OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Public Administration Committee

Tuesday 12 December 2023

Session 6

The Scottish Parliament
Pàrlamaid na h-Alba

Tuesday 12 December 2023

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
33rd Meeting 2023, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Michael Marra (North East Scotland) (Lab)

COMMITTEE MEMBERS

Ross Greer (West Scotland) (Green)
Jamie Halcro Johnston (Highlands and Islands) (Con)
*John Mason (Glasgow Shettleston) (SNP)
*Liz Smith (Mid Scotland and Fife) (Con)
*Michelle Thomson (Falkirk East) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Carl Emmerson (Institute for Fiscal Studies)
Richard Hughes (Office for Budget Responsibility)
Tom Josephs (Office for Budget Responsibility)
Professor David Miles CBE (Office for Budget Responsibility)
David Phillips (Institute for Fiscal Studies)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 12 December 2023

[The Convener opened the meeting at 09:30]

Budget Scrutiny 2024-25 (United Kingdom Context)

The Convener (Kenneth Gibson): Good morning, and welcome to the 33rd meeting in 2023 of the Finance and Public Administration Committee. We have apologies from Jamie Halcro Johnston, who is unwell, and from Ross Greer, who will be late. Michael Marra joins us remotely.

The first item on our agenda is an evidence session with the Office for Budget Responsibility on the United Kingdom autumn budget statement and the wider UK context, with a view to informing our scrutiny of the upcoming 2024-25 Scottish budget. I welcome to the meeting our witnesses from the Office for Budget Responsibility: Richard Hughes is chair of the budget responsibility committee; Tom Josephs is a member of the budget responsibility committee; and Professor David Miles, who joins us remotely, is a member of the budget responsibility committee. I understand that questions should be put to Richard Hughes and that he will bring in Professor Miles if he needs to do so.

We will move directly to questions from me; I will then bring in other members of the committee.

It appears that, in September, the Chancellor of the Exchequer was in—let us say—deep trouble with the fiscal situation, but by November, he had some significant wriggle room, thanks to OBR predictions of higher inflation and fiscal drag. I understand that that amounts to around £14 billion since March alone. Can you talk us through how the OBR forecasts have changed over the months since March?

Richard Hughes (Office for Budget Responsibility): Sure. Good morning, and thank you for the invitation to be here.

You are right—our forecast has changed considerably since March. To start with the picture on real gross domestic product, one thing that we learned between March and November was that the economy recovered more fully from the pandemic and the energy crisis than we thought. There were big revisions to Office for National Statistics GDP data, which were mostly to do with the past. That meant that the economy was 2 per cent above pre-pandemic levels, whereas we thought that it was still about 1 per cent below them. There was a 3 per cent difference. GDP was the starting point for our forecast. That also meant that there was less scope for catch-up growth. That, together with some other revisions to the drivers of growth, led us to slightly downgrade our forecast for real GDP growth going into the medium term by about a quarter of a percentage point a year, to 1.6 per cent on average over the five years.

What gave the chancellor extra fiscal wriggle room was, in essence, the fact that inflation also turned out to be considerably higher than we thought back in March and—this is most important—more persistent over the forecast period. That lifted tax receipts, and it also lifted benefit costs and interest rates. Interest rates have also risen since March, in line with higher inflation expectations. That raised costs.

The chancellor got significant fiscal windfall from higher revenues. He had to spend some of that on indexing benefits to the higher inflation, and he had to spend a bit more of that on higher interest costs. However, because he left the public spending plans more or less unchanged in cash terms in particular, that gave him a net fiscal windfall of about £27 billion, which he spent on two big tax cuts—on national insurance and on making permanent the full expensing measure within corporation tax.

The Convener: I understand that the expensing measure amounts to around £3 billion a year, but the increase in corporation tax from 19 to 25 per cent is worth about £18 billion. Is that right?

Richard Hughes: That is right. There is still a net increase in corporation tax even after the full expensing measure.

The Convener: You talked about where you predicted the economy would be and the economy having been stronger than you thought. However, the 3 per cent difference seems quite big. It was thought that the economy would be 1 per cent below pre-pandemic levels, but it was actually 2 per cent higher. Why was there such a significant difference from what you anticipated in the forecast?

Richard Hughes: That was entirely driven by ONS historical revisions rather than anything that changed in our forecast outlook. The ONS found that the economy had made more of a recovery from the pandemic in 2021 and 2022, so the starting point for our forecast was a higher level of real GDP. Our March forecast still assumed that we would be doing some catching up from the more depressed post-pandemic level of GDP. However, because we had a higher starting level of GDP, there was less catching up to do over the medium term. Therefore, more growth was dictated by our long-run view of the potential growth of the economy, which is around 1.6 per cent.

The Convener: Interestingly, the UK population has been growing very consistently over the past three years by about a third of 1 per cent a year. When it looks at growth for the UK economy, does the OBR also look separately at per capita income growth, or does it simply look at the economy globally? You are talking about 1.6 per cent growth in the UK economy but, if you take population into account, it is probably about 1.2 or 1.3 per cent. Do you look at that?

Richard Hughes: We look at GDP growth as well as GDP per capita.

Professor David Miles might want to say more about how our estimates of the population also feed into our estimates of GDP, employment and other things.

Professor David Miles CBE (Office for Budget Responsibility): I apologise for not being able to be in Edinburgh—I am afraid that a family issue has turned up. I was looking forward to being in Scotland.

We take account of the demographics and the population change. The convener is right to say that welfare in the UK is far better measured by GDP per capita than simply by the change in GDP. GDP per capita will grow less than aggregate GDP by a fairly disappointing amount over the forecast horizon.

Population growth also has an impact on the supply potential of the economy. Obviously, what matters there is the change in the proportion of the population that is working—it is the working-age population change that is a meaningful growth over the forecast horizon. There is a lot of uncertainty there, particularly about the level of net migration into the UK, which is probably more difficult to forecast than the natural growth of the population domestically.

The Convener: Yes, although it is quite easy to predict what the natural growth in the population of people born in the UK is, because you get about 16 to 18 years' lead time on that.

One of the issues of concern in your report is that almost 650,000 more adults were outside the labour market in the autumn of 2022 than at the start of 2020. You go on to mention the £7 billion that is being spent each year on health-related benefits and the resulting £9 billion that is lost in foregone tax revenue. That is at the same time as unemployment is set to increase by around 85,000 more than was predicted. What is the impact on growth of those figures?

Richard Hughes: A significant source of the sluggishness in the post-pandemic recovery has been the fact that there appears to have been a loss of workforce since the pandemic, as well as growing numbers of people on inactive benefits, who cite health-related reasons in particular. That turns out to be a drag on the participation rate of the adult population, especially among older workers.

Some measures have been taken in the autumn statement to move people off inactive benefits and into employment. That has some effect on the problem, to the tune of a few tens of thousands, but we still see persistent and growing levels of inactivity for health-related reasons, which also shows up in our estimates of the benefit rolls, because those people also turn up as a cost in the welfare system.

Tom Josephs might want to say more about that.

Tom Josephs (Office for Budget Responsibility): It is very nice to be here.

The OBR did a lot of work on that in the summer. We produced an in-depth report on fiscal risks and fiscal sustainability, which looked at the issue of the rising inactivity rates that have been seen probably over the past decade, but particularly during and since Covid. A large proportion of that is due to people who are inactive for health-related reasons, and that trend seems to have continued even after Covid.

In our current forecast, a very significant driver of increased welfare spending is increased spending on health and disability-related benefits. We have made an assumption in the forecast that some of the recent increases that we have seen may be related to cost of living pressures, in addition to the underlying health-driven factors. Therefore, because we expect those cost of living pressures to ease in the future, we have forecast some reduction in the growth rate of the case load of those health-related benefits over the medium term, but there will still be a significant increase, which will be a big driver of the increase in the Government's welfare bill.

I would say that there is quite a lot of uncertainty around that part of the forecast. We try to underline the risks and uncertainty around all elements of our fiscal forecast, but that is a particular uncertainty, given that we are not completely sure about what have been the big drivers of the big increase that we have seen over the past decade, which creates uncertainty as to how long it will continue for.

The Convener: Legal migration to the United Kingdom was roughly 750,000, net, last year, which was a record number. I would imagine that most of those people will be of working age. Has that not increased growth in the UK economy? What has been the impact on that?

Richard Hughes: One of the reasons why we have GDP growing in 2023, but per capita GDP falling in 2023, is the fact that relatively high levels of net migration are assumed in the forecast. When we closed our forecast, the most recent estimate that we used for net migration was 606,000. The day after our forecast came out, we got the latest migration figures, which, as you said, were above 700,000, so the starting point for the level of migration turns out to be higher than the numbers that we used.

Our forecasters always assume that the Government takes some action to bring migration numbers down over the medium term, and we assume that, by the time we get to the fifth year of our forecast, migration levels will be back at 245,000, which is a sort of average of where they were before the pandemic. A lot of the recent inflows have been students. There have also been dependents of students and dependents of workers, so it is not necessarily the case that all migrants are people who come here and work in employment.

There is a box in our economic and fiscal outlook in which we examine what are the right assumptions to make about the new cohort of migrants, because it is a very new regime for us to get our heads around. It has only really been in force since 2020, so we have only a few years of outturn data. It is clearly bringing in a lot more people in total than the previous regime did. Some of that increase is due to temporary factors, such as students coming back to go back to university, and some of it is to do with refugees, but quite a lot of the migrants are dependents of people who are coming here to work.

The assumption that we have made about the employment rate of the migrant population is that it is roughly in line with that of the native population, once you take account of the fact that people who are here on work visas are very likely to work, but the dependents who come with them may or may not be likely to work. Students sometimes work and sometimes do not—it depends on the profile of the student.

On average, we assume that the migrant population is basically similar to the resident population, but that is an assumption that we keep under review. We are learning more about both the composition of the migrant population and—just as important—how likely they are to stay in the country, because that obviously affects what their economic profile turns out to be.

For the moment, we assume that net migration will come down from its very high level of nearly 750,000 to 245,000. The actions that the Government has taken in the past few weeks are consistent with the kind of tightening up of the regime that would bring the numbers down, but we keep the situation under review.

The Convener: Overseas students still put billions into the economy, even if they do not work. What is the contribution to the UK economy of the overseas student population? There are thousands and thousands here in Edinburgh, and in Glasgow, Manchester, London and elsewhere. What is their net contribution to the economy?

Richard Hughes: Professor Miles is probably best placed to answer that question.

The Convener: I thought he might be.

Professor Miles: Without the income that is generated by overseas students, there would be a severe funding problem for universities. They would almost certainly have to cut back, and some people who are working in universities would no longer be working in universities. The question is about what those people would then do. Could they move into other jobs? They would not necessarily become unemployed.

However, it seems plausible that, in the short run, a decrease in overseas students would cause significant problems in parts of the economy, particularly for cities that are heavily reliant on university populations. Edinburgh would be one; others I could name include Oxford, Cambridge and Bristol. Quite a large number of cities would be significantly hit. The impact on universities and their funding would be very significant, unless there was some change in Government funding.

09:45

The Convener: But we do not know what the contribution to the economy is, generally speaking.

Professor Miles: One way to assess that is to ask what would happen to the level of GDP in the UK if overseas student numbers were dramatically lower. That would depend a bit on what activities would not take place. Universities could be cut back and the question would then be whether those people who no longer had work at the universities would become unemployed for a long time, in which case GDP would fall materially, or whether they would find other things to do, in which case the economy would rebalance with a smaller university sector, while other sectors of the economy might be larger.

The Convener: Would it not also mean that billions of pounds would not be circulating in the economy? Students tend to rent accommodation, go to cafes, buy food at Tesco, spend money on clothes and so on, and go around the country to visit castles and lochs and God knows what else, so surely there would be quite a significant overall impact.

Professor Miles: In the short run—and it might last for several years—there would be a material hit to demand in particular sectors. For example, it would have an impact on the property market. One reason why rents are rising so strongly in many cities across the UK—I am sure that this is true in Edinburgh; my daughter is at Edinburgh university, so she has first-hand experience of this—is the fact that student numbers have increased sharply. That has pluses and negatives. In some ways, it is good for the local economy, but it makes it difficult for people to afford accommodation. In several cities, there has not been as much of an increase in the availability of rental property in line with the increase in demand.

The Convener: I was not really planning to go down that road. I was just curious about the overall contribution of overseas students.

The OBR has commented that there is

"little sign in the UK of significant new investment in low-carbon energy and heating technologies in response to the rise in gas prices."

Why is that?

Richard Hughes: There are probably a number of factors, the most important being what the industry highlights as the difficulties in attaching new renewable energy, be it from windmills or solar power, to the grid and the long delays in being able to hook up any new investment into the grid and actually starting to make money. The big challenges include regulatory barriers, difficulties in getting the grid to where the renewable energy source—the windmill—is and delays in getting it connected.

In addition, recently, subsidies for renewable energy have been lower than they were in the past, and certainly in comparison with those in countries such as the US. Those are two reasons why we have seen less of a supply response to what ought to be a relatively attractive price for energy from renewables versus gas.

The Convener: Does that mean that Britain's international competitiveness in this sector is falling back?

Richard Hughes: It certainly poses challenges for the transition to net zero. We got a head start in the energy transition mostly because we simply shut down coal-fired power plants, but we were also quite good at getting renewables up and running, especially offshore wind. We still have quite a way to go to meet our net zero commitments. We remain very dependent on gas for much of our energy, and so much of the power transition is yet to happen. The fact that the pace has been slowing recently means that it will need to accelerate even faster if we are going to get there by 2050.

The Convener: Public debt is a major issue now facing the UK economy, and you have highlighted the fact that it has more than trebled from below 30 per cent of GDP at the start of this century to almost 100 per cent of GDP. The Institute for Fiscal Studies director, Paul Johnson, has said that

"early action to tackle these risks and vulnerabilities can help to contain their fiscal consequences"

and that

"delay or inaction is likely to see debt continuing to rise toward unsustainable levels in the decades to come".

What is the level of debt in the UK? How many billions of pounds a year are we now paying to service our debt? What will the impact be on the forecast for the UK's long-term sustainability?

Richard Hughes: We are approaching £3 trillion-worth of debt, which means that our debt to GDP ratio is approaching 100 per cent of the size of the UK economy. As you pointed out, that is more than three times what it was at the start of the century.

That might have been manageable, had interest rates remained at the historic lows that we saw in the run-up to and immediately after the pandemic, but the challenge is that interest rates have also risen dramatically, having gone from below 1 per cent to above 4 per cent. That means that a larger and larger share of Government revenue is being consumed by the need to service that large stock of debt: those debt service costs now come to more than £100 billion a year, which means that, if debt servicing were a UK Government department, it would be the second largest after the national health service.

That constrains the Government's ability to pursue other priorities, such as spending more on public services and benefits or cutting taxes. We can see the constraint that that has put on chancellors' recent budgets. They have had relatively little wiggle room against their fiscal objectives and have often found that wiggle room eaten up by the rising interest on the stock of debt.

Tom Josephs, do you want to add anything?

Tom Josephs: I will say a couple of things.

Our report looks at the public debt position of the UK compared to other similar G7 economies. There are a couple of things to highlight. First, pretty much all the G7 economies have seen a rapid increase in public debt levels over the past 15 years, quite a lot of which has been driven by the same factors, which are the impacts of two or three big global crises—the financial crisis, Covid and the energy price shock that followed that.

Those have pushed up levels of Government debt, because of both the impact of those crises on the economy and the cost of the very large Government support packages that have been introduced to support economies through those crises.

The UK is not unique in that respect, but we have experienced a more significant impact of rising interest rates on the cost of Government debt than have most other G7 economies. That happened for a couple of reasons. One is that we have a relatively large stock of index-linked gilts and therefore, as retail price index inflation has increased, the cost of servicing that debt has increased very significantly. Secondly, because the Bank of England's quantitative easing programme means that quite a large stock of our gilts is now held by the bank and essentially remunerated at bank rates, our sensitivity to short-term interest rates has also increased quite significantly. That is why the UK has seen a very significant increase in debt interest costs and one of the largest in the G7.

We expect our debt interest costs to fall in the medium term, largely because we expect inflation to fall back down to the Bank of England's target level. That will reduce debt interest costs in the medium term, but they will still be at very high levels historically.

The Convener: Inflation is persistently higher than you predicted even in March of this year. You spoke about debt interest of more than £100 billion. I think that the last figure I saw was £116 billion or £118 billion. Is that about right at this point?

Richard Hughes: Yes, that is right.

Tom Josephs: Our forecast is that it will be £116 billion this year.

The Convener: What is the impact on public service spending as a result of that?

Richard Hughes: The rising cost of interest is one of the things that has constrained public service spending, while another is the pressure that inflation has put on the welfare bill. The amount that is spent on public services in England is ultimately at the discretion of the chancellor. Our forecast gave him a net windfall of £27 billion, which was essentially from fiscal drag, net of a few things. He opted to cut two taxes in his autumn statement, rather than to try to protect the real spending power of public services.

As a result, because the chancellor left public service spending plans unchanged in cash terms, despite a higher forecast for inflation, the real spending power of Government departments in England goes down by about £19 billion over the forecast period.

The Convener: What are the implications of that for the Scottish budget?

Richard Hughes: The implication is that, if those spending plans are sustained, there will be fewer real increases in Barnett consequentials for Scottish departments because in practice less is being spent in real terms on health, education, transport and other areas where spending is devolved here in Scotland.

The Convener: So, what are we talking about here? You have discussed how

"the spending of unprotected departments"—

that is, UK departments—

"would need to fall by 2.3% a year in real terms from 2025-26, increasing to 4.1% a year, should the UK Government continue with its ambition to increase defence spending to 2.5% of GDP and return overseas development assistance to its 0.7% of gross national income target."

What are we talking about in ballpark figures at today's prices?

Richard Hughes: I would struggle to put a number on a 2 per cent real-terms fall in unprotected departments, because I am not sure what the baseline is. The reduction in the real spending power of all public service spending over the five years of our forecast is about £19 billion. Part of the challenge is that the Government does not have any spending plans beyond March 2025, so we do not know how much the Government is planning to spend on health, education, transport and other departments by the time we get to the end of our forecast period.

The real spending power of the entire sum of money that the Government is planning to spend by the time we get to 2027-28 is about £19 billion lower, basically because the spending plans were not changed in response to higher inflation.

The Convener: I have two more questions for you before I let colleagues in. One is on the fact that public sector capital spending has been frozen in cash terms. What is that likely to mean for infrastructure and economic growth?

Tom Josephs: You are right that the UK Government has chosen to freeze total capital spending. The Government has not set any detailed spending plans beyond next year. Beyond the end of next year, when the current spending review period ends, all we have is the top-level envelope for capital spending. It is not really possible for us to say what the implications are for public investment in the UK, because the Government is not saying how it would allocate that envelope.

On the level of that envelope, capital spending has increased as a share of GDP over the past few years, but it is expected to fall back down again over the forecast period if it is frozen in cash terms. If such freezes were to be maintained over a long period, we would expect that to have a negative impact on economic growth over the longer term.

The Convener: My final question is effectively from the IFS.

Paul Johnson has said that the chancellor

"or his successor is going to have the mother and father of a headache when it comes to making the tough decisions implied by this statement in a year or two's time."

What do you feel that the statement means in the medium to long term for the UK economy, and what might the knock-on effects be for Scotland's economy?

Richard Hughes: I would agree with Paul Johnson that the public finances remain in a very constrained state. The chancellor has left himself with about £13 billion of headroom against his target to get debt falling in five years' time. It is important to point out that he has that headroom only because the deadline year for the target has shifted forward a year. He has taken full advantage of the fact that he has got himself an extra 12 months to get there. He is barely scraping by when it comes to getting debt down: debt fell by 0.1 per cent of GDP in the previous year, so he is just scraping by for the year before. The public finances are based on historically relatively low growth in current spending for departments and on investment spending that is frozen in cash terms and falling as a share of GDP. That would imply some very strict prioritisation of departmental spending in order to deliver the targets.

One also has to bear in mind that we have an ageing society, which will naturally put pressure on things such as the health service, social care and pensions. Those costs will need to be accommodated somehow, through finding either efficiencies or additional resources. We also have a tax burden that is rising to historic highs.

10:00

Our forecast, which leaves the chancellor a vanishingly small amount of headroom in the grand scheme of things in five years' time, is premised on not only the tax burden getting to a historic high, but growth and spending on public services being relatively low. That is partly an artefact of relatively high interest rates on a high stock of debt that needs to be serviced, and an economy whose growth performance has been relatively disappointing compared to pre-financial crisis rates of growth.

The Convener: The historic tax burden is 37.7 per cent, which is, I think, the highest that it has been since the second world war. Professor Miles, do you want to come in?

Professor Miles: One way to think about the rather tricky road ahead—tricky is a bit of a euphemism, really—is that last year the Government borrowed about 5 per cent of GDP. That is the fiscal deficit. However, the stock of debt was close to 100 per cent of GDP. If you want to stop that rising and rising, you need to bring that deficit down.

The way that the Government does it in our forecasts is that it gets 5 per cent borrowing down to 1 per cent, and 1 per cent fiscal deficit just about levels off the stock of debt. You would begin to see it marginally come down, but only five years down the road. The Government has to go from borrowing 5 per cent of GDP to borrowing 1 per cent. Essentially, it will do that through increasing taxes relative to GDP by 2 per cent of GDP, and cutting spending relative to GDP by another 2 per cent. That is how it gets from 5 per cent deficit to 1 per cent.

Things may turn out better than that if our central forecast of, for example, productivity growth turns out to be a bit pessimistic, although for most of the past 10 years it has been too optimistic. However, if productivity growth turned out to be better, that could be almost transformational. If it was not at a miserable rate of under 1 per cent and turned out to be 1.5 or even 2 per cent, that would transform the picture over the next five years.

However, the risks are symmetric, and our relatively pessimistic forecast of productivity may turn out yet again to be too optimistic, in which case things will be even more difficult.

The Convener: On that note, I will open up the session to colleagues.

Liz Smith (Mid Scotland and Fife) (Con): Good morning. I will pursue that issue of productivity, which is absolutely critical, as Professor Miles said. I also want to interrogate the panel about the unemployment forecast and the participation forecast, which are extremely important.

You said earlier that for the unemployment forecast you are using material from the business labour market surveys, information from HM Revenue and Customs and the Department for Work and Pensions, and so on. Your prediction for the end of next year is that the unemployment rate will be 5.5 to 6 per cent. Are you detecting that there is a danger of an increase in unemployment in any particular sectors?

Richard Hughes: There are general signs across the labour market of labour demand weakening as firms come under financial pressure and as real wages start to recover and put burdens on payrolls. There are signs across the economy of the labour market cooling compared to the very tight position that we saw last year and at the beginning of this year.

The rise in unemployment in the forecast is significant but relatively modest compared to past economic slowdowns. It stays below 5 per cent in the forecast, whereas it got above that during the pandemic, and it has been well above that in the recent past.

When we think about the state of the labour market, we tend to think of unemployment and inactivity together. Inactivity has risen more dramatically and poses the challenge of being more persistent. Once people leave the labour market and no longer participate, they tend to stay out for long periods.

Liz Smith: I will come on to inactivity in a minute. On unemployment, are there trends suggesting that there are different parts of the UK where the threat of rising unemployment is worse, or is it too early to tell?

Richard Hughes: It is probably too early to tell.

David Miles, do you want to add anything on that?

Professor Miles: The softening in the labour market is pretty much across the board. That is what you might expect, because it is partly a reflection of the tightening in monetary policy.

The Bank of England has put interest rates up a lot over the past year or so. Most of the effect of that—perhaps more than half of the impact—is yet to come through. Interest rate increases probably have a broad-brush impact across most sectors of the economy. Most companies borrow money, so there is a squeeze there. A large portion of households have debt in one form or another, so it is a pretty broad-based squeeze on household budgets on top of the squeeze from higher inflation.

I do not see a particular squeeze in one part of the economy. We do not have a booming labour market in one place and a dramatically weakening one with major lay-offs in another area. It seems to be pretty broad-based at the moment.

Liz Smith: Thank you, that is helpful.

Inactivity is another critical issue for the future of the economy. The Chancellor of the Exchequer has tried various measures—some of them a bit more successful than others—to ensure that inactivity is reduced, which is critical to productivity. Do you see any trends in the different age structures that suggest where people are more likely to come back into the labour market? Could you expand on that a wee bit?

Richard Hughes: Maybe I can say a bit about the trends, and then Tom Josephs might want to say more about the specific policies that were included in the autumn statement related to the long-term sick.

Generally speaking, before the pandemic started, there was a relatively positive trend of people with caring responsibilities coming into the labour market—especially women, so female participation was rising—and older workers working longer through their lives and retiring later. The rising participation rates among those two groups was one of the things that supported growth in the period after the financial crisis.

In the aftermath of the pandemic, there was a big rise in inactivity for, in essence, a transitory reason, which was people going to university. More people went to university during the pandemic. They were not in the labour market but, more recently, they have been coming back out of university and heading into the labour market. That issue has not proved persistent.

More worrying has been the fact that people who are out of the labour market for health reasons—often, people who are older—left it in their hundreds of thousands in the aftermath of the pandemic. Some have come back, but not all, so there seems to be a persistent problem of high and rising rates of inactivity among older workers, who cite health as their reason for being out of the labour force. The most common health reason cited is mental illness.

Liz Smith: Is that largely in the 45 to 60-year-old group?

Richard Hughes: It has a bimodal distribution. There are a lot of young people and a lot of older people out of the labour force for those reasons.

Liz Smith: For different reasons, presumably.

Richard Hughes: Both groups cite mental health as their principal reason. Among older workers, there is also a significant proportion of people who cite musculoskeletal conditions, and there is a longer list of conditions. There is also a large group of people whose reason is given as "other", which obviously does not help you for analytical purposes.

Liz Smith: Is early retirement a big factor in that?

Richard Hughes: It was at the start of the pandemic, but, surprisingly, it has not proven to be lasting. Some people have come out of retirement and rejoined the labour force.

Liz Smith: Do you have any idea of the numbers that are coming back?

Richard Hughes: Those numbers are relatively small. Chart 2.11 in our "Economic and fiscal outlook" has the number of retirees. It is in the low thousands—not more than tens of thousands. That is compared with the number of people who are out of the workforce for long-term illness, which was in the hundreds of thousands.

Liz Smith: That is all very helpful. During the past several years, we have had various deliberations about how we articulate the forecasts from the OBR, the Scottish Fiscal Commission and the Office for National Statistics. Although it is nobody's fault, there is frustration that we cannot get the forecasts all lined up and covering the same time period. That is very difficult for both Governments, particularly the Scottish Government, which is having to interrogate all three of the forecasts, whereas that is not the case in Westminster. Based on comments that we have had from other witnesses, I understand that co-operation between all three groups is very good. Is there any way that we can try to minimise the problem with the time lag between different forecasts and ensure that they are all on the same page?

Richard Hughes: That is a perennial problem, and it is made more difficult when forecasts get separated by several months in time. It is also particularly challenging because we have been operating in a very volatile environment since 2020. Now, a month can be a very long time in forecasting, because gas prices change dramatically, inflation expectations change and interest rates change, as well as migration and GDP. All of those are proving very volatile at the moment. If we had a period of stability, it would probably matter less what month a forecast is done in, but we learn an awful lot in a month nowadays.

We do our best to work closely with our colleagues in the Scottish Fiscal Commission, as well as with colleagues in Northern Ireland and with those in the Welsh Government, to share assumptions and be on the same page, broadly speaking, about where we think the economy is going in the run-up to putting our forecasts together, consistent with our obligations to maintain confidentiality with our official counterparts in the Government.

We have also gone quite a long way down the road of providing quite detailed reconciliations for when they have a different number from us. When we ask why that is, we find that the single biggest difference is time; whoever went last had access to a bit more data about the state of the world than the others did. We do not differ much on the fundamental questions of what we think productivity growth is, and we use the same assumptions about interest rates and about energy prices. Therefore, we do not take fundamentally different views of the economy, but some have more time to learn about it than others.

Liz Smith: It is all a very inexact science; I completely appreciate that, and I know how difficult it is because of the time periods. However, it would be helpful if the accuracy of the forecasting improved; it is critical for Governments to be able to make the right decisions. I am interested to know your views about how we can try to continue to improve forecasting.

Richard Hughes: It may be worth saying a few things about our income tax forecast, in particular. Tom Josephs will say a few words about that.

Tom Josephs: I have couple of things to add. First, regardless of who is doing the forecast, there is always going to be a huge amount of risk and uncertainty around it; that is the nature of forecasting. That has been especially true through this very volatile period for the economy as we have come out of Covid, and then there was the energy-price shock.

One way that we try to deal with that is by providing as much analysis as we can on the risks around our forecast. We aim to have a central forecast in which the risks are, broadly, evenly balanced either way, because that is the best basis on which Governments should make their plans. We try to illustrate the scale of those risks through scenario analysis and sensitivity analysis to help policymakers reach their decisions. The Scottish Fiscal Commission does the same.

We also do a lot of evaluation of our forecasts. That means looking back at our previous forecasts and explaining the differences with outturn. We do that to illustrate the scale of the risks that we are dealing with and also to try and improve our forecasts so they are more accurate and more central in the future.

We did a lot of work during the summer—we published it in the autumn—that looked specifically at our devolved income tax forecasts for Scotland and Wales. That had some very detailed analysis of the drivers of the change and of the outturn data during the past 10 years, and it looked in particular at reasons why income tax per capita in Scotland has not increased as quickly as it has in the UK as a whole, which is driving a divergence. It also looked at whether we could identify any particular drivers of that to incorporate into our forecasts in the future to improve the forecast.

Basically, that work taught us that it is really trends in employment income that drive the divergence and therefore, the most up-to-date outturn information from HMRC on employment income is a really important source of data for us and we are going to look at how we can improve the use of that data in forecasts. That is just one example of how we are trying to improve our forecasts and particularly our devolved forecasts.

Liz Smith: That is very helpful because it is an area that is absolutely critical to productivity. It is important to ensure that we have absolute accuracy when it comes to the numbers of people in the different categories of income levels, as they will obviously benefit the tax revenue and things like that.

10:15

John Mason (Glasgow Shettleston) (SNP): On the question of forecasting accuracy, I think that in March the forecast for debt interest was £94 billion and it is now £116 billion, which is quite a change. Is that one of the most difficult forecasts to pin down?

Richard Hughes: It is the most difficult to predict. However, in some ways it is one of the easiest things for us to put into a forecast, because we just take the market expectations for interest rates. We do not try to guess what the Bank of England is going to do; we look at where the market is putting its money. Similarly, for the gilt market and the cost of UK Government borrowing, we take the yield curve and use that as the basis for projecting debt interest on UK gilts. The issue is that market expectations have been jumping around a lot and one of the big changes is that they rose a lot post-pandemic but then they rose further between March and November as everyone expected inflation to prove to be more persistent and interest rates to have to remain higher for longer to bring it under control.

John Mason: Did you suggest earlier that that is more of a challenge for the UK because our interest rates are more index linked? Are other countries different?

Richard Hughes: It is down to a number of things. One is that our interest rates have risen by more than those in some other countries, especially elsewhere in Europe. Our interest rates have ended up somewhere between those of the US and the eurozone, although they all started out in roughly the same place at between zero and 1 per cent.

The challenge for the UK is that any rise in interest rates hits our interest costs faster, partly because we have got lots of RPI. A quarter of our debt is inflation linked, as Tom Josephs mentioned, so higher inflation just feeds directly into our interest costs when inflation goes up, which is on top of the increase in nominal interest rates.

The other point that Tom Josephs highlighted was that because quantitative easing by the Bank of England effectively refinanced the long-term debt that the bank bought and replaced it with short-term debt, which the bank has issued at bank rate, much more of our debt is sensitive to day-to-day changes in the bank rate, rather than being paid at the interest rate of whatever the gilt was that it purchased, which often had a 15 to 20-year maturity and was well below market interest rates.

Those two factors in particular mean that when interest rates go up, they hit the Government coffers much faster than in other countries that have a relatively long average maturity and much more of their debt on straight, nominal interest rates, rather than rates that adjust immediately to reflect what inflation turns out to be.

John Mason: Is it about the choices that other—certainly, European—countries made? They did not do the same amount of quantitative easing but did more traditional debt.

Richard Hughes: There are two things. First, about a quarter of our debt stock is inflation linked. Other European countries did not issue as much inflation-linked debt—the second highest issuer outside of the UK is Italy, with about 10 per cent—which means that much less of their debt costs are directly sensitive to higher inflation.

Secondly, the way in which we account for quantitative easing is also different from the rest of Europe: the Treasury directly indemnifies the Bank of England for any losses that it incurs on quantitative easing, which means that any rise in bank rate feeds directly into the fiscal cost in the UK, whereas in other countries, including in the eurozone, those losses are accumulating in the European Central Bank. At some point those losses may get visited on member states and they will have to compensate the central bank for those costs, but that has not happened and, for now, those costs have not been realised in fiscal terms in those countries. However, such costs are immediately realised fiscally in the UK because of the indemnity that the Treasury provides to the Bank of England.

John Mason: Okay. I think that I partly understand that. [*Laughter*.]

The GDP deflator has come up a few times in our committee. I noted that, for 2023, it was forecast to be 5.7 per cent and it is now 6.7 per cent. In practice, where does that impact? Does that make any difference?

Richard Hughes: David, do you want to have a go at discussing the GDP deflator versus other flavours of inflation?

Professor Miles: Yes. The GDP deflator is a decent indicator of what you might think of as inflation pressures within the UK, because it measures the cost of things that are produced in the UK, whereas the consumer prices index or the retail prices index is a reflection of the price of things that are consumed in the UK. Since we are a very open economy and a lot of what we consume is imported into the UK, CPI can move in quite different directions from the GDP deflator. In fact, when consumer price inflation was at its highest at 11 per cent at the beginning of this year, and retail price inflation was even higher, the GDP deflator was rising much less strongly than that.

Over the past year or so, inflation in the UK has become a bit more domestically generated and much less a reflection of big increases in import prices into the UK. In fact, gas prices, which are the biggest single factor, have gone in the other direction—they have been falling.

The GDP deflator has now moved up quite significantly relative to consumer price inflation. That sounds bad in some ways but, fiscally, it is quite helpful because when inflation reflects domestically generated sources—and that is partly a counterpart to wage increases—that increases the tax base and is increasing tax revenue that is coming into the UK Government. It has been a big factor behind what is, in some ways, a more favourable fiscal situation, certainly in terms of the tax revenue that the Government is getting now compared to a year ago or even back in March.

The GDP deflator is probably also a better indicator than CPI inflation or RPI inflation of the cost of things on which Government spends money. That is another reason why what happens to the GDP deflator and its difference from consumer prices is fiscally rather important.

I will briefly make a point about one of the major factors as to why the UK Government's interest costs have gone up so much, which is a reflection of having a large amount of inflation-proof or index-linked debt. That rises very sharply in cost when retail price inflation is high. At the beginning of this year, it was running into double figures and was even higher than the 11 per cent or so consumer price inflation. It is very painful when those inflation rates are high, but the cost of that debt will come down quite sharply as retail price inflation falls away again. It has already fallen back quite a lot relative to where it was at the beginning of the year. We think that it will fall quite a bit further.

Therefore, at least one element of what has driven up the big rise in interest costs for the UK Government will go into reverse. Further, it will do so in a way that is different from the other bits of Government debt, which are linked to interest rates, the rates that the Bank of England sets or gilt yields. Those interest rates will probably not come down terribly sharply. The expectation is that the Bank of England might reduce interest rates a little bit next year but not by very much. In fact, inflation might be coming down because the Bank of England is not reducing interest rates.

There will be a switch in the story about interest costs to the UK Government debt. In relation to last year, it looks like the inflation-proof debt has been a very costly thing to hold and that the other kinds of debt where the costs are linked to the Bank of England rate have not gone up so much. I think that that will switch around. That is one of the reasons why the interest burden of the stock of debt in the UK, high though it is, will probably get a bit less painful over the next few years.

John Mason: That is helpful. I will press you again on the practical impact of the GDP deflator. My understanding is that the Scottish Government uses it to measure factors such as how much it can borrow. However, the illustration that we are always given is inflation in the capital sector—for example, buying materials such as concrete and steel, which have been expensive. Am I right in thinking that the GDP deflator effectively constrains the amount of capital expenditure going forward, or is that a misunderstanding?

Richard Hughes: As Professor Miles pointed out, the index that is generally used to measure the Government's purchasing power is the GDP deflator rather than CPI. Governments tend to employ people domestically and buy materials that have been produced here, whereas consumers tend to buy food from overseas, go on foreign holidays and do other activities where they are exposed to international prices. Generally speaking, therefore, the GDP deflator is used to examine the purchasing power of Government, whereas factors such as CPI are used to index benefits, because that is supposed to reflect the cost of living that individuals face. As a country that imports half its energy and half its food, we must consider the international prices that feed into such imports. However, it stands to reason that the lower the GDP deflator, the less we would index upwards whichever factors are indexed to the deflator, such as the Scotland reserve.

John Mason: I will move on to another point. I believe that the concept of full expensing of fixed-asset expenditure covers only plant and machinery. How will that approach play out? As I understand it, there will be a short-term hit and then a longer-term advantage. Is that the plan?

Richard Hughes: David, would you like to have a go at answering that?

Professor Miles: The expectation had been that full expensing—that is, offsetting the whole cost of investment, at least on plant and machinery, against corporation tax—would be in place for a temporary period. That approach gave companies an incentive to bring forward spending while that relatively generous allowance was in place. It has now been replaced with a permanent full expensing strategy. Companies do not now need to undertake some of the investment spending that might otherwise have been brought forward, because they can expect to get the allowances indefinitely.

There will be a slightly negative effect on investment spending because of that, but only in the short run. However, there will be a beneficial impact in the long run, because having that measure in place increases the incentive to invest, at least in the types of capital that attract the 100 per cent allowance. Our estimate is that there will be a smallish reduction in investment in the very near term—just for the next year or so—followed by a persistently higher level of investment than would otherwise have taken place. Over the whole period that we consider, which is from now until 2028-29, the net effect of the full expensing is positive: I think that it increases investment by about £14 billion or £15 billion over that period. However, it stretches further into the future. As long as that approach is kept in place, the level of investment will be higher than it otherwise would have been.

John Mason: On the positive side, if companies have more modern machinery, that should help their productivity. However, is there not also a risk that they might invest for the sake of it, to get their tax bills down, and so make poor investments?

Professor Miles: It certainly reduces the cost of investing. I would not go so far as to say that the allowances are so generous that even something that you know will lose money somehow becomes worth doing. In fact, in some ways, it makes the tax system a little bit more neutral—certainly for investment that a company finances from retained profit or by issuing shares. The part of investment that is financed through what we might call equity financing rather than debt is now treated for tax purposes in a way that removes the general disincentive that corporation tax brings to not invest so much. Any movement is in the direction of the tax system no longer disincentivising most types of investment.

For the bit of investment that companies undertake that is financed by debt, there is now a subsidy element. In many ways, because the UK is a relatively low-investment country with a lower overall level of investment to GDP than most other relatively rich countries, if the recent change introduces a small element of subsidy, that would probably be welcome in a country with a very low investment rate.

10:30

John Mason: My final question is on the tax burden, which is 4.5 percentage points higher than it was before the pandemic. How does that compare with other countries? Does that have an impact on our economy?

Richard Hughes: Tom Josephs might want to say more about what drives the increase in the tax burden. We have always been well above the US, and we are becoming less and less like the US and more and more like other European countries with large welfare states that need to be paid for. We are still below countries with the highest tax burdens in the Organisation for Economic Co-operation and Development, such as France, whose tax burden is getting up to close to 50 per cent of GDP—38 per cent does not quite get you there.

Tax burdens are rising pretty much everywhere in the world, because working populations are shrinking and the numbers of people who are on state pensions or consuming public healthcare are rising. Therefore, if working people are not becoming significantly more productive than they were in the past—we heard in the earlier part of the evidence session that they are not—you need to get more tax out of your working population in order to deliver those pensions and to pay for those services. Working people are less productive than they were in the past. That is the arithmetic that is driving tax burdens higher everywhere.

Our tax burden has gone up more quickly than in other countries. We have certainly delivered a much bigger tax rise over the past few years than other places have, but that is partly because we have a fiscal rule in place that requires chancellors to get debt under control and to start falling. That might have precipitated earlier policy action than there has been in places such as the US, which still runs a 7 per cent of GDP budget deficit. It seems to be content to let that ride rather than, as David Miles said, get a 5 per cent of GDP deficit down to 1 per cent. Some of that adjustment may be yet to come in other countries, which may also see their tax burdens start to rise.

Tom, do you want to say a bit about what is driving the increase in the tax burden?

Tom Josephs: Yes, briefly. As you say, we forecast that the tax burden will rise, compared with pre-Covid levels, to 4.5 per cent of GDP higher, near to 38 per cent of GDP. A large part of that is driven by policy choices, one of which is the increase in the corporation tax headline rate. The biggest are the freezes in personal tax thresholds, which, combined with very strong nominal earnings growth, means that more people are pulled into paying tax or pulled into higher rate tax bands. That is driving much of the increase in the tax GDP ratio over the forecast period. That has increased since our previous forecast in March because of the increase in nominal earnings.

Again, that is a forecast for five years down the line, so there is a lot of uncertainty around that number. As David Miles mentioned, if productivity, which is a big driver of wages, turns out very differently—if it increases compared with our forecast, or is even weaker compared with our forecast—those numbers could change significantly. However, based on our current numbers, we expect a big increase in the tax burden.

Michelle Thomson (Falkirk East) (SNP): Good morning. This has been fascinating. I will pick up on a couple of points and bottom them out. Professor Miles, we talked about productivity earlier, and you suggested that your forecast may be on the optimistic side. The freezing of public sector capital expenditure is obviously a fall in real terms. Will that have an impact? Logically, it would. Therefore, what is your feeling about how this continual limitation in capital expenditure will ultimately affect productivity? Will you flesh that out a bit more?

Professor Miles: You are right. If the level of public sector investment is lower, it will reduce the size and quality of the capital stock in the UK. That is not helpful. That will tend to make labour productivity a bit lower. We take that into account in our forecast, because we keep track of not just the investment in the private sector and what that does to the productive capital stock in the UK but also the public sector bit.

The size of that effect is not enormous over a relatively short horizon—four or five years—because of the amount of investment done in one year relative to the overall size of the capital stock. For example, if you think about the road network in the UK, the amount of spending in one year relative to the value of the accumulated road stock is actually quite small. Nonetheless, if, year after year, you have very low public sector investment, in the longer run, that undoubtedly has a material impact.

What is likely to have a much bigger impact on the standard of living and the fiscal position in the UK is not so much the bit of productivity linked to the capital stock but so-called total factor productivity. That is a piece of economic jargon that is about how we get better at doing things because we discover new things, make new inventions, learn by doing and look at advances in other countries and adopt the most successful techniques. It is not particularly linked to the capital stock but just happens because we get better at doing things.

Historically, over the past 60 to 70 years in the UK, we have got better by almost 2 per cent a year at doing that stuff, which is what has driven increases in living standards. Since the financial crisis, for the past 15 years now, instead of getting 2 per cent better a year, we have barely got better by half a percent. That 15 years of underperforming by 1.5 per cent gets you a 20 per cent hit to the standard of living of people in the UK, so it is absolutely enormous. It is not unique to the UK that performance in the past 15 years has been bad, but it has probably been worse in the UK relative to history than in most of those other countries. It would make an absolutely enormous difference if productivity growth in the next seven or eight years was a bit more like the long-run average.

What do I mean by transforming the situation? We did a simulation in which, if the rate of that improvement in technological knowledge and productivity matched the longer-run historical average for the UK, the fiscal position in the UK, five years down the road, in terms of how much debt was outstanding, would be £200 billion better than our central forecast. However, if the next five or six years were as bad as the past 10 or 15 years—we are a bit more optimistic than that on our central forecast—and we just assumed that things would carry on as poorly as in the period since the financial crisis 15 years ago, the fiscal situation in relation to the stock of debt would be £200 billion worse.

The view of the future and what will actually happen is hugely sensitive to that crucial assumption about whether what we have seen in the past 15 years is just an unusually bad period and that we will go back to the 50-year average, where things just get better and we get more productive, or whether the next five or so years will be no better than the past 15 years.

Our central forecast has taken an in-between position, not based on strong evidence but more as a central assumption. We get to a sort of halfway point, with productivity growth not as good as it was in the UK over the past 50 years but not as bad as it has been over the past 15 years. That is what underpins our central forecast, but there is a lot of uncertainty about whether things will be materially better than that or materially worse. That is an indication of the risks to the fiscal position that Governments will face in the UK.

Michelle Thomson: That long-range looking back and the figures that you have set out are very helpful. I was not entirely clear from the autumn statement what the significant trigger factors would be that would make the change from what you have set out as the position over the past 15 years. In fairness, some of that is because of the lack of flexibility for all the areas that we have discussed, such as debt servicing and so on. Correct me if I am wrong and being somewhat pessimistic.

Professor Miles: You are probably not wrong to be pessimistic, because there are limits to what

Governments can do in that area. Productivity improvements are, to some extent, a reflection of technological progress in inventing new things, but some economists are pessimistic and would say that we have discovered all the really transformational things—such as electricity and increased computing power—in the past hundred years and cannot expect anything so transformational to happen in the future.

If that is true, there is not an awful lot that Governments can do about it. The Government did some things in the autumn statement and we have talked about one, which was changing the allowances on investment. We factored that into our forecast, and it adds a bit to the productive potential of the UK. However, to a significant extent, many of the forces that drive productivity are things that Governments have a rather limited ability to influence.

Michelle Thomson: I appreciate that talking about technology can be very complex, but what consideration are you giving to the impact that artificial intelligence might have on productivity? I understand that any answer will, in essence, be wrong, but what is your thinking? That is one area that could have an impact.

Professor Miles: You are absolutely right. One of the reasons why our central forecast is more optimistic than most for the UK is because of our belief that AI, as it is rolled out for ever greater use across the economy, might be the thing that makes productivity in the next five years and beyond better and higher than we have seen in the rather dismal period since the financial crisis of 15 years ago.

It may be that AI has particular impacts on the provision of some Government services, particularly the health service. It is difficult to know yet, and lots of people who know a lot more about the implications of AI than we do at the OBR have different views, but I think that that was one of the reasons why our central forecast had a more optimistic productivity profile than you would predict just by looking back over the last 10 or 15 years.

Michelle Thomson: Would you not therefore have expected to see incentives to encourage investment in AI, rather than the investment in plant and machinery that we spoke about earlier?

Professor Miles: There is a question of affordability. The fiscal position is difficult and the full expensing measure, which applies only to plant and machinery in the short term, is pretty expensive for the Government. It costs something like £10 billion a year, and the national insurance cut is another £10 billion a year, so the Government has essentially used up the extra headroom it got from having more tax revenue coming in. I am sure the Government would have liked to offer incentives for investments beyond plant and machinery, but I think that constraints on the fiscal position limited those to plant and machinery.

Michelle Thomson: That leads me on to my next area of questioning, which will apply to you all and is about renewables. I thought that £960 million for the green industries growth accelerator was a relatively low amount. I recall what Richard Hughes said about how we got slightly ahead of the curve, but there is significant competition for investment and the UK has to compete globally.

I saw the £960 million as a signal. Given the wider fiscal environment, and given that companies are faced with a choice and can invest in other locations, that changes the risk profile of the UK, because of appetite and ability in a longer-run environment. I would appreciate your thoughts about that as well.

10:45

Richard Hughes: We took a detailed look at what the cost of getting to net zero might be for the UK economy and for the UK Government, as a subset of that, in our 2021 sustainability report.

More recently, we checked those estimates of cost against where the Government has actually spent its money and found that the Government had spent roughly the amount of money that we expected it would spend to deliver the transition, although the composition has been different from what we expected. The Government has ended up spending more on nuclear power and on the construction of new nuclear generation capacity. The challenge with that is that there is a very long lead time to get it up and running, so it does not contribute much to decarbonisation in the near term. Also, some of the technologies in which the Government is investing are speculative, such as the small modular reactors, for example.

There was less than we expected of delivery of proven renewable resources and, in particular, onshore wind. That is not so much about a lack of public investment as it is about the regulatory barriers that we talked about—the difficulties in getting planning permission and getting a grid connection. That just means that the payback period for an investment is much longer than most private companies are willing to accept, even at what can be relatively competitive auction prices.

The third area where the transition has been slower than our estimates assumed is in the conversion of domestic heating from gas-fired boilers to electric—that is, heat pumps. We are well behind some countries in making that transition. It is proven technology. We do not need to invent the heat pump, because it already exists.

The technology is expensive to install, especially if you are on low incomes. People might have to find tens of thousands of pounds to make the conversion.

Other countries have more generous support to make that transition happen and stricter requirements about making it happen, although some Governments such as in Germany are starting to back off from those. It is in particular in the transition of domestic and commercial heating to renewable sources where we have the furthest to go and are lagging behind other European countries, which have taken that much more seriously.

Michelle Thomson: My last question concerns Brexit, which I know you have baked into numbers generally. For a period of time, it was difficult to disaggregate the data, given what was happening with wider geopolitical issues such as the energy crisis. My guess is that it is only the longer-run forecasts and the evidence therein that will start to show, or at least allow us to apportion some data to, the impact of Brexit. Am I right or wrong in that?

Richard Hughes: That is right. Ever since the referendum, we have assumed that, in the long run, the decision to leave the EU would reduce the trade intensity of the UK economy by about 15 per cent and reduce the long-run level of productivity in the UK, relative to a counterfactual of staying in the EU, by about 4 per cent. Obviously, our departure from the EU and its impact on trade was complicated by the fact that we also had a pandemic in the middle of it, which disrupted everybody's trade. We have seen more recently that, if you look at advanced economies that have a similar economic profile to ours, you find that our trade intensity has recovered by less than is the case in those other countries. We are toward the lower end of the G7 league table on trade intensity as a share of GDP.

Within that, there have been surprises, however. We have seen quite a strong recovery and strong growth in services exports for the UK, whereas manufacturing has been doing relatively poorly. There are encouraging signs on the services side, as well as what I would call predictable challenges with manufactured exports. However, so far, what we have seen does not lead us to change our view that, in the long run, Brexit will have the effect that we anticipated on trade and on growth.

Michelle Thomson: Thank you.

The Convener: I have a few more questions.

It is interesting that, 10 years ago, when Robert Chote used to give evidence to the committee, productivity was a bugbear, and there were a number of suggestions about how we could improve it—everything from further investment in research and development to new technologies.

Since then, there has been the growth of working from home. A few weeks ago, *The Economist* suggested that working from home reduces productivity in the medium term by an average of about 19 per cent. I do not know whether you want to comment on that. *The Sunday Times* certainly touched on that on Sunday, in its report about the UK's 552,000 civil servants.

You predicted that there would be an 85,000 head count increase in unemployment in the first quarter of 2025. How much of that will be caused by a reduction in public sector head count? A couple of years ago, the Scottish Government was looking to reduce the public sector head count to what it was pre-pandemic. It seems to have gone a wee bit quiet on that, and we will probably question the Government about it in the weeks ahead. Do reductions in public spending of 2.3 per cent in the short term and 4.1 per cent in real terms factor into your figures?

Richard Hughes: The situation is driven by cyclical factors. In particular, as David Miles pointed out, rising interest rates are putting financial pressure on firms. It really is just a general cooling of the labour market. The fact that the Government is also in the process of fiscally retrenching will mean that it adds less to aggregate demand in the economy and to demand for labour in that sense. It is certainly not the case that the Government is providing much counterweight to what is likely to be some retrenchment in the private sector, because it is reducing its own spending, as we have discussed, over the next five years. It stands to reason that it will also be constrained in its employment choices—on top of the fact that it has increased public sector wages significantly in the recent past, which means that public sector employment unit costs will be higher.

The Convener: Have you looked at the impact on pensioners of fiscal drag? There has been an 8.5 per cent increase in the triple lock, but that seems to have increased the number of pensioners who pay tax. In 2010, about half of all pensioners paid tax; now, it is about two thirds.

Richard Hughes: We have not looked at pensioners in particular, but it is to be expected that fiscal drag would have its biggest impact on older workers, because they tend to earn more and are more likely to end up in higher tax brackets.

The Convener: You are right, but does it not affect pensioners specifically, because people who have retired have already paid tax and are now having to pay tax on their pensions? Is that not an issue of concern?

Richard Hughes: David Miles might want to say more, but the increase in the triple lock has been generous, relative to what working people have had. The triple lock may well put pensioners into higher tax brackets by virtue of the fact that, every time, they get upratings for either inflation or earnings. However, we have not looked at that in great detail.

The Convener: It is difficult to look at the triple lock, because, certainly, over the past decade, pensioners have become relatively more prosperous than other age groups—than younger people in particular. According to your analysis, the UK standard of living will fall by about 3.1 per cent by 2024-25. Have you looked at how that impacts on different age groups?

Richard Hughes: We have not, but others have done so, particularly because benefits and pensions have been protected against the rise in inflation whereas people who are earning have not, because their wages have not kept pace with inflation. The hit from living standards is particularly concentrated among those of working age.

The Convener: We talked about the GDP deflator. John Mason asked questions about that, and Professor Mills gave us a detailed answer. An issue for me is the unrealistic nature of the GDP deflator, in how it is likely to impact on capital. Over the next four years, it is predicted that the impact of the GDP deflator on Scotland's borrowing would allow the ceiling to go from £3 billion to £3.165 billion, which is a measly cumulative 5.5 per cent over four years. That is now baked into the fiscal framework. Is it in any way realistic?

Richard Hughes: It is partly because we know that the committee is always interested in different kinds of inflation that there is a box in the economic and fiscal outlook document that talks about the implications of different kinds of inflation for the public finances. One of the challenges in that regard is that a lot of what is driving the volatility in tax receipts both in Scotland and in the rest of the UK is the fact that you have had much stronger wage growth recently. That ought to be reflected in a higher GDP deflator, however, because the biggest component of the GDP deflator is higher wage growth.

The Convener: I am thinking about the impact on capital. Capital inflation is running higher than resource inflation, yet the GDP deflator is predicted to grow by only 5.5 per cent over four years. That seems to be nonsense. Anyone who wants to get a house built or a road patched and goes out to tender will not be quoted a 5.5 per cent increase over the next four years, will they? Surely there should be a much more realistic look at how inflation is impacting on capital in particular.

Richard Hughes: We do not use a different deflator for capital—we simply apply the deflator to all Government spending. Sector-specific deflators are sometimes used in contracts, for example in construction or defence. Defence contractors use some defence-specific inflation. The OBR is forecasting at the macro level and not looking at individual projects, so it does not make a lot of sense for us to look at even more specific sectors and specific inflation.

It is certainly the case that headline numbers can hide an awful lot of different trends in different areas. As you said, if, as there has been in the past, there is a higher rate of inflation in the construction and investment sectors, that means that you are that much more constrained in those areas relative to the amount of money that you are getting from the reserve, because that is going up only by the economy-wide deflator.

The Convener: I am glad that you look at it in defence procurement, because the costs for the Ajax project or for certain aircraft carriers have been billions of pounds higher than initially estimated. Of course, that was the case with HS2 as well. All those major projects seem to be hugely over budget.

Incidentally, does the OBR ever look at the price of procurement in the UK relative to other parts of Europe? All capital projects seem to be phenomenally more expensive in the UK than they are in Europe, for example.

Richard Hughes: Because we are doing macroeconomic forecasting rather than looking project by project at value for money—

The Convener: I am thinking about looking in the round and looking not at individual projects but at capital procurement, which is a huge aspect of UK public spending relative to the same projects on the continent.

Richard Hughes: Trying to get some kind of economic return from those projects is certainly a challenge, because the more you spend on them per unit, the less return you get per pound spent. The fact that the spending is falling as a share of GDP compounds that challenge, because if the unit cost is also going up, you are getting even less in terms of GDP.

There was a very good recent study by a gentleman named Bent Flyvbjerg—I am not sure how to pronounce his name; I think that he is from either the Netherlands or Belgium. He did an extraordinary panel study looking at cost overruns on different projects in different countries.

Interestingly, he found that, although the UK has some very big projects that overspend massively, we are not unusual around the world. A lot of countries have mega projects that go over budget by several times, and we are not a particular outlier.

The Convener: I am thinking about how the costs are set initially rather than the cost overruns. When you go out to tender on a project in the UK, it always seems to be 30, 40 or 50 per cent higher—or more—than an equivalent project would be on the continent, even in countries where the standard of living is comparable to or higher than ours. That seems rather odd. I just wanted to know whether the OBR took those kinds of things into account.

I have one last point, because our 90 minutes will finish in about one minute, and I do not want to keep you too long. It concerns what the chancellor did in his autumn statement and how that will impact on the OBR's forecasts in the spring. I want you to comment on what the IFS said. Paul Johnson of the IFS said:

> "In reality debt is set to be just about flat at around 93 per cent of national income"—

we have touched on that—

> "And that is on the basis of a series of questionable, if not plain implausible, assumptions. It assumes that many aspects of day to day public service spending will be cut. It assumes a substantial real cut in public investment spending. It assumes that rates of fuel duties will rise year on year with inflation – which they have not done in more than a decade and they surely will not do next April. It assumes that the constant roll over of 'temporary' business rates cuts will stop. It assumes, of course, that the economy doesn't suffer any negative shocks."

11:00

Richard Hughes: I would agree with Paul Johnson. There are a host of risks to our forecast which, as he pointed out, only sees the chancellor barely get debt falling in the fifth year of our forecast. Many of those risks are exogenous and so come from the outside world—the uncertain geopolitical situation, the uncertain interest rate outlook and the uncertain inflation outlook—but some of them are risks that the Government generates for itself. The classic one of those in our forecast is fuel duty. The Government always claims that it will index it to inflation, but it never does, and then it loses about £6 billion-worth of revenue as a result.

The fact that the Government also does not set out detailed spending plans beyond March 2025 for the major public services also poses a risk for delivering what is implied in the totals, which is a big reduction in the growth rate of spending on those services. It stands to reason that the longer we wait to set out detailed plans with specific implications for health, education and transport, the less likely it is that those plans will be delivered in practice.

That in turn poses another big risk to the realisation of our forecast, which is that, if the Government cannot stick to its quite tough plans for public spending and public investment, the chancellor's ambitions for debt will not be delivered.

The Convener: Does Mr Hughes or Professor Miles have any final comments? Are there are any areas that you feel we have not touched on that you want to emphasise?

Professor Miles: I have a comment on Paul Johnson's somewhat pessimistic assessment of the outlook. Everything he says is right, but there is an upside as well. The final chart in the rather long report that we put out after the autumn statement is the most important chart in the whole document. It is on page 145, which many people will not get to, because it is the last page. It shows that there is a sort of symmetry: there is an upside and a downside to a lot of the biggest risks that the UK faces.

One can certainly envisage situations in which things turn out to be much more difficult than the central forecast in our analysis, but there are some situations that, if they transpired, would generate much more favourable outcomes. We mentioned what is probably the most important of those things, which is productivity. It is not obvious that the next five to 10 years will be as dismal as the last 15. There must be a risk—and it is a good risk—that things will be much more like the long-run average. If they are, that will be quite transformational, in a positive direction, for the fiscal outlook. It is not all doom and gloom.

The Convener: Let us hope not. I thank our witnesses very much for answering our questions so succinctly and comprehensively. I also thank Mr Josephs and Mr Hughes specifically for coming to Edinburgh, and I hope to see Professor Miles in Edinburgh next time.

11:03

Meeting suspended.

11:09

On resuming—

The Convener: We move on to the second part of our evidence session on the UK autumn budget statement and the wider UK context. We are joined remotely by Carl Emmerson, deputy director, and David Phillips, associate director and head of devolved and local government finance at the Institute for Fiscal Studies. Good morning, and

I welcome you both to the meeting. I am glad to see that you are sitting together; that should make life a wee bit easier.

I will start where we left off. I quoted Paul Johnson's response to the autumn statement to witnesses from the OBR, who gave evidence just a few moments ago. Professor Miles said that he thought that the IFS was being "somewhat pessimistic" in its outlook. What is your view on that?

Carl Emmerson (Institute for Fiscal Studies): We have some forward-looking fiscal targets, which there are some merits in having, because they allow the Chancellor of the Exchequer time to adjust if there is a shock. The forward-looking nature of those targets means that they have much to commend them. However, one of the downsides of a forward-looking fiscal target—we will borrow less than X in five years' time or debt will be falling in five years' time—is that you need a credible set of tax and spending plans that apply to a credible set of economic forecasts.

The future is always uncertain. Professor Miles was right to point out that there could be a recession and weak productivity growth but that we could also get much higher productivity growth. Things could be much better than we expect, and I certainly accept that. Where I would question the chancellor's plans is around some of his stated policies on tax and spend, and whether they are credible. We know that, under his stated plan, fuel duty will go up by 5p plus RPI this coming April and then by RPI every year going forward. However, we also strongly suspect that that will not happen and that we will continue to freeze fuel duty, which will reduce revenues by about £6 billion by year 5.

The temporary business rates reliefs that were introduced during the pandemic, for good reason at that time, keep being extended by a year, and we suspect that they might continue to be extended, again reducing tax revenues.

On the spending side, we do not know whether the Government will be able to deliver the spending plans that are set out beyond March 2025, but they look incredibly tight. They imply a return to austerity for some Government departments and the Government has not set out any detail about how it intends to apply those spending plans, so I think that they are also pretty questionable.

We know that, since 2010, when Conservative chancellors get to a spending review, they have often topped up the spending plans before they divide the cake between spending departments. We would not therefore be surprised—we think it is more likely than not—that fuel duty and business rates will rise less than the forecasts suggest, and that we will end up spending more on day-to-day public services than the forecast suggests. Our central assumption is therefore that the forecasts are a bit optimistic on those grounds.

David Phillips (Institute for Fiscal Studies): What we saw in the autumn statement was quite a big upwards revision in inflation forecasts for 2023-24, but no upwards revision to spending plans this year, next year or in the longer term to account for that. With higher inflation, we had higher revenues coming through from the fiscal drag through the freeze of the income tax thresholds and things like that, but there was no increase in spending to offset that. If the chancellor had wanted to offset the impacts of inflation, around £19 billion would need to have been added to the public service spending totals for next year and beyond, but we did not see that. Instead, the headroom that was created by the extra fiscal drag slightly improving the underlying forecasts was used for some discretionary tax cuts on corporation tax and national insurance.

Carl Emmerson: The risk there is quite clear. We are paying for tax cuts that we almost certainly would like to have. Lower national insurance contributions and a more generous regime in corporation tax for investing are nice to have, but they have a certain cost to public finances. How are they being paid for? It is an uncertain saving, because we do not really know that we are going to be able to keep to the spending plans, which are now tighter than previously implied because of the higher inflation.

The Convener: In his response to the statement, Paul Johnson said that fiscal drag is now running at £50 billion, and £14 billion of that is since March. That puts into perspective the £10 billion or so cut to NIC.

We discussed this to some extent in the earlier session, but you also say that the number of people who are on incapacity benefit and related universal credit has increased from around 1 million people to about 2.4 million during the past decade. Is that trend likely to continue, or will it reduce or stay the same? Where do you think we are with that, and what impact will it have on public finances?

11:15

Carl Emmerson: We have certainly seen big increases in the numbers on incapacity and disability benefits, both in the period since 2010 and particularly since the summer of 2021, in which period the numbers of new claims for those benefits have been running well above pre-pandemic levels. That has a number of consequences. Clearly, it is very bad for those individuals. If they are in worse health, that is disastrous for them. However, it also has a public finance consequence, because those people are not just making claims for those benefits; they are being successful in those claims and getting extra money from the Exchequer.

The forecast assumes that there will be pretty strong growth in the numbers of people claiming and, therefore, in spending over the next five years. However, there is a lot of uncertainty around that. It could be that we will see an upward revision yet again. That has certainly been the pattern over the past 10 years. However, it is also possible that we will see a slowdown—let us hope that we do—relative to the position since the summer of 2021.

There is one thing that I would caution against. The Government has announced a couple of reforms, but the history of reforms in this area shows that, when reforms are implemented that are intended to reduce the number of claimants and reduce spending, they have often not been anywhere near as successful on those grounds as was hoped. One lesson of history is that, when we try to change the system to reduce the number of claimants or reduce spending, we often fall short of what we expect. I would not put too much hope in the idea that the reforms will lead to a big saving.

David Phillips: The chancellor has announced a change to the work capability tests, which basically makes the system more stringent. The OBR forecast assumes that those plans would freeze or stop the further increase in the number of people getting the most support. I guess that Carl Emmerson is saying that that was meant to be the plan with the personal independence payment. That plan was meant to lead to a reduction—of 20 per cent, I think—in the number of claimants, but instead the number continued to rise. There are risks related to the downside, by which I mean higher numbers of claims and higher spending, rather than lower numbers of claims and lower spending than in the central projection, although the changes are intended to arrest those increases.

The changes to the incapacity benefit rules will apply in Scotland because universal credit is still a reserved benefit. Some changes that are potentially even more radical are coming down the line as regards the tests that determine whether people will get the disability elements of universal credit. Rather than there being a separate work capability test, the system will rely on the disability tests that are used for PIP. However, PIP is, of course, devolved to Scotland and is being replaced by adult disability payment. It is therefore not clear at this stage how the changes will apply in Scotland.

The Convener: I was going to move on to discuss social security, so I am glad that you have mentioned that. The problem with social security benefits, of course, is that they are demand led. How do you see the Scottish Government being impacted over the next year and beyond by the increase in the number of people who are seeking benefits? Where do you see that going?

David Phillips: Universal credit, including the incapacity benefits, is still a reserved function. Any changes in demand for universal credit or employment and support allowance will be covered by the UK Government. That matters to people in Scotland because the new tests will affect them if they are unwell and they need to claim benefits.

The bigger issue for the Scottish Government's budget is what is happening with the number of claims for, and the cost of, adult disability payment versus PIP. It is still forecast that PIP expenditure and claim numbers will increase over the next few years. The forecast expenditure is revised upwards in the autumn statement, although that is largely related to inflation rather than to the numbers of claims. What will matter for Scotland, as ADP is rolled out, is how the numbers of successful claims and their durations change relative to PIP.

Previously, the SFC forecast that, because of the changes in the eligibility conditions and how claims are assessed and reassessed, there will be more claims, more successful claims and longer claims in Scotland's disability benefits system. Actually, I think that that is part of the policy aim. The Scottish Government wants to have a system that is more people centred and less stressful, and which takes more account of people's circumstances.

If there are more successful and longer claims, that will push up costs. We now have a few months of data coming through, and we hope that the next set of SFC forecasts will give some indication about the extent to which things are coming forward in the first 18 months or so of the roll-out of ADP. Will the figures be in line with the forecasts? Will there will be somewhat more expenditure on claims? Are the numbers running ahead, or is the situation not as bad as that? It will be important to see, in the forecasts next week, what the potential implications are for the Scottish Government's budget.

Carl Emmerson: I suspect that for disability benefit claims, where there has been even bigger growth than for incapacity benefit claims, there is more uncertainty about where we will land in five years' time. There is more uncertainty around the bit that has been devolved to Scotland and it looks as though there is more growth in cost pressures there.

The Convener: We will be taking evidence from the SFC next week. Is it your view that there are likely to be tens or hundreds of millions of pounds of additional expenditure in the years ahead?

David Phillips: The total volume of expenditure will grow by hundreds of millions of pounds in the coming years, partly because of inflation and partly because of increases in the volume of claims. I would not want to say whether I think that that is running ahead or behind in the SFC's previous forecasts. By the end of the forecast horizon, I think that there will be about £500 million more expenditure per year than for the equivalent UK benefits. That is an increase of about 20 per cent above UK expenditure levels. It is not clear to me yet whether that is in the right ballpark or whether the amount will be higher or lower than that. I would wait until the forecasts come out next week.

The Convener: I will move on to debt interest. One obvious concern is the fact that debt interest is increasing and national debt is now at 93 per cent of GDP. I understand that the cost of servicing that debt is about £116 billion this year. Could you discuss what you feel the impact of that will be for the next year or two and beyond?

Carl Emmerson: The fiscal situation is incredibly challenging. We know that the UK Government has accumulated a lot of debt through the financial crisis, the pandemic and now the cost of living crisis. That is all for good reasons. It is understandable that when a big, bad shock hits we want to support households, businesses and public services. Through the 2010s, that big increase in debt did not lead to an increase in debt interest spending because the Government was able to borrow so cheaply. Now, interest rates are much higher. Also, the way that quantitative easing works means that increases in interest rates feed much more quickly into increases in the Government's debt interest bill.

It looks as though debt interest spending will be running at close to 4 per cent of national income over the next few years. That is about 2 per cent of national income more than what we were used to through the 2010s or what was projected for now, back before the pandemic hit. An increase in spending of 2 per cent of GDP on debt interest is a huge amount: it is equivalent to what we spend on the defence budget in its entirety. There is a big fiscal pressure there, and that is combined with a weak growth outlook. A big increase in spending on debt interest alongside a pretty weak outlook for GDP growth translates into a very tricky fiscal situation.

David Phillips: We have seen a substantial increase in the tax burden during this parliament, with a long-run increase of around 4 per cent of GDP. The 2 per cent increase in debt interest spending is around half of the increase in tax that we have seen during this parliament.

The Convener: I think that the debt interest in the UK is now about six times Scotland's annual expenditure on the national health service, which puts things in some kind of perspective.

You have touched on health and social care spending in relation to departmental expenditure limits, saying that it is

"reaching 45 per cent of total resource DEL"

compared with

"25 per cent at the turn of the century."

That is clearly on an upward trajectory. Given the fiscal position that we are in, how sustainable do you believe that to be?

Carl Emmerson: There are clearly lots of pressures on the NHS budget, with the challenges of an increasing number of older people. The baby boomers are reaching the point in their lives when they will put increasing strain on the NHS. In the NHS workforce plan, the Government has very commendably set out what it thinks the NHS will need by way of workforce over the next 10 years.

Rather shockingly, that is the first time in its history that the NHS has produced a long-term workforce plan, so that is well overdue and very welcome. Both the Conservative Party and the Labour Party have signed up to that plan. We estimate that funding the plan will require something like 2 per cent extra of GDP to be spent on the NHS in about a decade's time—about £50 billion a year. That is sustainable if we want to do it, but it gets increasingly difficult to say, "We'll fund that by cutting spending elsewhere."

If you look back at UK history, we have seen NHS spending grow as a share of GDP but we have cut defence spending pretty dramatically since 1983 as we have reaped the rewards of ending the cold war, getting peace in Northern Ireland and so on. We are now one of the few countries that is complying with the NATO commitment to spend 2 per cent of GDP, but only just. It seems unlikely that we will be cutting defence spending. Indeed, the chancellor has spoken about the need to increase it.

I can see a world in which we increase NHS spending. However, it is really challenging to see how we would do that without increasing the overall size of the state further. Of course, the flip side to that is that the UK tax burden is already high by UK standards. Do we as a country want to make the choice to push it up even further? I would not be surprised if we do make that choice, but there are clearly other options available.

David Phillips: I will add another one or two small points on the overall pressures on NHS spending. It is correct that demographics is a key pressure, but a large part of the spending will be on the predicted increase in the unit costs of the NHS. Traditionally, health productivity rises by even less than productivity in the rest of the economy—which has been pretty weak, as we know, over the past decade and a half. Therefore, in order to maintain wages in the NHS, if productivity is not going up, you are increasing your unit costs.

At the end of the first session, David Miles made the point that we need to look at the extent to which we can try to eke out what productivity growth we can and at the way that new technology can improve that. That is a really important focus. Whether we can substantially reduce expenditure on the NHS because of it, I do not know, but it is a key issue.

Colleagues at the IFS have looked at what increasing the NHS budget over the next spending period might mean for other service areas. These figures are for England but they would be fairly similar for Scotland, I think. The NHS workforce plan would require an increase in spending for the NHS of about 3.5 per cent a year, but if you throw in school spending, maintain commitments on defence and the Foreign Office and add the new childcare commitments in England, that would mean other services seeing cuts of 3.5 per cent per year, so there would be quite substantial cuts outside the NHS. In Scotland, the figures would not be exactly the same, but if, again, increases in NHS spending were around 3 to 3.5 per cent in the next spending review period, that could imply cuts to many other services of around 3 to 3.5 per cent.

The Convener: Carl, you said that there are options other than raising tax, which I find intriguing. What are those other options?

Carl Emmerson: We could make the choice as a country not to accommodate the extra pressures on the NHS and instead to opt for a less comprehensive, less good NHS than what is implied by the workforce plan. As I said, I would be surprised if we were to go down that route. The Conservative Government and the Labour Opposition, I believe, have signed up to the NHS workforce plan, so it is not what they want to do, but it is an available option.

We could start to look at other parts of what the state does and decide that we want to cut them back. I would caution against the view that we just need some efficiency savings; something on a bigger scale would be required. We would need to look at something big that the state currently does—from the education budget, the defence budget, or the social security budget, maybe—and decide that we do not want to do that any more, because we want to use that money to finance our NHS. Such options are available to us, as a country, if we want to take them. I do not think that it is likely that we will take one of those options, though.

David Phillips: There are a number of areas to consider on the tax side. Rather than just looking at tax rates or tax thresholds, there could be opportunities for a fundamental reform of taxes. One area that is ripe for reform in England and in Scotland is property tax. You could reform the property tax system to revalue council tax and make it more proportionate. You could raise more through council tax and less through stamp duty or, in Scotland, land and buildings transactions tax. Because that system would impose less cost on the economy and would penalise people less for moving around, for taking new jobs, and for trading up and trading down, more could be raised for less efficiency cost. Therefore, rather than just considering tax-rate changes and freezing thresholds, we should consider whether we can reform the systems to make them more efficient and, thereby, raise more for smaller economic costs and smaller distortions of the economy.

There are things that we can do in relation to property tax and taxation of various forms of remuneration, such as earned income and self-employed income dividends. We could make changes to corporate tax. There is also further to go with regard to changes that the UK Government recently made in relation to full expensing. Changes could be made to inheritance taxes. A host of things can be reformed beyond tax rates and bands.

11:30

The Convener: I have two more questions before I open up the discussion to other members. One is on capital. You touched on the full expensing policy. That will be a £3 billion tax cut, but corporation tax is going from 19 to 25 per cent, which is an £18 billion tax hit. What impact, if any, has that corporation tax rise had on investment? What is your view of the impact of flat cash for capital investment in relation to UK infrastructure and growth?

Carl Emmerson: On the corporation tax changes, the rate rise will raise a lot of money in the near term. There is, however, good economic evidence that a higher corporation tax rate will lead to a reduction in investment in the longer term; it will hit productivity a bit. That tax rise might raise some money in the long term, but not as much as it will raise in the near term.

I also criticise the Government for not having a strategy. Through the 2010s, Mr Osborne, when he was Chancellor of the Exchequer, said that his strategy would be to cut the corporation tax rate and broaden the base, and we followed through on that. We had a credible plan for what we would do to corporation tax to try to give certainty to those who were looking to invest in the UK.

Over the past couple of years, we have seen anything but a consistent corporation tax strategy. We had the increase in the rate from 19 to 24 per cent that Chancellor Rishi Sunak announced: Kwasi Kwarteng then reversed that. Then, on his first day in the job, Jeremy Hunt said that he would reinstate it. We had the big introduction of the superdeduction to try to undo some of the harm that had been done by pre-announcement of the corporation rate rise by Rishi Sunak. Then the full expensing policy was announced and implemented.

We could have introduced a more coherent package of reforms by considering a strategy and working out what we wanted to do and what tax base we wanted. That might well have incorporated some elements of the full expensing policy. We could have a more generous corporation tax base—there is a case for that—and we could, at the same time, decide to make the rate a bit higher.

However, the journey that we have gone on is probably harmful to investment in the UK because we are not providing certainty to investors. Will a big multinational company that is thinking about investing in the UK believe that the current UK corporation tax system will stick for the next three, four or five years, or might it worry that yet more changes could be coming? That might make some shy away from making that investment choice.

David Phillips: We have said that the move to full expensing is, on balance, a good thing. It removes a big disincentive to make marginal investments funded by equity or cash in the bank, so it is expected to increase investment, rather than it not happening. I do not have figures to hand about whether that offsets the reduction in investment because of the higher corporation tax rate but, on its own, it is expected to increase investment by what looks like a fairly modest amount—let us say a boost to GDP of 0.1 per cent by 2028. That seems like a small amount, but it is about £3 billion, which is fairly similar to the £3 billion long-run cost of the policy. Therefore, it is not a big cost for little gain.

However, I agree with Carl Emmerson that it is only one part of the reform that is needed, because the full investment allowance—full expensing for plant and machinery—means that there is now a big incentive to invest in plant and machinery and not in buildings, for example. Therefore, if it is more profitable to invest in buildings, there is now a tax incentive not to do that but to consider investing in plant and machinery instead. That means that we are distorting investment decisions.

There is now an even bigger subsidy for certain kinds of investments that are funded by debt. If businesses are using debt to fund their investments, not only can that policy increase the incentive to be overly leveraged, which might increase the risk to businesses, but it means that they might invest in things that do not have a payback, because they get no tax incentive to do that.

Therefore, I think that this is very much one stage of tax reform, and that more needs to be done to look fully at all the different parts of the tax system. I agree that we need a strategy for corporate tax, and not a series of ad hoc changes.

Carl Emmerson: You asked about public service investment plans, too. Public sector net investment in the UK has been remarkably volatile from year to year; however, it has been increasing over the past couple of years, and at the moment we are investing quite a lot more than we have done on average over the past 40 years or so. Since 2019, the Government has been increasing investment spending pretty sharply and is now delivering what is, by UK standards, quite a high level of investment.

However, I find it disappointing that, having got investment levels up—and for good reason—we are now pencilling in a plan that involves investment being frozen in cash terms and being cut pretty substantially as a share of GDP over the next five years. That would return it roughly to the long-run average, but it seems odd that, having gone to all the effort of ramping up investment spending and having made the arguments for why we need to invest more as a country, the Government is suddenly saying, “Now we’re going to freeze it and cut back.” Again, it looks as if, as soon as we hit a fiscal challenge, investment spending is one of the easiest things to cut.

The Convener: Yes, but that is not good for long-term growth, is it?

This will be my final question before I pass on to colleagues. The OBR has predicted a 3 per cent reduction in living standards in 2024-25 from pre-pandemic levels, but when we asked it to advise us on the impact on different age groups, it was unable to do so. Does the IFS have any detail on how the reduction will impact on different age groups in society?

Carl Emmerson: That is not something that we have done on a forward-looking basis. It is certainly the case that we have had, since 2008, terrible growth in living standards and that, over the same period, the working-age population has done worse than the pensioner population.

That is down to a combination of things. First, the period of very low interest rates has benefited people who have assets, and pensioners and people who are approaching retirement typically have more assets than younger individuals. Moreover, when you look at some of the very big calls that have been made by the Government, during the decade of austerity, on which areas of spending to protect relatively and which to cut, you can see that the cuts were clearly targeted more at working-age individuals than they were at pensioners. We have made the state pension system more generous while making the working-age benefit system less generous through reforms.

David Phillips: When we look over the period, we can see two areas of costs that are going up quite substantially but to which pensioners are, I guess, less exposed than the working-age population. They are private sector rents and, because of higher interest rates, mortgage costs. I would not want to say that that means that pensioners have done better overall than the working-age population, but on the basis of those two factors alone, the fact that most pensioners own their homes outright while those who rent tend to be more in the social rented rather than the private rented sector means that, as far as housing costs are concerned, there will be less pressure on pensioners than on the working-age population.

The Convener: Pensioner poverty is a reality in many communities in many parts of the country but, according to *The Economist*, half of the 14 million pensioners in the UK do not have any housing costs, because they have paid off their mortgages.

I am now going to open out the session. I call Liz Smith, to be followed by John Mason.

Liz Smith: Good morning. I want to ask you about a comment that your colleague Paul Johnson made, which was that he felt that Mr Hunt was on course—just "on course"—to meet what he described as

"his (poorly designed) fiscal rule".

What do you feel is "poorly designed" about it, and what would you like to see instead?

Carl Emmerson: The chancellor has said that he wants debt to fall over the medium term. I think that there are very good reasons for having such an aim. As we know, and as recent history has shown, when a bad shock comes along, the Government steps in and helps people, and Government debt goes up as a result. In short, therefore, whenever there is a bad shock, we are going to increase Government debt. That means that, in the good years, when we can look forward and do not expect a bad shock to happen, we should be aiming to get debt down in order to create the headroom that will allow us to increase debt again the next time a bad shock does, unfortunately, come along. Therefore, I agree with the principle behind the fiscal target—I think that aiming to get debt down is a good idea.

What I have a particular problem with is the idea of aiming to get debt down in year 5 of the forecast horizon. Taken literally, that means that debt in March 2029 has only to be lower as a share of GDP than debt in March 2028. There is nothing particularly magic about those two dates. Taken literally, that target would mean that it was okay if debt was rising considerably, falling for 12 months and then rising again, whereas it would not be okay if debt was falling sharply, ticked up slightly and then fell again.

There is something rather odd about that particular lens being focused on that two-year period, and there is something a little bit odd about that also being predicated, as I said earlier, on some plans around fuel duty and business rates that are questionable, and some plans for day-to-day spending on public services that are also pretty questionable. The chancellor's principle behind his fiscal target is a good one, but the specific operation of it is not good; it has been poorly designed.

The chancellor is meeting the target by a hair's breadth, but that position is really volatile in the sense that what we assume about growth in the economy in that last year really matters. If the OBR said that growth was going to be a little bit higher in that last year, the chancellor would have loads more—quote, unquote—"headroom", but I do not think that that should have been used to cut taxes or increase spending. If the OBR had been slightly more pessimistic about growth in that last year, that could easily have wiped out the supposed headroom.

Liz Smith: Thank you for that. Therefore, there is a problem with regard to the timescale but you also feel that it is not sufficiently diverse in its targets—it is too tight. Is that what you are saying?

Carl Emmerson: In a sense, it is loose in that it is about getting debt down only in five years. Previous fiscal targets that Gordon Brown, Alistair Darling and George Osborne set were tighter than that. I think that the chancellor has set himself the loosest fiscal rule of any chancellor in modern history so, in that sense—

Liz Smith: I am sorry. May I come back on that? You are arguing that there should be other factors in improving that fiscal rule, so I am a bit confused as to why you think that it is too loose, when you feel—

Carl Emmerson: It is loose in the sense that it allows him lots of wiggle room over the next five years. Debt is only barely falling and it is, in fact, arguable whether debt will be falling in five years' time. I do not think that it is very challenging to say, "Oh, we'll just have debt falling in the fifth year." You could ask why it should not fall in four years, so it is a pretty loose fiscal target. What I do not like about it is the way that it has been operationalised—specifically the fact that debt must fall only in the last year and the idea that that will mean that everything is okay. That is rather odd as a fiscal target.

We want fiscal policy to be set so that we have debt on a decisively downward trajectory over the medium term. I do not particularly care about year 5, provided that debt is on a decisively downward trajectory over the medium term in a credible way, based on credible plans. That would make me much happier.

David Phillips: I am maybe going to go slightly off script here and give a personal view on how the fiscal rule is operating. The idea behind fiscal rules is that they provide something of a straitjacket for chancellors so that they are constrained from being too profligate with regard to cutting taxes or raising spending. Recently, my concern has been that it is being seen not as a constraining fiscal rule, but more as a target that must be met, which means that if any headroom opens up, we spend it, either on extra spending or on tax cuts. Rather than focusing on whether debt is falling just a little bit in that final year, we need to ask whether that is sustainable.

My personal view is that there is a question about whether a numerical target for five years' time is the best way to do that. Should we be looking at something a bit more holistic, and asking whether the policy is actually substantially reducing our debt costs in the good times so that, in the bad times, we have headroom to deal with the shocks?

Liz Smith: That is very helpful, because I think that that is about factors other than those in the current set-up.

I asked the OBR witnesses this morning where they feel we have the greatest challenge when it comes to productivity, in terms of unemployment and the participation rate. I would also like to ask you whether you detect, in the slight increase that is forecast for unemployment, that that will happen on a UK basis, or are there particular aspects that mean that unemployment in some parts of the UK is rising faster than it is in others, and that different sectors are showing different trends?

Carl Emmerson: The challenge that the UK has is not so much about formal unemployment. It is about the number of individuals who are out of work but who are not formally classified as unemployed—for example, people who are out of work because of sickness or disability. It is a huge challenge, and the problem has got a lot worse in recent years.

11:45

The second challenge is about knowing how those who are in work are progressing, how much they are earning and how we can get productivity growth because, ultimately, that is what is going to be needed to fuel wage growth. Those are the UK's two key labour market challenges.

First, we need a strategy for getting people who are out of work and are economically inactive into work. Secondly, we need to know how to help those who are in work to progress, and how we can get the productivity gains that can ultimately deliver wage gains. We have done the latter particularly badly during the past 15 years.

Liz Smith also asked about the labour market. One of the challenges is that our data on the labour market is being exposed as being quite poor. The response rate to the labour force survey—LFS—has gone down massively. The information that we get from it and the data from the HMRC's real-time information, for example, are often completely inconsistent. For example, based on the labour force survey, Scotland seems to have had an improvement in its labour force participation and employment relative to the rest of the UK since before the pandemic. It shows that the number of employed people is going up in Scotland, but has fallen slightly in the UK. However, HMRC data shows that Scotland has the lowest increase in employment of any region in the UK—2.7 per cent compared with about 4 per cent in both England and Wales and 6 per cent in Northern Ireland.

At the moment, I would not want to say that we are flying completely blind, but we are certainly flying with blinkers on when it comes to the labour force and labour market position.

Liz Smith: We were talking about that earlier. Obviously, different interpretations can be made of the data that is available to allow the OBR to make its predictions. You are absolutely right to say that the biggest challenge for the UK economy, in order to increase productivity, is to ensure that we get far more people back into the labour market than we have at the moment. However, different age groups seem to have different reasons as to why they are out of the labour market. That is a really big challenge.

Different policies will have different effects on younger cohorts or on older people who are approaching retirement and who happen to have taken it early because of the pandemic. I am interested in what policies we should be pursuing, especially if there are different reasons for people being out of the labour market. Are there specific trends that we should be wary of?

Carl Emmerson: We have observed an increase in the number of people who are out of the labour market for reasons of sickness and disability across all age groups. There also seems to be growth in the number of people out of work for physical health problems and in the number of people out of work for mental health problems.

There seems to be a particular challenge around a group of people who moved out of paid work and subsequently became sick or disabled. That might point to policy challenges, as we might need to engage more with unemployed people before they develop depression or other health problems. The story is not quite as simple as people in work getting ill and leaving the labour market; it is a more complicated story than that.

The other group that people often point to is older people who have left the labour market and who classify themselves as early retired. It is much harder to imagine policy levers that we can pull to get that group back into the labour market, because they have made what looks like a choice to leave the labour market. We might worry about whether that is a choice they will always be pleased with or whether they will regret it in a few years. We have to consider the advice that we provide to them about accessing their pension early, and ensure that if they access a defined-contribution pension they will not subsequently regret it, and that they will not wish that they had remained in the labour market for a bit longer. Often, those individuals are not customers of the DWP, so it might be harder to work out what policy lever we would pull and how we could best engage with them.

John Mason: I will ask you some of the same questions that I asked the first panel, so if you were watching, you will know what they will be.

My first question is on debt interest. I think that it was in March that the OBR forecast debt interest to be £94 billion. Now, it is saying that the figure will be £116 billion for 2023-24. When I asked the witnesses from the OBR about that, they just said that they follow the markets and that that is what the markets said. Should the OBR be able to forecast a bit more accurately on a figure like that?

Carl Emmerson: There are two reasons why debt interest spending is a lot higher than what the OBR thought that it would be back in March. First, inflation has been far more persistent than the OBR forecast and a quarter of the Government's debt stock is tied to the RPI measure of inflation. The OBR's March forecast, which showed inflation dropping very sharply to very low levels, looked rather odd in my opinion. For example, if it had looked at the Bank of England's forecast for inflation, it would have seen a less quick and less sharp fall, even at the time, let alone what has materialised. Perhaps it should be asking itself questions about its inflation forecast, which has consequences for its debt interest forecast.

The other component of how the OBR forecasts debt interest is simply to take market expectations of interest rates. That is literally what people are betting on interest rates being. The OBR is basically saying, "Let's assume that the market is wise. We don't have more information than what is out there in the world. People are trading on the idea that interest rates will be at a certain level over the next few years. We'll just take the average of those interest rates over a window before our forecast is produced." I have some sympathy with that method of taking the interest rate for its forecast. It might be quite difficult for the OBR to say, "The market expectation is this, but we take the view that interest rates will be higher or lower than what market participants think." I have sympathy for that part of the OBR's forecast, but I have perhaps a little bit less sympathy around its inflation forecast as of last March, where its view on how quickly inflation was going to fall looked a little odd.

David Phillips: As was its view on how low—down to 0 per cent—it would fall.

John Mason: You have got a lot of faith in the market, which maybe I do not entirely share. Is that not the same as following the bookies, which is to do with what is popular rather than what you are expecting.

Carl Emmerson: At one level, if you took a different view to the market and you were right, you could make a rather large sum of money by betting on your view.

To partly agree with you, if you ask economists who work in the city what will happen to the Bank of England's interest rate over the next few years, they think that it will run lower than what is implied by taking the market expectations.

It is noticeable that taking the bookies approach, if you like, and seeing what people are betting on seems to imply a higher level of interest rates over the next few years than is the case were you to speak to city economists who have been thinking about the issues. The OBR could go in the direction of surveying some people and considering that alongside the market expectation.

At the moment, it is also true that interest rates and market expectations of interest rates are not just high but pretty volatile and they move around a lot. In part, it might be that it is harder to forecast interest rates at the moment. Therefore, whatever method you come up with for forecasting, we should not be surprised if it turns out to be wrong. That is in comparison with what we were used to before the pandemic, when it was perhaps much easier to forecast interest rates and things did not look as volatile. There has been a tremendous amount of volatility in interest rate expectations over the past couple of years.

John Mason: Okay; fair enough.

The suggestion is that the UK is more index linked and that other countries have got more fixed rates. They are gaining at the moment but, in the long run, they will have to pay more, we will pay less and it will all even out. Is that a fair assessment?

Carl Emmerson: That is a fair assessment. Whoever ends up winning or losing will depend a bit on whether inflation turns out to be higher or lower over the long run than what was expected when the Government sold the gilts. However, we should not worry too much if our higher exposure to index-linked gilts turned out to be a bit expensive for a period like the current one. Equivalently, when we have a period of negative inflation or low inflation, we will be gaining from that, as we will have done in many years of the past decade.

It is a bad time for the UK in terms of debt interest. Part of that is a temporary bad time. I would not worry too much about the big spike this year. I worry much more about debt interest spending as forecast in three, four or five years' time, which is after inflation drops back to normal levels. At that point, we still expect to be spending about 2 per cent more of GDP on debt than we were expecting to spend before the pandemic.

We are spending more on debt. As I said earlier, the increase in debt interest spending is about the size of the entirety of the defence budget. That is a medium-term challenge. I worry about that a lot more than I do about the huge spike in debt interest spending that we had last year and this year, which I think is largely temporary, as inflation will work its way through the system and will drop back down to something like more normal levels.

John Mason: On the subject of inflation, we have the GDP deflator. I was somewhat surprised that the OBR said that that was 5.7 per cent in 2022-23 but says that it is now 6.7 per cent. That is a reasonably big difference compared to the past. Is the GDP deflator a vague figure that we are not very clear about at any given point? As I understand it, the UK Government uses that figure a lot. Does that have an impact on spending?

Carl Emmerson: The upwards revision to the GDP deflator in both the previous and current financial years has been absolutely huge. There was an incredibly big upwards revision in the OBR forecast, which tells us that, at the moment, we are experiencing not only high inflation but a complicated mix of inflation, much of which is driven by increases in the price of imported goods such as energy and food. That has a very different effect on household inflation than it does on the GDP deflator and it is very difficult to be right about how that will work through into the GDP deflator. That is what the OBR struggled with.

My approach is to look at what other people are saying. If you look at the OBR forecast for growth or for the CPI, you could look at what the Bank of England thinks, or at what other city forecasters think. However, as far as I can see, no one else is trying to forecast the GDP deflator, so the OBR cannot do a sense check by asking what others are saying, whether it agrees or disagrees, and, when it disagrees, whether it is happy about why it does so. That external view does not seem to be there for the GDP deflator, which makes it hard for the OBR. When the OBR is thinking about the Bank of England's views about the CPI or growth, it can at least look at forecasts and know that it is more optimistic than the Bank for certain reasons, or that it disagrees with the Bank for certain reasons, but it cannot do that with regard to the GDP deflator.

David Phillips: Unlike CPI, which is estimated and can then be revised but is more or less fixed, GDP—both at the cash level and in the sense of what is real versus what is caused by inflation—is subject to revision and can remain so for years after the initial figures. We saw a change of around one percentage point for 2022-23. It is worth noting that, back in March, we did not have figures for the final quarter of that financial year and that the first estimates for quarter three of that year would also have been pretty uncertain at that point, so the figures can move around a lot.

The much bigger revision is not the one for last year, but for the current financial year 2023-24. As I said earlier, when we have upward residual inflation, we know that the money to be spent on public services will go less far than was initially thought. One of the most obvious areas where we see that is in public sector pay, which has gone up to compensate households and workers for higher consumer price inflation, creating an additional pressure on budgets that was not there, or was not expected to be so high, back in March.

The UK Government uses the GDP deflator a lot, but it is also used in the Scottish Government's own presentation of the budget. A lot of the figures in the Scottish Government's budget for 2023-24 were for real-terms increases of certain amounts for different departments, but we now know that those increases will be much smaller because of higher inflation and that the Scottish Government has not had the resources to top up those budgets because of the fiscal framework that it operates within.

John Mason: Is there any backdating? Does revising the GDP deflator have any practical effect?

David Phillips: If the GDP deflator is revised, that changes our assessment of how big the economy is now compared to its size in the past and how high the price level is now compared to the past. It is for the Government to decide whether to revise its spending totals. In the current financial year, it does not make sense to revise those based on the GDP deflator, although it may make sense to revise them based on the actual cost pressures to the public sector. For example, additional funding was found for pay deals in the NHS in England, which generated consequentials, but the autumn statement provided no additional funding for other departments.

It has slightly revised cash increases in spending from 2024-25 onwards, because it has revised the GDP deflator from then onwards. However, it has not revised the 2024-25 baseline figure despite the fact that it increased forecast inflation last year by 1 per cent and this year by closer to 3 per cent. The £19 billion cut in the real-terms value of public spending comes from the fact that it has not revised the figure for that base year to account for the higher inflation that we have seen in the past two years.

12:00

John Mason: I will move on to full expensing. The OBR seems to feel that that will bring a bit of a hit in the short term, in that businesses will not bring forward capital expenditure, but that it will be beneficial in the longer term. I did wonder whether full expensing could encourage companies to make poorer investments because they would get tax benefits. What are your thoughts on that? Earlier, David Phillips said that if a company had been considering investing in buildings, full expensing might push it towards investing in plant and machinery instead.

David Phillips: Overall, on net, we think that it is a positive thing. At the moment our tax system penalises quite strongly investment that is funded through a company's equity or its cash at the bank. Moving to full expensing, whereby a company can deduct costs, removes the tax on marginal investments—those that are just profitable—which it wants to fund through cash at hand or through equity.

As I said, however, it also widens existing distortions in the system. Companies can fully deduct the costs of eligible plant and machinery up front, but the treatment of buildings remains a lot less generous. If it is more profitable to invest in a bigger or nicer building and have a bit more space in which to operate, perhaps companies will now not do that and instead will buy a more compact machine because even if that is not economically the best thing to do, it is now the tax advantaged thing to do.

The other point is that in many cases the tax system already subsidises debt-funded investments, because companies can deduct both costs and interest payments. Making it possible to deduct all the costs up front further increases the subsidy for debt finance investments. That might mean that companies will do things via debt rather than via equity and so become overly leveraged, which distorts their decisions on how to finance their investments. You are also right that it might mean that companies could invest in something that, economically, does not pay itself back. Because it attracts a tax subsidy a company might invest in something that does not generate an economic return that makes it worthwhile doing. That is why I said that, ideally, what we would have seen here is a broader pattern of reforms—or at least what we might call a road map of reforms—to fix all the issues with the corporate tax system rather than fixing one issue but having little issues pop up elsewhere. We need a strategy, rather than whack-a-mole.

Carl Emmerson: The UK needs more good investment. That is what we want. The full expensing policy will certainly lead to more investment. The issue is whether that will be more good investment. It might lead to more bad investment, which we do not need or want.

John Mason: Would there be any impact on research and development, or is that pretty well written off as it happens anyway?

David Phillips: The autumn statement also contained changes to the treatment of research and development costs. I do not have those to hand. We might want a tax subsidy for research and development, because that could have wider societal benefits. Initially the knowledge might be under patents and so on, but it will eventually benefit others and could spur innovation. There could therefore be a reason to have subsidies for innovation or other measures that have wider societal benefits. What we should not want the tax system to do is subsidise investments that have purely private benefits for the company in question. They should do those anyway; if they are not, then they are not worthwhile investments.

John Mason: On the question of the tax burden, we now seem to be at 38 per cent, or 37.7 per cent or thereabouts, which our previous witnesses said is nearly 4.5 percentage points higher than it was before the pandemic. However, it is a lot lower than the figure for France, which, it was suggested, was nearly 50 per cent. Should we be worried about that total figure, or is it how it is broken down that matters?

Carl Emmerson: The UK tax burden is high by UK historical standards. The Government is pushing it up to a level that we have not ever sustained in our history. Indeed, the 2019 to 2024 Parliament is the biggest tax-raising Parliament in modern history. It is a tax-raising Government that is pushing the UK tax burden up to levels that we have not seen in the UK.

It is worth noting that, in western Europe and Scandinavia, there are many successful economies with bigger tax burdens. If the UK wants, it can go further down the path of being a higher-tax economy and still be successful—that is an option.

I would point out, as David Phillips said earlier, that if we are going to have bigger taxes, it is even more important that they are well designed. A badly designed tax system will not do as much harm if your tax burden is low, but it will do a lot more harm if you push those taxes up. If we are going for high taxes, and we want to have more growth and to be a successful economy, that makes it more and more important that we reform those taxes and make them well designed before we start pushing them up to get more revenue out of them.

There is a choice to be made about how big a state we want in the country. What we should not be doing is pushing up unreformed taxes. We want to get them right before we push them up.

David Phillips: Again, if you look at what other countries that have higher tax burdens than us do, in general—not in every case—you see that two areas of taxes are higher. One is general consumption taxes—in other words, VAT. That is because the UK has quite a wide range of reduced rates and exemptions for VAT. We try to use VAT to redistribute. From an economic perspective, it is better to get revenue in from a broader, simpler VAT and do the redistribution through the direct tax system or the benefits system, which is better able to target lower-income households. You see that happening more in other countries.

The other area is social security contributions or income tax on middle earners. The UK stands out, not so much in having low taxes on top earners but in having relatively low taxes on middle levels of earnings. That does not mean that if we wanted to raise our taxes, we would have to follow another strategy. There could be different ways of doing it, but those are the key differences between us and, say, France and Scandinavia. We tax consumption less, and we tax middle earners through social security contributions less.

John Mason: The UK Government is aiming support at the retail, hospitality and leisure sector through non-domestic rates. Is that because that sector is particularly struggling at the moment?

David Phillips: It is clear that there have been difficulties for parts of that sector. We are seeing, I guess, a structural change in the retail environment, in particular, with sales moving online, and we are seeing a decline in secondary retail centres, such as high streets in towns. There has been what is called a “flight to quality” in the property industry. We are seeing big out-of-town centres and very strong city centres doing well, and a decline in comparison retail, in particular, in smaller towns across the country. It is clear that structural changes are going on in retail.

The hospitality and leisure sector has been affected recently by the rise in energy costs and, potentially, by recruitment difficulties in certain parts of the country. You can see why there is concern about that, but there is a question about what is the right way to tackle the situation.

I might quote what I said in our response to the autumn statement. Although we think that benefits will flow largely to businesses in the short term,

> “in the longer term, the biggest beneficiaries of cuts to business rates are likely to be landlords, as rents rise. And uncertainty about whether reliefs really are temporary or are likely to be permanent makes it difficult for both businesses and property owners and developers to plan. In particular, there is a risk some businesses in the retail, hospitality and leisure sectors may be made worse off in future: if the reliefs are believed to be permanent, rents are likely to bid up, leading to an increase in overall property costs if the reliefs are in fact allowed to expire as planned.”

The key thing is that the evidence suggests that, in the short term, the biggest beneficiaries of cuts to business rates are those who pay them: the business occupiers. However, there is very good evidence that, over time—and, actually, sometimes quite rapidly—rents adjust. As it becomes more valuable to be in those properties and people are able and willing to pay more, the rents go up. The risk is that someone who is paying a high rent might think that the rates relief is going to be permanent, but when the relief goes away, they are made worse off.

I think that, if this is to become a permanent part of the tax system rather than a series of rolling one-off reliefs, we need to make it clear that that is what it is. However, we must be aware that that means that what we are really doing is subsidising landlords of commercial property rather than the businesses in question.

John Mason: That is great—thank you.

Michelle Thomson: Good morning. I have just one question, which is related to inflation and, therefore, debt payments on PPI-type models. I have not heard a lot of talk about that. Obviously, various public sector bodies have seen massive increases in their repayments. Although we can take a view on what the OBR predicts about future inflation, I imagine that it will need to be considerably more cautious, in that when inflation goes down, it goes down. There is a clear link. Can you give me some more guidance on that? Also, what behavioural impacts—if any—will there be for finance executives in public sector organisations who are managing those greatly increased PPI payments?

David Phillips: That is not an issue that Carl Emmerson or I have looked at, I am afraid. On the wider decisions, I know a lot about English local government. I have been speaking to people in English local government, and what they have said is that, so far, their debt interest costs have not really risen that much, because they locked in the lower interest rates for much of their existing stock of debt through borrowing from the Public Works Loan Board. They are being much more cautious about future investment, which would be funded at the higher interest rates.

There has been a reduction in capital borrowing by local authorities in England. Part of that is in response to the concerns about investment in commercial property and that being tightened up. I think that it is also in part because they know that, instead of their having to pay 2 to 3 per cent to the Public Works Loan Board, the interest rates are going to be higher. That makes it less viable to borrow and to fund the repayments, either through the return on the investment or through their general day-to-day capital budget.

That is certainly happening in English local government, and it would not surprise me if it was happening in Scottish local government as well. That will mean that more investment by local government in Scotland will be funded through the central Government support for investment, rather than through prudential borrowing by local authorities.

Michelle Thomson: It sounds as though, collectively, we do not know a great deal about the data and the impact of it. It strikes me as quite interesting that, if we are looking at the longer-term trajectory, even though we all assume that inflation will come down—which I think is correct—we also agree that it will not come down to the historically low levels that we previously had. It strikes me that it would be interesting to work through the impact of that on a variety of public sector organisations. I realise that I do not know about the issue, so perhaps it is heartening that you do not, either—I do not know. Anyway, thank you.

David Phillips: There are two bits of data on this that you can look at. Certainly in England, there are the capital accounts that come out of councils. Those are published each quarter, so you can see what they are investing in quarter by quarter. Councils in England also have to say what share of their reserves are being held for public-private partnership servicing costs.

I am not sure whether that data is held in the Scottish Government's local government finance returns. If it is not, the committee should ask for that. That data was asked for in England precisely because people like me said that we could not tell what was happening to local government's capital spending or why authorities were holding £30 billion of reserves. Once they had labelled it, we could see a bit more of what was going on. The committee should ask for that data if it is not already there.

Michelle Thomson: In fairness, it might be; the issue might be my ignorance. If we have the data, we can start to interrogate what the impact could be, and how that plays into the real economy, which is why I am asking.

The Convener: There is just one further question, which comes from me. We are coming towards the end of the 28th United Nations climate change conference of the parties. The OBR said that there was

"little sign in the UK of significant new investment in low-carbon energy and heating technologies in response to the rise in gas prices",

and it explained its view as to why that was. What is the IFS's view on that?

Carl Emmerson: I do not think that we have looked at that issue and taken a view on it. That is not a question I can help you with, I am afraid.

David Phillips: It is not a question that I can answer, either. I am sorry to be unhelpful .

12:15

The Convener: That is okay. I asked about that because net zero is, obviously, a key issue in Scotland and, indeed, elsewhere.

Does either of you wish to make any further points before we wind up the session?

Carl Emmerson: On that last point, it is clear that the Labour Opposition has a very high-profile pledge to deliver £28 billion a year in public sector capital spending for net zero purposes. We have looked at that a bit. It is worth noting that the £28 billion a year compares with about £8 billion a year that the Government currently spends, so that is probably better described as a £20 billion increase. That is a huge increase, and it raises two issues.

The first issue is the challenges around doing that spending and doing it well. Under Labour's plans, we would go from £8 billion a year up to £28 billion, albeit over a Parliament. The second issue is, of course, how that is funded. Earlier, we talked about the current Government's cash spending plans on investment being frozen and cut back as a share of GDP. There is an open question. If there is so much Government investment in things to do with net zero for good reasons, what will happen to Government investments that are not related to net zero? What about other investments in growth or public service delivery that do not have consequences for net zero? It might be pretty challenging, to say the least, to try to keep within the Government's spending plans and carve out £28 billion for net zero-friendly investments.

David Phillips: When Carl Emmerson mentioned that, it made me realise that one thing that is key is that, in thinking about net zero policy, there might be policy trade-offs between the different objectives that seem to underlie a lot of net zero policy.

We can look at that as a triangle. On one side, there is decarbonisation; on another side, there is the desire to reduce our reliance on China, for example; and on the third side, there is the desire to have good industrial jobs. If spending on green technologies and the green transition is going to be substantially increased, there will be choices to make about what is prioritised. It may be that what achieves most in terms of decarbonisation does not get the most jobs in the UK or the most in terms of decoupling from China. There are real questions about what we are trying to do with green investment. For example, is it really green investment? To what extent is it industrial strategy investment? Those can be integrated, but they are not perfectly aligned. There could be some trade-offs.

The Convener: Yes. It will be interesting to see what is included in the £28 billion and whether that will be linked to inflation. The figure was £28 billion when the policy was announced. Will that money be worth the same in real terms in year 5? What pace will things progress at?

Thank you very much for your evidence today, gentlemen. As always, it has been really helpful.

12:18

Meeting continued in private until 12:30.

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