

MAYOR OF LONDON

Jenny Jones AM

Baroness Jones of Moulsecoomb
Chair, Economy Committee
Greater London Authority
City Hall
The Queen's Walk
London, SE1 2AA

Date: 23 December 2014

Dear Jenny

The Europe Report

Many thanks for your additional questions on the Europe Report. Please find enclosed my answers.

First, regarding reforms. In answering your question let me give some background so that you and the Committee understand our thinking and hence the approach we took. There were many different aspects to the Europe Report, of which the outside forecasting work was one, albeit important, component. The aim of the outside work was to have an independent econometric analysis to supplement the other elements of the Report, and act as an independent benchmark. Having taken that approach we then appointed Volterra, who are on the approved vendor list at the GLA. As this forecasting aspect of the work was independent it was not for us to tell them what specific reforms to include.

Moreover, the advice we received from Professor Paul Ormerod, who was to be one of the two main people overseeing the longer-term forecasts included in the Report, concurred with my thinking based on years of econometric forecasting. His comment to us was, "The idea that there is a unique one-to-one correspondence between inputs and outputs is a fundamental feature of conventional thinking about economics. As Harstad and Selten, for example, stated in the prestigious Journal of Economic Literature in 2013: 'The fundamental tool of neoclassical economics is an objective function that maps the space of all relevant decision variables into a real scalar'. Increasingly, this is seen as a limitation of the discipline. This is not to detract from its many achievements, rather to point a way in which economics can be developed even further. So there are several ways in which supply side reforms can be articulated, which would lead to the same output. I do not think it is useful to privilege one set over the others. This is also relevant to the point about self-employment and flexible working."

In addition, the challenge was even greater because trying to map out a one-to-one correspondence becomes more difficult the further ahead one projects. Yet, and as I explained in testimony to the Committee, any short-term analysis may tend to be biased towards the status quo, whatever it is, and in this case remaining in an as yet unreformed

EU. Thus, a longer term forecast horizon was needed to provide forecasts that best captured the four scenarios outlined in the Report.

As a result, we chose to look at forecasts based over a time period that could be generally felt as capturing a couple of economic cycles, hence a twenty year forecast period was chosen. Moreover, while the analysis was robust, the margin of errors in such forecasts means the outcomes should be taken as providing a broad guide to possible outcomes as opposed to likely pinpoint accuracy. Given this, the focus was then on capturing best what we felt would reflect the four different scenarios. Hence the focus on supply side reforms to reflect a reformed EU.

In regards to your point that included mention of self-employment and flexible working, there may well be some productivity gains to flexible working in specific firms, but it would be difficult to attempt to quantify this fully as vital to assumptions made on forecasting long-term productivity growth of a large national economy such as the UK or even a major city such as London, as opposed to say a single employer. Changes in productivity reflect many factors, and this is a current key area of debate within the UK, where there is a productivity puzzle, as productivity has been relatively low. Working practices may be one of many factors contributing to this. Indeed in the recent economic cycle, rising unemployment was not the outcome as many economists had expected, but instead employment rose and instead wages appeared to act as a shock absorber. There was a change in working practices, seen in higher numbers in part-time as well as in full-time work, and more people on zero hour contracts. Apprenticeships continued to rise, too. The Report showed that in a number of future economic scenarios, employment in London would continue to rise. With many competitive and innovative employers, and with high rates of new firm growth, this should mean that over the twenty year time horizon of the forecast, new working practices are inevitable. We are not assuming an abolition of workers' rights, or a race to the bottom to compete solely on low costs, far from it. The Volterra appendix in the Report makes clear that innovation is a key aspect of the positive growth forecasts. This should allow a healthy employment environment if the policy environment is sensible and hence two of the four scenarios were clearly more favourable.

This is linked into your second and third questions. An ongoing comment made by various businesses was the scale of regulation. I have called it a 'regulatory paradox', as the point was sometimes made that in isolation individual regulations were fine, but collectively there were problems particularly in terms of costs associated with a heavy 'weight' of rapid regulatory expansion. Another general point made was linked to the need to open up the service sector. The possible reforms came up throughout the process, both before Volterra's work and after. Also, the technical appendix contained some specifics linked to different sectors. The TUC made clear to us their view, which is on the record, and the importance of workers' rights. The TUC were keen for the posted workers directive to be reformed so that social taxes were paid in the domestic market in which people are working, which would mean NI being paid in the UK. They supported EU membership as long as it was seen by them as being in the favour of their members. We did not make any major assumptions about changing workers' rights, we only specified the need for the UK to secure a permanent opt out of the Working Time Directive (so maintaining the current arrangement) and the need to return other limited areas of concern to UK national control (such as health and safety).

MAYOR OF LONDON

We asked Professor Omerod to comment on your last question. His reply was, "It is precisely economic development and wealth creation which enhances both the environment and health. The connections, for example, between income per head and both life expectancy (positive) and infant mortality (negative) are established beyond any reasonable doubt." Whilst you may state that it is unacceptable that the Report does not feature a more thorough analysis on several non-economic areas, among them on health and environment, we have touched on several impacts of reform or exit on the environmental and health sectors in the Appendix.

Regarding your request that we undertake further work on the topic, if we were to do this, it would be a decision of the Mayor. That being said, we continue to monitor these topics and stay abreast of developments and aim to anticipate any key developments that will impact the London economy, and peoples' economic wellbeing.

Yours sincerely

A handwritten signature in blue ink, reading "Gerard Lyons", with a horizontal line underneath.

Dr Gerard Lyons
Chief Economic Advisor

