe are contracting and some are contracting a great deal more than the United Kingdom is forecast to contract this year. Of course it is disappointing the economy is forecast to contract by minus 0.1% this year but contrast that with a recession where the economy contracted by 6% in 2008–09. That is what we are recovering from. That is the damage that was done to the British economy. As I say, of course you can point out, as you are, that the GDP numbers are not what we hoped they would be, but you can't accept one part of the forecast and not at the same time accept the analysis that goes behind it. The OBR, totally independent of me, has said that the deterioration in the UK's GDP forecast is more than accounted for by the deterioration in the eurozone and the impact on net trade to the eurozone. I am the first person who wishes that were not the case, but that is the independent analysis we get.

Q325 Mr Love: As Mr McFadden and Mr Mudie mentioned earlier, is the deterioration and the borrowing requirement not of a scale of economic failure that it is bound to be taken up by the credit reference agencies and the markets?
Mr Osborne: As I say, the test we have is one we have to meet every week when we go and try to sell our gilts.

Q326 Mr Love: You mentioned earlier on you missed your debt target. Is that something that the markets would be concerned about?
Mr Osborne: The markets obviously were aware of that and paid attention to what I said. Indeed, some were anticipating it in advance. But you didn't see a reaction in the markets to that because they saw that by spelling out further measures that we were taking, including the difficult measures like welfare uprating, we were maintaining our determination to deal with our debts, that we had extended the consolidation. So in the end the question is one of credibility out there in the international investing community, which is tested, as I say, on a weekly basis in our gilt auctions.

Q327 Mr Love: Do you expect the coming downgrade to make it more expensive for the Government to borrow? There is contradictory evidence from others who have been downgraded.
Mr Osborne: I am not going to speculate about future decisions of credit rating agencies. I am going to tell you about what is currently happening out there in the investor community. I see in the current environment, with a lot of problems elsewhere in the European continent, that the UK has been something of a safe haven. We have had money flowing into the UK from some of these economies rather than flowing out of our economy as some of our neighbours have experienced.

Q328 Mr Love: As you know, we have various groups of experts come in and speak to us and they all had an opinion in relation to the economic consequences of a downgrade. They did not have a political opinion. Can I ask your opinion? Do you think it will affect the credibility of the Government and its economic strategy if there is a downgrade?
Mr Osborne: I am not going to speculate. What I am saying is my job is to maintain the credibility of the UK's ability to go out there and borrow as cheaply as possible in international debt markets. We are currently borrowing at the lowest rate at which anyone doing my job before me has ever borrowed money. That saves us real cash for the people we all represent in this Parliament because we are not having to pay so much debt interest, both to our domestic creditors and our overseas creditors.

Q329 Mr Love: Can I come on to questions that Mr McFadden asked and try to tie you down just a little bit? This is in relation to the 1% cut over the next three years. In their evidence to us yesterday the IFS said that it was certainly a majority of those affected would be in work. As Mr McFadden said, the Resolution Foundation, who have done a great deal of work in this area, said that it would be at least 60%. Do you accept those figures? You didn't earlier on. I am trying to clarify.
Mr Osborne: I have accepted today, as I have accepted in the past—in fact, it is not a question of accepting. I am very conscious that, of course, tax credits go to working people as well as to out-of-work people—indeed, one of them is called the Working Tax Credit—but in dealing with this debt we have to make decisions that affect all groups of society. We have done it in a way that supports those in work because we have also taken decisions to increase the personal allowance. You can't separate the two because they were decisions taken together. In everything we have done we have made sure that those who have had the biggest impact on their incomes have been those who are among the richest in our society. I think that was very clearly demonstrated in the IFS presentation.

Q330 Mr Love: The reason I want to press you on this is that the justifications you gave in your Autumn Statement were that benefits had gone up twice as fast as wages over the last five years; that we were restraining wages in the public sector to 1% therefore it was appropriate, all of which tends to the view that who you were trying to focus this cap on was those not in work, yet the evidence seems to suggest that the majority are in work. Don't you find that somewhat contradictory?
Mr Osborne: What I was seeking to do, and I explained it very clearly, was take a series of difficult decisions that were fairly distributed across the income distribution and that affected the rich most in order to go on dealing with our deficit and reduce the structural costs of the British state. That is what I set out to do. I also set out to support, where I could,

people in work by increasing the personal allowance, by freezing fuel duty and freezing the council tax. So I have done a series of things to help working people. You have to take those in the round. But if you are really saying to me that you could deal with a 11.5% budget deficit without touching the welfare bill, which costs £200 billion, or without touching tax credits, the cost of which have doubled in the previous decade to £30 billion, and you can do all this when even decisions to take child benefit away from the richest 10% are opposed by the opposition, then I don't think you have a credible fiscal plan. By all means come up with some alternative, explain why the defence budget should be cut more or education should be cut or the NHS should be cut or child benefit should be taken away from other groups of people, but you can't just say, "I oppose this, I oppose that, I oppose this," and have no alternative. The real choice I am facing is one of what do you do to deal with a very large budget deficit, a structural deficit as well, one that doesn't go away when the economy recovers.

Q331 Mr Love: It is your choices that we are investigating here, because this is a Treasury Select Committee meeting looking at the Autumn Statement not a debate on what the alternative economic policies should be. Undoubtedly that debate has to take place, and I accept that.

Let me ask one final question. In your replies to Mr McFadden you seemed to be giving the impression that quite a lot of families would be better off with a totality of those measures taken or encapsulated in the Autumn Statement. The IFS have done a great deal of work on this and they have looked at the totality of the Autumn Statement, not taking into account the budget before, not taking into account some of the changes that will occur related to the Universal Credit, and they said that for the average family with one child with one person in work they would be losing £534 a year by 2015. Do you dispute that figure? You mentioned earlier you had read the IFS submission. That was core to them giving an idea of what the impact of the Autumn Statement would be. Do you accept that?

Mr Osborne: I think it is a selective thing. It does not include the total increase in the personal allowance next April nor, as I understand it, does it include the impact of Universal Credit. What it does is it takes Universal Credit as the baseline and then takes off the baseline individual decisions we have taken on Universal Credit, for example to uprate some of the disregards by 1% as well, without taking into account the stock of the impact of Universal Credit on lower income working families.

Q332 Mr Love: Let me just press you finally. They explained to this Committee that they did not take into account any aspects of Universal Credit other than those that related to this Autumn Statement.

Mr Osborne: That is why I think it is selective, Mr Love.

Mr Love: Except that they are giving a picture of what the impact of this Autumn Statement will be, just the Autumn Statement and nothing else. Do you accept, looking at just the Autumn Statement, that what the IFS have said about £534 is an accurate view?

Mr Osborne: The average working family is £125 better off because of the measures in the Autumn Statement. I think it is very selective to take the policy decisions that affect Universal Credit without looking at Universal Credit itself, which hasn't even come into effect.

Q333 Mr Love: We are looking at the Autumn Statement not what happened in the Budget, not what will happen with Universal Credit.

Mr Osborne: If you look at the Autumn Statement, average working families are £125 better off.

Mr Love: They would disagree with that.

Q334 John Mann: Thank you for listening, Chancellor. In your Budget I only raised four issues with you. They were petrol duty, caravan tax, pasty tax and drawdown pensions. I wanted to thank you for responding on all four over the last six months and listening to what I had to say.

Mr Osborne: I am here to serve you, Mr Mann, and maybe the Shadow Chancellor will listen to your advice as well.

Q335 John Mann: I thought we might try to build a bit of consensus here. The Chief Economist of the Bank of England last night said something I agree with. I just wanted to check that you concurred as well. He said that, "The harsh but inescapable reality is that households and families are worse off, much worse off." Would you agree that that is the situation?

Mr Osborne: I think it is an inescapable reality that families are worse off because of the financial crisis, the recession and the efforts that the entire country has to make to deal with the consequences of that.

Q336 John Mann: He was referring to the last two years, reading his speech. Would you agree that with your policies households and families are worse off, much worse off?

Mr Osborne: I publish, in a separate distribution that we as the Government do and no previous Government has done, the cumulative impact of the consolidation on the population. There is no doubt that it involves tough decisions and people have seen VAT go up and they have had to see, for example, benefits underrated, but there is no other way to reduce a structural deficit. If you have significant tax rises that you would propose as alternatives or significant spending cuts you would propose as alternatives then I am all ears. But, as I say, of course dealing with an 11.5% budget deficit, which is what I have inherited, requires all groups of the population to make a contribution.

Q337 John Mann: You are in listening mode so I will make sure you get some more of my proposals. Now is not the time to do that, but I am trying to build this consensus on where we are at. I noted in your first Budget that you very helpfully asked the OBR to project what would happen under your predecessor's budget, and there are some interesting divergences from what the OBR has come out with this week. The

most interesting is on debt where the OBR said that under the previous Government's plans—and you in fact used the words—without further action to tackle the deficit the following would happen, that the debt to GDP ratio would rise by 2014–15 to 74.4%. But it has now gone up to 79%, has it not, so a 5% increase under your watch?
Mr Osborne: It is certainly the case that the economy has been impacted by the weak eurozone and that has led to a deterioration of growth forecasts. We have also had the oil price shock. The OBR do not model alternative economic policies but the IFS do. The IFS have looked at what would have happened to borrowing if we had stuck with what is known as the Darling plan. They assume that we would still have had a eurozone crisis, they assume we would still have had an oil price shock, that even my very talented predecessor would not have been able to stop those things. If you take into account those things and then factor in the consolidation that was put in place by my predecessor it would have added £200 billion extra on top of the numbers you read out. They did this analysis after the Budget, but I am sure they have done that this time.

Q338 John Mann: Chancellor, we don't want to break our consensus, because you and I also agree that your setting up of the OBR was in fact a good move. So let us not use third party; let us use the OBR. On the structural deficit, the OBR said that under your predecessor's plans it would be 2.8% of GDP, going to 2014–2015, but now they are saying under your plans, with the changes you have made, that that has increased to 3.7%. Again, under your plans the structural deficit projections have worsened from what they were going to be.
Mr Osborne: The OBR have not changed their view on the fiscal multiplier, so they have not changed their view on the forecast impact of the consolidation on economic growth. The most significant change was in last year's audit statement. They have changed their view on the impact of the financial crisis on the structural performance of the British economy. They made a change in their analysis; it was last year, not this year. This year, they think there has been a largely cyclical deterioration, brought about, as they say, and more than accounted for, by the problems in the eurozone.

Q339 John Mann: You did say then that the structural current deficit would be eliminated by 2014–2015, but that has now been pushed off. In fact, we do not have a projected year when that is going to be eliminated yet. Your years run out before that.
Mr Osborne: No. The fiscal mandate is to get to a place where we have a current cyclical budget in balance.

Q340 John Mann: But the OBR is saying that that is not happening. I am just trying to create a consensus. A good quantification, how much has the structural debt increased under your watch?
Mr Osborne: The structural deficit has fallen by 3% which is faster than any other G7 economy. In the spirit of consensus, Mr Mann, you cannot pretend that over the last two years, the European continent, the western world and indeed the rest of the world has not been impacted by some very significant shocks, including the eurozone crisis, which is what I was at a meeting about last night. These things have happened to the British economy. The question is, was the British economy better placed to deal with it because of the credibility of the fiscal plans we put in place, the structural reforms we are delivering. My answer to that would of course be yes.

Q341 John Mann: I know, but the OBR has these projections on the previous plans, so we can compare with your plans.
Mr Osborne: But they don't take those plans and then model those plans for what would have happened to those plans if you had had the impact on the eurozone, the fall in net trade and the like. You are comparing the world as everyone thought it might be in 2010 to the world as we know it to be in 2012, and the very significant external impacts and, to be fair to the OBR, you also have to take into account the assessment they made last year of the impact of the financial crisis.

Q342 John Mann: I am sure you would have been just as generous if the OBR had been projecting in 2008 and 2009.
Mr Osborne: I have not gone around trumpeting the fact that the unemployment numbers—I have mentioned it once here—I have not made it a central piece of my claims that we have done much better on employment than the OBR forecast. The OBR forecasts were wrong in that respect. I try and take a measured approach to all these things.

Q343 John Mann: But these are the current forecasts. You don't disagree with current OBR forecasts?
Mr Osborne: I have accepted the OBR forecasts.

Q344 John Mann: So we know what their projections are. Just to be clear, you are saying that there has been, under your definition of structural deficit, no increase in the structural deficit under your years as Chancellor? That is what you are saying.
Mr Osborne: The structural deficit has fallen. The overall deficit has fallen by 25%.
John Mann: So there has been no increase?
Mr Osborne: The structural deficit has fallen by 3%.
John Mann: You are saying that it has fallen?
Mr Osborne: Yes.

Q345 John Mann: I think we are perhaps going to need to look, at a further stage, at your definition of structural deficit and what that means. You are not saying, are you, that the debt to GDP ratio has improved under your watch?
Mr Osborne: No, the debt to GDP ratio has gone up, but that is because the deficit is the amount you add to the debt every year, and if you are borrowing 11%, you are adding a lot to your debt. If you are borrowing 8% of your national income, you are borrowing a bit less, so you are adding to the debt a bit less. The way to get the debt to GDP ratio falling is to get your deficit down.

Q346 John Mann: And to give *The Financial Times*' deficit, that is the term that should be used to calculate the ability to pay off the structural deficit.

Let me finish with one other question. You are the first Chancellor since Neville Chamberlain to see food banks set up across the country, so I wondered what your festive message is to those who will be forced to queue up at food banks this Christmas?

Mr Osborne: I would say to the entire country that this is a difficult economic situation, but we are dealing with our problems, we are making progress. The deficit is down. As we saw yesterday, unemployment has fallen, jobs are being created. It is, as I said, a hard road, but it leads to a better future.

Q347 Mr Ruffley: Chancellor, the cyclically adjusted current budget needs to balance by 2017–2018. How much do you have to take out of the DWP budget between now and then to achieve that objective, in cash terms?

Mr Osborne: We have cut welfare bills by £18 billion a year, and then in the Autumn Statement we are doing about £3.5 billion a year on top of that.

Q348 Mr Ruffley: In relation to those numbers, how many have been announced or pre-announced in the Autumn Statement, on DWP?

Mr Osborne: The major set of measures were taken in 2010–2011. For example, moving the uprating of benefits from RPI to CPI, and some of the reforms we have made to some of the benefits. But further steps were taken in this Autumn Statement, including the underrating of benefits below CPI for the benefits we have been talking about today.

Q349 Mr Ruffley: Do you anticipate having to take any more steps, further policy changes, in other words, to the welfare system?

Mr Osborne: As a result of the Autumn Statement, we have a spending envelope for 2015–2016, which is the last year of this Parliament, and we have said that we now look to divvy that up between the departments, and we need a spending round to do that, and we are looking for around £10 billion from the departments. In the years after that, whether consolidation continues in a new Parliament with a new Government, in the sense that, certainly, I am clear I would like a majority Conservative Government, that in that situation we have further decisions to take, and this will be true of anyone seeking to be the Government in the next Parliament. Those decisions will involve a combination of spending cuts in terms of departments, or welfare cut or, if people want to propose them, tax rises. Those are the questions that are going to be facing anyone seeking office at the time of the next general election.

Q350 Mr Ruffley: Can you tell us a bit about the spending review that you are going to be announcing some time next year?

Mr Osborne: We have to take, again, a series of difficult decisions. We are going to maintain the protections we have put in place, for example, with health spending and school spending and our overseas aid.

Q351 Mr Ruffley: Which is about, what, 47% of general Government expenditure?

Mr Osborne: It is absolutely about half of the general Government expenditure.

Mr Ruffley: I just want to go back to—

Mr Osborne: Well, departmental expenditure.

Q352 Mr Ruffley: Yes. Just going back to welfare, it was pretty heavily trailed that two things were certainly being looked at. One was restricting housing benefits to the under 25s, and secondly, even more radically, that for new claimants of Child Benefit there might be a restriction to receiving Child Benefit in relation to just the first two children, and not the third and subsequent children. Those were the kind of radical, tough decisions some of your friends from the economic right of the political spectrum they have been urging you to take. Can we take it that you have dropped those two ideas as a source of savings between now and 2017–2018?

Mr Osborne: There is a real question for all of us about housing benefit provision for the under 25s, and why it is the case that housing benefit will provide you with accommodation, when people not in receipt of housing benefit are probably unable to afford accommodation and have to live with their parents, or many have to. There is also a good debate to be had about why it is the case that many working families, before they have an extra child—it is not the only reason, by the way, they have children—but before they have an extra child, have to weigh up the economic cost of having an extra child, whereas, in our current welfare system, you get more money, or are financially rewarded, in that sense, for having an extra child. I think these are legitimate debates to have, and the Prime Minister has raised them, as have I. But obviously, they are not measures that we have announced in the Autumn Statement.

Q353 Mr Ruffley: But we cannot deduce anything from their nonappearance in the Autumn Statement? We cannot deduce that you have gone off those ideas?

Mr Osborne: I think they are worthy of debate and investigation. All of us, again, in this Parliament and those aspiring to election to the next Parliament, are going to have to answer the question, what are you going to do to make sure we have a state that this country can afford. You can propose tax rises that will probably affect the broader scope of the population. Then there is temptation to think you can just do something on the very rich, but frankly, we have increased taxes on the very rich and they are paying more and currently, the top 1% provide 25% of our income tax revenue. We are all going to have to face questions of where we get the savings from.

Q354 Mr Ruffley: I quite understand, Chancellor, and you have explained that well. I just want to be clear. Those two particularly radical policies, we could expect to see them in the spending review announced next year? You have not ruled them out?

Mr Osborne: They are questions that I raised at the Conservative Party conference and the Prime Minister raised in a speech. They are not things that feature in the Autumn Statement.

Mr Ruffley: No, indeed. That is why I asked about it.
Mr Osborne: The default assumption of the spending review is that the money will come from the departments. It will not come from tax rises or additional welfare savings.

Q355 Mr Ruffley: On that point you have proposed the 80–20 split and that is very clearly your view as between spending caps and tax increases making the contribution to the fiscal consolidation. The Institute for Fiscal Studies estimates that under current plans, in other words, after the Autumn Statement, they reckon that the ratio by 2017–2018 will be 85–15 rather than 80–20. Does that imply you might raise taxes to bring the ratio in line with your initial thought, that it should be 80–20?
Mr Osborne: 80–20 is not an exact science; it is a rule of thumb I used in 2010, and it applies today. You have to assess these things at the time, and if you think a tax rise of £7 billion or anything else is less damaging to the economy than a £7 billion saving in welfare or in public expenditure, then I guess you would go with the tax rise. But I do not think you should let the rule of thumb drive that decision. I think you should make that decision on the merits of the policies before you.

Q356 Mr Ruffley: It is not a hard and fast ratio that you are proposing to be bound by. There is no reason you should. But you are saying there is flexibility around that. Could I ask finally, two points? First of all, going back to some speculation about a mansion tax, or let us be more specific, introducing a further band or bands—extra bands—for properties over £2 million, or some people put it even lower than £2 million, might be a new threshold. Could you say to us why you seem to have rejected that option? Is it because you think it might trigger a wholesale council tax revaluation, or was it cost, or was it the length of time it might take to get any kind of new banding system in place?
Mr Osborne: On council tax bands, as I said to the House of Commons, I have yet to see any plan that this could be done without a revaluation of a significant number of properties. With the mansion tax, that would require a wholly different and new tax regime, because it is a national tax. As far as I understand, those who proposed it have not advocated that the money goes to the local authority. It comes to the central government, so that would require a completely different and new tax regime.

Q357 Mr Ruffley: Do you think a council tax revaluation is overdue, because it could raise a lot of additional revenue, could it not?
Mr Osborne: I would say that a number of Chancellors and Governments before me have attempted general revaluations, and have usually come to regret it.

Q358 Mr Ruffley: My final question is on infrastructure. There has been some criticism that perhaps in the last two years since the announcement of the national infrastructure plan, that maybe the wheels of Whitehall grind exceedingly slowly when it comes to getting big infrastructure projects underway. Do you think that criticism is unfair?
Mr Osborne: It is fair to say that it is frustrating how long it takes to get some roads built. The plan did not say everything would start construction in 2011. Some of it was due to start construction in 2013 or 2014. It was a multi-year plan. But there is no doubt that I have found it frustrating that it takes a very long time to get planning permission and build a road. I have two roads in my own constituency that have been funded, and I am pressing for them to get the construction underway. The planning regime takes too long. I am trying to accelerate the time it takes, so that people can make their legitimate objections but they can do so without it taking years. The Prime Minister announced at the CPI conference plans to speed up the construction of roads so that we can overcome some of these obstacles.

Q359 Mr Ruffley: Do you think there is any improvement you can make in the machinery of government, having a dedicated and very senior infrastructure minister reporting directly to you? Or do you think that is just a sideshow?
Mr Osborne: I am generally quite sceptical of big changes in the machinery of government, because I think they create a lot of heat and not very much light, but we are, within the existing machinery of government, hiring, if that is the right word, or he has agreed to serve as Her Majesty's Minister, Paul Deighton, who was the man who delivered the Olympic games, the chief executive of LOCOG. He is starting a Treasury Minister at the beginning of the new year, and he is going to have an explicit focus on the delivery of infrastructure projects, which of course the Treasury has a responsibility for. He will be doing that across Whitehall, and he has proven experience of doing it, not just in the private sector, but with LOCOG in quite a complicated interaction between the private sector and the public sector.
Chair: We are very grateful for your evidence this afternoon, Chancellor, not least in view of the fact that you have come straight from Brussels and an all-night, difficult negotiation. Thank you very much for coming to see us. It has been very helpful.
Mr Osborne: Thank you very much.

Written evidence

Written evidence submitted by Paul Mortimer-Lee, Global Head, Market Economics, BNP Paribas

This paper gives a brief assessment of the Autumn Statement.

The Autumn Statement shows a picture of slower growth and, consequently, higher budget deficits than before. Policy measures to counteract either revision are largely absent, as the Statement sees largely offsetting changes in terms of policy measures over the next few years. There is more capital spending and less current spending. Discretionary policy decisions add to the deficit by almost GBP 4 billion this year, but this includes receipts from the 4G licences. The underlying slippage in the accounts is more like GBP 11 billion when we allow for weak revenues and a change in the treatment of departmental underspending. That is getting on for ¾% of GDP. In 2013–14, the policy decisions subtract less than GBP 1bn from the deficit, or less than 0.1% of GDP.

The major worries we have about the forecasts are that the growth numbers will not be achieved due to a smaller-than-expected benefit from net trade, lower wages and consumption, slower productivity growth and slower investment growth. The greatest risk is from slower consumption and wage growth. Over the next five years, we estimate cumulative growth to be about 2½% below the OBR's estimate. We think the Statement is likely to prove too optimistic on public finances, probably due to a shortfall in taxes compared with projections. We would estimate the cumulative overshoot to be GBP 40bn or so, enough to take the gross debt/DGP rate over 100%.

In our opinion, the decision not to tighten policy to correct the overrun foreseen in borrowing is the right one and the decision to have more capital spending and less current spending is also welcome. The question is whether the constraints on capital spending could have been eased still further.

The key disappointment in the Statement is that it lacks real measures to stimulate growth. The disappointing growth performance in the UK lies partly in the sluggishness of growth in mainland Europe. However, exports to the eurozone are equivalent to only about one-sixth of UK GDP. The Budget estimate of UK-weighted export market growth for 2012 has been revised down by 1%. This should knock 1pp off UK export growth and, even allowing for multiplier effects, about ¼% or so off the level of UK GDP.

Since the Budget, the UK growth forecast for 2012 has been revised down by 0.8pp, significantly more than the downward revisions to eurozone growth would imply. Most of the weakness, therefore, must be domestically sourced. The Statement argues that in addition to the impact of the eurozone crisis, we are seeing a bigger-than-expected effect on GDP and productivity from the financial crisis. We would agree with this, but where are the measures to overcome it? The Statement also argues that commodity-driven inflation in 2011 reduced real incomes and raised business costs. True, but this was hardly unknown in April when the Budget was formulated, so cannot reasonably be cited as a reason for the downward revision.

In our opinion, the speed of the reduction in the cyclically adjusted budget deficit is about right—roughly 1% per annum. We do not feel that the disappointing performance of the UK economy is due to excessively rapid fiscal tightening. Neither is it due to an uncompetitive exchange rate. In our view, the root cause of the demand deficiency underlying the UK's disappointing performance is monetary.

We are concerned that credit availability is poor and that full account of the future potential losses of UK banks has yet to be made. This is manifest in forbearance levels and the frequent reports of "zombie" households and "zombie" firms. Fearing future capital depletion, banks are, we would contend, holding back from lending to potentially productive projects and firms.

We are not the only ones. For example, Andrew Bailey recently said,

> *"the danger of a very slow resolution of the capital gap is that new lending to the economy is seriously restrained. This is the Japanese threat."*

In a similar vein, Mervyn King said, *"In judging whether the banks are adequately capitalised, we need to ensure that capital ratios do in fact provide an accurate picture of banks' health. At present there are good reasons to think that they do not."*

If there is, indeed, a capital constraint on lending, then no amount of liquidity provision or cheap finance, as through the FLS, will really cure that particular ill. At best, such measures will be palliatives. Our view is that there needs to be a thorough clean-out of bad and doubtful assets. We would advocate a "bad bank" scheme. We can understand that this is politically difficult—no-one wants to see more money being pushed into the banks at a political level and there are concerns about the UK's credit rating.

However, given the disappointing level of growth and the likelihood that this will lead to more bad loans and slower tax receipts, the nettle needs to be grasped. The lesson from Japan is that unless and until the banking system is adequately capitalised to deal with the opportunities of the future, bank management teams will be looking over their shoulders and dealing with the mistakes of the past. In any case, this is a recipe for downgrades, but in a context of miserable growth and extended fiscal adjustment.

We would also argue that while unconventional monetary-policy measures have been helpful, the UK has had the "wrong kind" of QE. In the UK, corporate bond-market financing is much less important than in the US. Bank-based finance is much more important to the UK corporate sector. QE in the UK has lowered gilt yields, but this has been of little use to SMEs, who do not use the bond markets and who are denied credit at the bank. The BoE has supported mortgage lending through QE much less than the Fed in the US. In the UK, QE has looked like more of a fiscal support mechanism than something that has really helped the private sector. Consequently, we would argue for much more credit easing in the UK, with the Bank of England buying not gilts, but packages of private loans. We can understand the difficulties the Bank might encounter in assessing whether packages of SME loans contain "lemons" or not, so would advocate a move first into buying securitised mortgages, which would leave the banks more room to lend to SMEs.

The economic projections provided by the OBR, meanwhile, look too optimistic.

In 2013, the forecast is for GDP to accelerate to +1.2% from -0.1% in 2012. Of this, 0.9pp is explained by an improvement in net trade, which subtracts 0.6pp from growth in 2012 and adds 0.3pp next year (Autumn Statement page 17, Table 1.2). There are two issues with this. First, exports of goods and services grow 3.1% in 2013, according to the OBR's forecast, compared with growth of 0.1% in 2012.

With the UK's major export market in the eurozone mired in recession, it is difficult to see how this can occur. Euro-area GDP is expected to be flat in 2013, whereas the ECB forecast is for shrinkage of 0.3% and our BNP Paribas forecast is for a contraction of 0.5%. With the euro area weak, it is difficult to see how the UK export market growth will keep pace with world trade, as the OBR forecasts.

Second, despite the pickup in UK GDP in 2013, import growth remains flat in 2013, at 2.1%, which seems to have upside risks, especially as inventories shift from a negative 0.6pp contribution to GDP in 2012 to a positive 0.2pp contribution in 2013. Growth in 2013 will probably fall short of the forecast by ¼ pp to ½ pp, in my view.

Growth picks up from 1.2% in 2013 to 2% in 2014, 2.3% in 2015 and about 2¾% in 2017 and 2018. Domestic demand explains this, as the contribution of net trade subsides a little from 2013 (maybe not enough, considering the pickup in domestic demand?). In 2014, household consumption rises 2.1%, despite a rise in real disposable income of only 0.8%.

The risks to consumption seem to be on the downside. Part of this stems from the behaviour of the savings ratio. But the pickup in wage growth looks questionable—average earnings accelerate from 2.2% growth in 2012 to 3.7% in 2015. This is despite inflation actually slowing and the ILO unemployment rate being at the same level in 2015 as it was in 2012.

How do GDP growth and CPI inflation come down from 2.3% and 2.8%, respectively, in 2012 to 2% on both counts from 2015 when wage inflation increases so substantially? The answer is a sharp pickup in productivity growth. By 2015, employment is 1.3% higher than in 2012, but GDP rises by 5½% in 2013 to 2015 put together. This is clearly a much better productivity performance than we have seen in recent periods.

One alternative scenario would be much slower growth in nominal wages and, therefore, less consumption and slower investment growth. Another alternative would be, assuming the same wage growth, faster employment growth, but also faster inflation, tighter monetary policy and slower growth in investment, exports and consumption. Slower productivity growth would give lower unemployment and imply a smaller output gap—meaning more of the deficit would be judged structural rather than cyclical.

My belief is that wages will not accelerate as the forecast assumes, that wage growth and consumption growth will be lower and, therefore, that GDP growth will be below the OBR's projections. There would be a clear implication for tax revenues.

The rate of growth of investment by the private sector—both business investment and private housebuilding—is relatively fast from 2014—some 8% and 10% a year, respectively. The OBR does not consider what rate of bank lending growth is consistent with these figures (it has house prices rising by 2.5% in 2013 and thereafter by around 4% per year). Is this rate of investment growth consistent with the picture we have of credit growth in the UK? Not if present trends continue.

There has clearly been an improvement in financial markets since the summer and the FLS scheme was announced almost simultaneous to Mr Draghi's "everything it takes" speech, which set off the improvement in financial conditions. Thus, banks' costs of funding have dropped. How much of this is the FLS and how much external conditions? It is difficult to tell. But costs have come down and there is evidence of some reduction in costs to borrowers. Will credit be sufficiently available over the coming years to finance the pickup in private activity? It is, again, difficult to say, but given the behaviour in recent years, there is a significant risk that the answer will be "no".

Our view is that rejuvenating banks' ability to lend, especially to the corporate sector, is vital to the UK's economic health and to the evolution of the government's finances. Unless and until adequate steps are taken, we can look forward to further downgrades of the OBR's growth estimates and upward revisions of its borrowing projections.

December 2012

Written evidence submitted by Professor Dieter Helm, Oxford University

Pierre Noël, from the Judge Business School, has argued that "there is a conflict over energy policy at the very heart of this government, but it is not merely about the role of gas, it is about the fundamental approach to energy and climate change". Do you agree with him and, if so, could you set out the main contours of the dispute?

The UK has adopted a unilateral target in the context of a global problem—climate change. It has done this for two separate reasons: that by unilaterally reducing carbon production in the UK, it will show "leadership" which others will follow; and separately because it was believed that current renewables would turn out to be cheaper than fossil fuels, on the basis on (DECC and CCC) forecasts of rising fossil fuel prices. Neither appears to be well founded. The current international negotiations suggest that only by 2015 will there be the possibility of agreeing what might happen after 2020—by which time on current growth rates, China and India will be double the current size, adding perhaps 400–600 GWs of new coal to the world's every system. There is no evidence that any of the main players have been persuaded by "UK leadership". In the meantime, carbon consumption by the UK has been going ever upwards. Finally there has been a revolution in global fossil fuel supplies, and it is more likely that international companies will move to the US for its lower energy prices, than to the UK for its expensive current renewables.

It is increasingly evident that many in government are becoming aware of the shortcomings in current UK energy policy.

Mr Noël goes on to argue that "this debate between ministers is far from conducive to the policy certainty pleaded for by the investors expected to fund new infrastructure". To what extent is this very public dispute about the long-term direction of UK energy policy damaging hopes of private sector investment in our energy infrastructure?

Many lobby groups claim that they want "certainty"—for the very good reason that they want to preserve and enhance the generous subsidies they currently receive—and hope for more from the new Feed in Tariffs in the Energy Bill. Since the current policies are likely to result in some very sub optimal investments based upon these subsidies, it is better to have a debate about the framework, and put in place market incentives—so it is the market which sorts out the most efficient ways of enhancing security of supply and reducing carbon emissions. What is needed is a solid framework within which companies can operate and invest, but not another batch of government negotiated specific subsidies.

To what extent are you surprised that the Treasury rather than DECC appears to be in charge of the development of the long-term direction of UK energy policy?

The decisions on energy and climate policy are complex and effect the whole economy, and hence it is natural for the Treasury to take a strong interest. It should also be added that the performance and resources which DECC currently fields are far from satisfactory, and there must be doubts about its capacity to take on the vast amount of detailed intervention and contract negotiations envisaged in the Energy Bill. Indeed the complexity of interventions is already so great that I doubt anyone in DECC could even list them all.

Do we need an Office of Unconventional Gas when we have DECC?

Most technologies have a separate "Office" now. It would be voice to think that the problems can be solved by inventing offices, but the creation of a new Office of Unconventional Gas is evidence of the disarray in DECC—the lack of a coherent overarching framework. Once government decides to intervene in each and every technology, rather than create a market framework, the proliferation of offices follows.

The article referred to is here: http://www.guardian.co.uk/environment/2012/nov/14/energy-policy-conflict-government

December 2012

Written evidence submitted by Rt Hon George Osborne MP, Chancellor of the Exchequer, HM Treasury

BORROWING, DEBT AND FUNDING FOR LENDING SCHEME.

During my appearance before the Treasury Committee on 13 December, I offered to write to you with figures on borrowing, debt and the Funding for Lending Scheme:

— I attach tables from the June Budget 2010 and Autumn Statement 2012, setting out the forecasts for borrowing and debt.

— 35 banks and building societies have signed up to the Funding for Lending Scheme as at 30 November. Six institutions drew £4.4 billion of funds in the first two months of the scheme. The Bank of England will provide updated figures on 4 March 2013.

I am copying this letter to all members of the Treasury Select Committee

21 December 2012

FISCAL FORECAST: AUTUMN STATEMENT 2012

TABLE B.5: OBR FORECAST OF THE FISCAL AGGREGATES

	Per cent of GDP						
	Outturn	*Forecast*					
	2011–12	*2012–13*	*2013–14*	*2014–15*	*2015–16*	*2016–17*	*2017–18*
Receipts and expenditure							
Public sector current receipts (a)	37.3	38.0	38.3	38.1	38.1	38.2	37.9
Total managed expenditure (b)	45.2	43.1	44.4	43.3	42.2	40.9	39.5
Of which:							
Public sector current expenditure (c)	42.1	42.3	41.5	40.4	39.5	38.2	36.9
Public sector net investment (d)	1.7	-0.5	1.5	1.5	1.3	1.2	1.2
Depreciation (e)	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Deficit							
Public sector net borrowing (b-a)	7.9	5.1	6.1	5.2	4.2	2.6	1.6
Surplus on current budget (a-c-e)	-6.2	-5.7	-4.6	-3.7	-2.9	-1.4	-0.4
Cynically-adjusted net borrowing	6.0	3.0	3.8	2.9	2.0	0.9	0.3
Primary balance	-5.0	-3.2	-4.2	-3.1	-1.8	-0.2	1.2
Cyclically-adjusted primary balance	-3.1	-1.1	-1.8	-0.8	0.3	1.6	2.6
Fiscal mandate and supplementary target							
Cyclically-adjusted surplus on current budget	-4.3	-3.6	-2.2	-1.4	-0.8	0.4	0.9
Public sector net debt[1]	66.4	74.7	76.8	79.0	79.9	79.2	77.3
Financing							
Central government net cash requirement	8.3	6.8	6.5	6.0	4.9	3.9	2.6
Public sector net cash requirement	8.1	6.6	6.3	5.8	4.6	3.7	2.4
Stability and Growth Pact							
Treaty deficit[3]	7.7	5.2	6.2	5.3	4.3	2.8	1.8
Cyclically-adjusted Treaty deficit[2]	5.8	3.1	3.9	3.0	2.2	1.0	0.4
Treaty dept ratio[3]	85.8	90.3	93.5	96.3	97.4	96.6	94.4
	£ billion						
Surplus on current budget	-95	-89	-74	-62	-51	-26	-8
Net investment	27	-9	25	26	23	23	23
Public sector net borrowing	121	80	99	88	73	49	31
Central government net cash requirement	127	106	105	102	86	72	51
Public sector net debt	1025	1186	1270	1362	1442	1498	1534
Memo: PSNB ex. Royal Mail transfer	121.4	108.5	99.3	87.9	73.3	49.0	31.2
Memo: PSNB ex. Royal Mail transfer (per cent of GDP)	7.9	6.9	6.1	5.2	4.2	2.6	1.6
Memo: Cyclically-adjusted PSNB ex Royal Mail transfer (per cent of GDP)	6.0	4.8	3.8	2.9	2.0	0.9	0.3
Memo: Output gap (% of GDP)	-2.7	-3.2	-3.5	-3.3	-2.9	-2.4	-1.7

[1]Debt at end of March: GDP centred on end March

[2]General government net borrowing on a Maastricht basis

[3]General government gross debt on a Maastricht basis

FISCAL FORECAST: JUNE BUDGET 2010

TABLE C6: FISCAL AGGREGATES

	Per cent of GDP							
	Outturn	*Estimates*	*Forecasts*					
	2008–09	*2009–10*	*2010–11*	*2011–12*	*2012–13*	*2013–14*	*2014–15*	*2015–16*
Receipts and expenditure								
Public sector current receipts	37.2	36.6	37.2	38.0	38.4	38.7	38.8	38.7
Total managed expenditure	43.9	47.5	47.3	45.5	43.9	42.2	40.9	39.8
Deficit								
Surplus on current budget	-3.5	-7.5	-7.5	-5.7	-4.0	-2.3	-0.9	0.0
Public sector net borrowing	6.7	11.0	10.1	7.5	5.5	3.5	2.1	1.1
Cyclically-adjusted surplus on current budget	-3.1	-5.3	-4.8	-3.2	-1.9	-0.7	0.3	0.8
Cynically-adjusted net borrowing	6.3	8.7	7.4	5.0	3.4	1.8	0.8	0.3
Financing								
Central government net cash requirement	11.3	14.1	9.9	7.8	5.5	3.8	2.0	1.1
Public sector net cash requirement	4.2	9.6	9.3	7.7	5.6	4.3	2.5	1.5
Sustainability								
Public sector net debt [1]	44.0	53.5	61.9	67.2	69.8	70.3	69.4	67.4
Net worth [2]	22.4	13.8	6.9	2.4	-0.8	-2.5	-2.2	-0.2
Primary balance	-5.0	-9.0	-7.4	-4.8	-2.7	-0.6	0.9	1.9
Stability and Growth Pact								
Treaty deficit [3]	6.8	11.3	10.1	7.6	5.6	3.6	2.2	1.2
Cyclically-adjusted Treaty deficit[3]	6.4	9.0	7.5	5.1	3.5	1.9	0.9	0.4
Treaty debt ratio[a]	55.8	71.2	78.9	83.6	85.5	84.9	83.1	80.4
	£ billion							
Surplus on current budget	-49.7	-105.6	-110	-88	-65	-40	-17	0
Net investment	46.4	49.0	39	27	24	20	21	21
Public sector net borrowing	96.1	154.7	149	116	89	60	37	20
Central government net cash requirement	162.4	198.9	146	121	90	65	35	21
Public sector net debt	616.9	771.5	932	1,059	1,162	1,235	1,284	1,316
Memo: output gap (%GPD)	-1.0	-4.1	-3.7	-3.5	-2.8	-2.3	-1.6	-0.9

Note: All measures are shown on the basis which excludes the temporary effect of the financial interventions except the aggregates shown in the Financing and Stability and Growth Pact sections.

[1]Debt at end of March: GDP centred on end march

[2]Estimate at end of December, GDP centred on end December

[3]General government net borrowing on a Maastricht basis

[a]General government gross debt on a Maastricht basis

Printed in the United Kingdom by The Stationery Office Limited
01/2013 026033 19585