House of Commons
Treasury Committee

Pre-Budget Report 2008

Second Report of Session 2008–09

Report, together with formal minutes, oral and written evidence

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The Treasury Committee

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

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Summary

The Economy

The Treasury’s forecast in the Pre-Budget Report is for a swift recovery in economic growth for 2010, after a significant decline in output in 2009. The outlook for economic growth remains highly uncertain, but the balance of risks to the Treasury’s forecast is on the downside, as illustrated by the two packages which have since been introduced. The overall effect of the fiscal stimulus remains uncertain. The cost of the reduction in VAT is considerable and, in the view of the majority of commentators, the Treasury’s analysis of its impact is an optimistic one.

The lack of bank lending remains the single most critical problem for the economy in the near term. The Government must ensure the availability of credit increases quickly. Without that increase in availability, the recovery of the economy will be placed in jeopardy. We recommend that the Lending Panel, or a suitable agency of the Treasury, provide regular updates on the actual lending by the banks to the real economy. We have noted the Government’s proposals announced on 19 January 2009, and we will monitor their implementation and effectiveness.

The risk of a self-reinforcing deflationary cycle exists in the UK economy at present. We recommend that the Treasury prepare and publish the actions it may consider taking should a period of “quantitative easing” be needed.

While the need for lower interest rates to maintain economic growth is crucial at the present time, the needs of savers must not be forgotten. We recommend that the Treasury consider measures that will support savers at this difficult time.

Public Finances

The forthcoming period during which the Temporary Operating Rule applies provides an ideal opportunity to re-evaluate the fiscal framework for the future. We recommend that the Treasury conduct a full public consultation on the design of such a framework. We note that at the time of writing the markets are supporting the Government in its raising of debt. We note the Chancellor’s acceptance that in due course the level of public sector net debt needs to be addressed.

Child poverty

We note with concern that the Pre-Budget Report contains no policy measures which will significantly advance meeting the 2010 child poverty target. We recognise the fiscal position is strained and that resources are limited, but believe meeting the 2010 child poverty target must not be allowed to fall by the wayside.
**Fuel poverty**

On fuel poverty, we expect the Government to act promptly on the Ofgem quarterly reports in order to ensure that consumers are not charged an inflated price for energy.

It is important that the Government ensures that the energy companies take urgent steps to resolve the unfair gaps in energy pricing and if necessary take the statutory powers to do so.

**Efficiency**

We note that the announcement of an additional £5bn of efficiency savings, without any supporting schedule showing the derivation of this figure. We recommend that the Government publishes where and how the additional savings will be made.

**Small firms**

We welcome the package of measures the Government has introduced to support small and medium sized enterprises. We welcome the measures to ease the tax burden on small firms facing difficulties, but will continue to monitor whether HMRC are devoting sufficient priority to this initiative.

**Improving the flow of credit to consumers**

We recognise that steps taken by the banks to rebalance their assets following the banking crisis late last year have resulted in reduced credit lines being made available to the public. It is clear that schemes introduced in the Pre-Budget Report, and the stamp duty holiday announced earlier, are not having any widespread effect. We recommend that the Government takes all possible steps to ensure that the banks lend fairly and responsibly to each other and consequently to the public. We are concerned that piecemeal measures introduced by the Government may not be adequate in the face of the crisis in lending.

**Air Passenger Duty**

We recommend that the Government monitors the impact of the introduction of higher banding Air Passenger Duty in order to ascertain the impact of APD on UK hubs and passenger preferences.

**Road Fuel Duty**

We note that the Government is relying on falling oil prices to counterbalance the impact on businesses of the 2 pence per litre rise in fuel duty. We believe that the Chancellor has missed an opportunity to assist the road haulage industry, a matter we think the Chancellor should address at the time of the Budget. We recommend that the Government continues to monitor oil prices and adjusts the level of fuel duty in light of any future increase in oil prices.
1 Introduction

1. The Chancellor of the Exchequer, the Rt Hon Alistair Darling MP, delivered his second Pre-Budget Report on 24 November 2008, which, in his own words, was set in the context of “a background of economic uncertainty not seen for generations”.¹ We held three evidence sessions on the Pre-Budget Report: from experts in economic affairs, accounting issues and the social impact of the Report on 4 December; from Treasury officials on 9 December; and from the Chancellor accompanied by officials on 10 December. We are most grateful to all our witnesses and to those submitting written evidence. Additional useful evidence for our inquiry was derived from our regular hearing with the Governor of the Bank of England (hereafter ‘the Governor’), and members of the Monetary Policy Committee of the Bank on the November 2008 Inflation Report, held on 25 November.

¹ HC Deb, 24 November 2008, col 489; HM Treasury, Facing Global challenges: Supporting people through difficult times, Cm 7484 (hereafter ‘Pre-Budget Report 2008’).
2 The Economy

Growth forecasts

2. At the time of Budget 2008, the Treasury forecast that GDP growth would be 1¾% to 2¼% in 2008, 2¼% to 2¾% in 2009 and 2½% to 3% in 2010.2 At that time, and after taking evidence from several witnesses, we noted in our report on the Budget that the lower boundaries of the Treasury’s forecasts were “above the average of independent forecasters”. We concluded that the Treasury might have:

given insufficient weight to the risks of continued financial market turbulence and that some of the UK economy’s characteristics that have proven beneficial in past crises (rapidly rising residential property prices, close links with the US and an increasing reliance on the financial services industry, for example) might prove to be conduits through which the current problems in global financial markets are transmitted to the UK real economy.3

The forecast as presented in the Pre-Budget Report 2008 was significantly weaker, with the Treasury forecasting only ¾% GDP growth in 2008, a range of –1¼% to –¾% GDP growth in 2009 and 1½ % to 2% in 2010, with growth reaching 2¾% to 3¼% in 2011.4 The Treasury explained its forecast as follows:

Having slowed progressively over the past year, GDP is forecast to fall by a ¼ per cent on a year earlier in the second half of 2008, leaving output in 2008 as a whole up ¾ per cent on a year earlier. The recession is forecast to continue into the first half of 2009, before GDP growth begins to recover in the second half of the year as credit conditions start to ease and the boost to real incomes from lower commodity prices, the stimulus from monetary and fiscal policy, and the effects of sterling’s depreciation, take hold.

3. Colin Talbot, Professor of Public Policy and Management at the Manchester Business School, was not convinced that the economy would rebound as quickly as the Treasury had forecast. In his written submission, he noted that under the Treasury’s forecast while the UK would go into a deeper recession in 2009 than the G7, it would then recover to GDP growth levels higher than in the G7 in both 2010 and 2011.5 He told us that he was “not convinced” by this forecast recovery and that he had “not seen anything in the PBR which explains why that is likely to be the case”.6 The Treasury however, explained that there were four factors underpinning its forecast:

• the sharp fall in commodity prices which would boost households’ purchasing power;

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2 Budget 2008, page 157, Table B3
4 Pre-Budget Report 2008, page 166 , Table A3
5 Ev 71
6 Q 5
• the very sharp fall in interest rates (including a fall of 300 basis points in one nine-week period;

• the fiscal stimulus and other discretionary measures which amounted to 1% of GDP; and

• the significant depreciation in the value of sterling which would stimulate activity away from imports.\(^7\)

4. When asked to explain why the UK would achieve higher rates of growth during the recovery phase than the G7, Dave Ramsden, Managing Director, Macroeconomics and Fiscal Policy, HM Treasury, explained that, compared to the euro area, interest rates had fallen faster in the United Kingdom.\(^8\) He also noted that “The experience of the UK is that we do have relatively flexible markets and that means it is reasonable to assume that they will adjust relatively quickly following a recession with growth picking up”.\(^9\) Prompted to provide details of other forecasters providing a similar forecast to the Treasury, Mr Ramsden cited Morgan Stanley for 2010, and the Bank of England.\(^10\) The Governor of the Bank of England (‘the Governor’) supported that Treasury’s stance, accepting that in “broad terms our forecast, allowing for all the probabilities, is close to that of the Treasury”.\(^11\) Mr Ramsden however, did accept that not all external forecasters were in step with the Treasury’s forecast, noting that “There are forecasters such as Citigroup, HSBC, who have a much weaker recovery”.\(^12\) He also stated that “but I do not think that our forecast of growth in 2010 of 1½% to 2% in 2010, while I am happy to acknowledge it is at the top end of the range of outside forecasters and is close to the Bank of England’s, is anything other than achievable”.\(^13\) The Chancellor supported the forecast as presented in the Pre-Budget Report 2008, but noted that uncertainties remained, telling us that:

I think, based upon the information that we have, based on the low interest rates, the advantages that will come from lower inflation, the fiscal stimulus that I put into the economy in the Pre-Budget Report, and also there are other factors — our economy is pretty flexible—I believe that the economy will start to grow in the second part of next year. It is broadly in line with what the Bank of England, quite independently of us, has also been saying. But there is a lot of uncertainty out there.\(^14\)

The Treasury’s forecast in the Pre-Budget Report is for a swift recovery in economic growth for 2010, after a significant decline in output in 2009. The outlook for economic growth remains highly uncertain, but the balance of risks to the Treasury’s forecast is on the downside, as illustrated by the two packages which have since been introduced.

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\(^7\) Q 111
\(^8\) Q 115
\(^9\) Ibid.
\(^10\) Qq 111-113
\(^11\) HC (2007-08) 1210, Q 69
\(^12\) Q 114
\(^13\) Q 115
\(^14\) Q 255
**Lost output**

5. As part of its assessment of the economic outlook, the Treasury forecast a reduction in the trend output of the economy, giving the following explanation for doing so:

For the 2008 Pre-Budget Report, to take account of the likely negative effect of the credit shock on trend output, a phased reduction to the trend level of productivity (and therefore the trend level of output) of about 4 per cent has been assumed over the two years from mid-2007, a period consistent with the credit conditions assumption that underpins the economic forecast more generally. This adjustment is within the range of external estimates of the impact of the shocks to credit and energy markets on medium-term potential output, though it is a key forecasting judgement around which there is very considerable uncertainty.15

Robert Chote, Director of the Institute for Fiscal Studies, highlighted why this forecast loss of output was important:

[The Treasury] have basically taken the view that the long-term output of the economy is going to be about 4% lower than it would have been expected to be prior to the announcement of the PBR, so in effect they are saying that for two years the trend growth rate of the economy will be 0.5% a year, not 2.5% a year. That knocks a £60 billion hole in the economy and means that you effectively have a permanent loss of about £40 billion in tax revenues and higher social security expenditure.16

6. There was disagreement as to whether the Treasury’s forecast of the reduction in the trend growth rate of the economy was realistic. Mr Chote stated that “Judging whether 4% is the right number in the middle of the two-year period in which you expect that adjustment to be taking place is a very difficult thing to do, but I have to say seeing the magnitude of that number in cold print it did not look to me as though they were being egregiously optimistic, it seemed to be a reasonable stab at that analysis at this stage”.17

Roger Bootle, Managing Director of Capital Economics, though held a less sanguine view:

the uncertainties are enormous but my reaction to the 4% was to think how large the figure was particularly given the uncertainties. If you read the section of the PBR where they try to explain and justify this, it really is the worst sort of 'Noddy' economics. It is all about the difficulty of co-ordinating inputs of labour and capital and there are no examples and no quantification. It really is a complete stab in the dark. No-one has a clue.18

He suggested that the Treasury’s forecast was “much too high”, stating that there would be “counter-vailing factors” from the recession that would increase the supply potential.19 He provided the following examples of how such changes could come about:

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15 Pre-Budget Report 2008, p 162 para A.58
16 Q 29
17 Ibid.
18 Q 29
19 Ibid.
Things get cleared out and moreover if the shape of our economy changes along the lines that we have been speaking about, that is to say a shift away from consumption and, relatively speaking, from government spending towards export, we may well find a period in which those parts of the economy whose natural productivity growth is faster are the ones that are growing fastest.20

Mr Ramsden, for the Treasury, was staunch however in his defence of both his Department’s forecast of the reduction in the potential output of the economy, and its presentation of that forecast.21 He maintained that the Treasury, like the Bank of England had “not only taken account of the demand side impacts of these shocks but also the supply side impacts of these shocks”.22

**Fiscal stimulus**

7. The significant worsening of the economic outlook since the 2008 Budget led the Government to announce at the time of the Pre-Budget Report 2008 a fiscal stimulus. This comprised a “temporary reduction in the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009”, as well as bringing forward £3 billion of capital spending from 2010–11 to 2008–09 and 2009–10.23 According to the Pre-Budget Report 2008, this discretionary action, which would cost £16 billion, would deliver an overall fiscal stimulus of around 1 per cent of GDP in total in 2009–10.24

8. Giving evidence on the November 2008 Inflation Report, the Governor was broadly supportive of the fiscal stimulus, as set out in the Pre-Budget Report. He told us:

> I thought in these extraordinary circumstances a modest fiscal stimulus was perfectly reasonable and appropriate, provided it met two conditions: the first condition was that it was temporary and the second condition was that it set out a very clear map and path back to fiscal sustainability. I think the announcements made yesterday meet those two conditions. Of course, the proof of the pudding, in terms of ensuring that we do get back to fiscal sustainability, will be in the eating, and there is a long, hard path back to fiscal sustainability.25

Sir John Gieve, Deputy Governor of the Bank (Financial Stability), agreed that “the case for a fiscal stimulus was a strong one”.26 On the question of whether the estimate of the impact of the fiscal stimulus was correct, Mr Chote told us that it seemed to be in line with the sorts of multipliers that the Treasury, had laid out when it was looking at the use of fiscal activism in its studies for the euro.27 One concern he had lay in the extent to which the

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20 Ibid.
21 Q 141-145
22 Q 41
23 Pre-Budget Report 2008, p 14, para 2.5
24 Ibid., page 14, para 2.7
25 HC (2007-08) 1210, Q 13
26 Ibid., Q 17
27 Q 21
impact of the stimulus would be modified by the extent to which other countries adopted similar measures “and therefore the benefits of the stimulus are not, in a sense, them leaking away or the benefits of other people’s stimuli leaking to us to the same degree that ours is leaking to them”. 28 Simon Kirby, Research Fellow at the National Institute of Economic and Social Research (NIESR), suggested that NIESR was expecting a “slightly smaller” effect from the fiscal stimulus than the one forecast by the Treasury. 29 For the Chancellor, the fiscal stimulus was “absolutely necessary”. 30 When the argument that the automatic stabilisers alone might have been sufficient to support the economy, rather than a fiscal stimulus, was put to the Chancellor, he argued that “If you allow a recession to become deeper and longer than it might otherwise be there is a cost to it”. 31 The Chancellor also did not rule out further fiscal stimuli in the future. 32

9. We discussed with several witnesses the design of the fiscal stimulus, especially the Government’s decision to reduce the rate of VAT, rather than other options such as reducing income tax, or providing rebates. One of the concerns about a temporary tax cut, is that consumers will save the additional money, rather than spending it. Charlie Bean, Deputy Governor of the Bank of England (Monetary Policy), explained that a temporary cut in income tax might be saved by individuals, rather than spent. 33 He argued that:

a cut in Value Added Tax at least gives households an incentive to bring forward some spending from the future to the present in some sort of switching over time. In that sense … it is a measure that works because it is temporary. 34

The Governor went on to explain “that during the second half of next year there will be a lot of advertisements saying: "Buy now before VAT goes up in January 2010"”. 35 This would lead to expenditure-switching, where expenditure by households would be moved from one period to another. The Governor did however point out that if demand were weak in the period after the stimulus ran out, and VAT rates had been reset, the switching would have been between the wrong time periods, and so of limited effect. 36 When asked whether the stimulus would lead to expenditure being concentrated towards the end of the lower-VAT period, the Governor explained that:

It is more likely to but, of course, people who have been thinking of spending may decide that some point in the next year is a good time to spend, why not do it now rather than the second half of next year? Decisions will vary from one individual or household to another. 37

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28 Ibid.
29 Q 22
30 Q 331
31 Q 332
32 Q 349
33 HC (2007-08) 1210, Q 21
34 Ibid., Q 21
35 Ibid., Q 24
36 HC (2007-08) 1210, Q 26
37 Ibid., Q 28
Mr Kirby, however, thought that the credit crunch might impact on the ability of households to take advantage of the lower VAT rates. He outlined the problem as follows:

The more important fact behind this is that one of the main points of the stimulus is a VAT cut. In normal times work would suggest that that is the sensible route to go. However, the problem is that we are currently in a banking crisis and we have households and firms that are credit constrained. It is trying to stimulate spending without addressing the problem of credit constraints which may mean that the actual VAT cut has less of an impact than we or even the Treasury at first think. Fundamentally, if you are going to do a VAT cut you also need to address the problems of credit constraints as well and, unfortunately, that is not happening.\(^{38}\)

10. Professor Talbot was in favour of the model adopted in the United States of America of a “direct and obvious cash benefit to individuals”.\(^{39}\) He then noted that should some of that direct payment have been saved, this would have helped in the recapitalisation of the banks.\(^{40}\) Mr Chote told us that he had expected a larger proportion of the stimulus to come in the form of “a permanent increase in the generosity of benefits and tax credits for relatively less well-off families on the grounds that they are relatively likely to spend a higher proportion of it and you would take it away from other richer households in the future”.\(^{41}\)

11. Mr Ramsden explained the rationale of the design of the fiscal stimulus as set out in the Pre-Budget Report 2008:

\[\text{it should be temporary so that you get the maximum effect over the period, something that the Governor of the Bank of England has raised, that it should be timely, which was why we went for the VAT reduction of 2}\frac{1}{2}\% \text{ that could be introduced immediately as well as bringing forward existing investment projects rather than starting new ones. We wanted it to be targeted, so we saw that VAT could actually impact not only across all sectors of society who pay VAT but also would be of help to ensuring that volumes continued in the retailing industry and help the retailing industry through a difficult period in that sense, so we looked at the quantum of thinking that 1\% was about appropriate.}\(^{42}\)\]

Mr Ramsden also pointed out that the automatic stabilisers, such as unemployment benefit and a decrease in the tax take, were also active in stabilising the economy at this time.\(^{43}\) This had therefore determined the size of the fiscal stimulus. Mr Ramsden assured us that the Treasury had not felt “constrained” by the state of the public finances.\(^{44}\) When asked whether this measure would lead to a bunching of consumption to the end of the VAT

\(^{38}\) Q 22  
\(^{39}\) Q 24  
\(^{40}\) Ibid.  
\(^{41}\) Ibid.  
\(^{42}\) Q 120  
\(^{43}\) Q 121  
\(^{44}\) Qq 120-121,124
reduction period, with consumers cashing in on both the VAT reduction and falling prices, Mr Ramsden argued that the VAT reduction was a valid strategy. Real purchasing power for consumers would rise straight away, for a 13 month period (other measures could not have been introduced until later in the year) since most retailers appeared to be passing the reduction on in savings to consumers; the other advantage was that the reduction achieved a “relative price effect”, making consumption cheaper now relative to a future date:

we have assumed that that relative price effect will be particularly strong actually at the beginning of the recovery, i.e. in the second half of next year, and that was the experience in Germany. Before their VAT went up at the beginning of 2007 there was a bunching of consumption because the relative price effect was stronger then but the income effect, the first effect, will apply throughout, so you get these two effects.45

He then went on to confirm that the multiplier effect was the one that had led the Treasury to decide upon a cut in an indirect tax.46

12. The overall effect of the fiscal stimulus remains uncertain. The cost of the reduction in VAT is considerable and, in the view of the majority of commentators, the Treasury’s analysis of its impact is an optimistic one. We will continue to monitor its effect as part of our ongoing work, and will return to this issue at the time of the Budget 2009.

Bank lending

13. The continued dislocation within the financial markets, and subsequent reduction in bank lending, remains a key risk to economic growth, affecting both companies and households’ access to credit. As such, the Pre-Budget Report 2008 notes one of the risks to the consumer spending forecast is the “the speed at which credit conditions normalise”, and that the “risks around the depth and duration of the adjustment in the UK housing market are linked to the ability of banks to resume profitable lending, further rebuilding their capital positions and increasing the availability of mortgage finance”.47 Companies face similar problems, with the Pre-Budget Report 2008 noting that “There are risks to the business investment forecast from developments in credit availability”.48 The Governor of the Bank of England also highlighted this risk, telling us that the “single most pressing challenge to domestic economic policy is to get the banking system to resume lending in any normal sense”.49 Mr Bootle agreed, that “getting the banks lending again is absolutely critical”.50 Mr Ramsden suggested that the Government acknowledged this point:

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45 Q 185
46 Q 186
47 Pre-Budget Report 2008, p 181, para A.129
48 Ibid., page 181, para A.130
49 HC (2007-08) 1210, Q8
50 Q 2
the return of credit conditions, both in terms of the price of credit and the quantity of credit, to what might be considered a more normal position is absolutely critical to achieving the forecasts that we set out. Indeed, it is the key assumption on which the forecasts were based.\(^5^1\)

14. The Government has provided significant support to the banking system. On 8 October 2008, the Government announced a bank recapitalisation programme of up to £50 billion, a Government guarantee of new short and medium term debt issuance of up to £250 billion (known as the Credit Guarantee Scheme), and the provision of at least £200 billion to be made available to the banks under the Special Liquidity Regime.\(^5^2\) The Chancellor told us at our meeting on 10 December 2008 that £100 billion had already been subscribed for by the banks under the Credit Guarantee Scheme.\(^5^3\) Despite this support, the banks were not yet lending. The Governor offered an interesting analysis of how bank lending appeared not to be in the interest of individual banks at present, even if it were in their collective interest:

What is happening, at present, is that what the banks are saying to themselves is: "Even if we see some apparently profitable lending opportunities, we had better forgo them because we are under enormous pressure to reduce the scale of our leverage" (to use that awful word) "of borrowing and we have to reduce the scale of our balance sheet." So they are giving up profitable lending opportunities in order to behave defensively and reduce the size of their balance sheet. Individually, it makes sense for a bank to behave in that way; collectively, it makes no sense at all, because if all the banks behave in that way not only will the economy go into a steep recession but the banks themselves will start to see even bigger losses on their pre-existing loans. … [we have] to find a way in which their individual incentives do not lead to a collective outcome that is clearly adverse.\(^5^4\)

15. Several solutions to encourage the resumption of bank lending were suggested to us. The Governor outlined four steps that he thought needed to be taken. First, better monitoring of the lending that was actually being undertaken. Secondly, ensuring that financial markets understood the aim of the bank recapitalisation. The Governor explained that it was of “the utmost importance that the tripartite authorities make crystal clear that regulatory minimum requirements have not been raised and, if anything, in these circumstances, might be lowered because banks will need to see their capital used to absorb losses in order to maintain lending”. Thirdly, further recapitalisation of the banks might be required. Fourth, the Government might have to intervene directly to ensure lending by the banks.\(^5^5\) One further solution which we put to the Governor was the creation of a “memorandum of understanding or a concordat” under which the principles of the levels of lending expected of the banks would be set out.\(^5^6\) The Governor, while not wishing to

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51 Q 104  
52 HM Treasury press release, Financial support to the banking industry, 8 October 2008  
53 Q 243  
54 HC (2007-08) 1210, Q31  
55 HC (2007-08) 1210, Q8  
56 Ibid., Q 36
commit himself, did not want “want to rule anything out”. Mr Kirby told us that further recapitalisation of the banks was one way forward. In his view, although the recapitalisation had to date cost very substantial sums of public money it should represent only the first tranche:

The average cost of a banking crisis is around 10% of GDP. Currently we have put in around 2.5% of GDP into a number of banks, so the Government perhaps wants to think about moving more towards putting some more money into banks, changing slightly how they do it, perhaps less onerous but taking more control over the banks themselves. Another 2.5% of GDP might move us towards the point where we can actually get the banks lending because at the end of the day that is what we need to do to get the economy moving.

Mr Bootle felt that further action, above and beyond recapitalisation, might be required:

I do not think this is only a matter of the money. You could be putting in lots of money and having no control and getting not much result. Equally, you could put in not that much money and take control and get a big result. I do not think it is necessary to own all the banks in order to direct their lending. I would point out to the Committee that in the years immediately after the Second World War it was normal in this country and other so-called capitalist economies for a weapon of monetary policy to be direction of bank lending. It was quite normal and it seems to me that we cannot go on for very much longer just encouraging banks.

Clive Maxwell, Director Financial Services at the Treasury, suggested that the Government had taken two steps to counter the problem. First, those banks which had used the recapitalisation scheme underwritten by the Government had made commitments to maintain lending in certain key respects, and these would be monitored by UKFI. Secondly, a Lending Panel, comprising the main lending institutions had been created. Mr Maxwell explained its role:

[it] is intended to bring together different groups to, firstly, monitor levels of lending and then look at the policy issues and other issues that arise in relation to that. It is a forum to bring people together, and it gives an opportunity to look at the situation and understand exactly what is happening and decide if things need to be done.

Mr Maxwell also indicated that one of its key priorities would be to make sure it had “sufficient information to actually understand what is happening”. The Chancellor provided further detail on the Lending Panel, telling us that he would meet with:

57 Ibid., Q 36
58 Q 36
59 Q 37
60 Q 130. UKFI is an arm’s length company created by the Government to manage the Government’s shareholdings in banks.
61 Q 223
62 Q 147
the chief executives of banks along with Lord Mandelson on a monthly basis ... In addition to that there are three groups at a working level, one looking at the small business side of things, and that has been meeting for a couple of weeks now, one looking at mortgage finance ... and another one looking particularly at the credit card problems which are slightly separate but are part of the whole.\textsuperscript{63}

The Chancellor also confirmed that he was prepared to look at other initiatives in this area.\textsuperscript{64} When asked whether he would be prepared to direct the banks to lend, the Chancellor suggested that there were practical limitations on the nature of government involvement:

Where I think it will be more difficult is for any government, frankly, to be standing in the place of bank managers up and down the country and saying to you, ... when you come in, “Yes, I will lend you so much at such-and-such a rate and these are my terms and conditions”. You could do it with a few large customers, I suspect, or you could do it in sectors but for the state to get into millions and millions of individual decisions would be difficult. I would rather use the banking system, … to make sure that it delivers for us.\textsuperscript{65}

Overall though, he acknowledged the need for the banks to lend given the public money that had been provided to them:

The banks have to understand that we have put very substantial sums of public money in to support them. They, in turn, have to play their part ... There are a number of areas where I believe they need to go much further.\textsuperscript{66}

16. On 19 January 2009, the Treasury announced a new set of measures to support the banking system and encourage additional lending. These comprised:

- Extending the drawdown window for new debt under the Government’s Credit Guarantee Scheme;
- Establishing a new facility for asset backed securities;
- Extending the maturity date for the Bank of England’s Discount Window Facility;
- Establishing a new Bank of England facility for purchasing high quality assets;
- Offering capital and asset protection schemes for banks, with proposals for this to be coordinated internationally; and
- Clarifying the regulatory approach to capital requirements, through an announcement by the Financial Services Authority.\textsuperscript{67}

\textsuperscript{63} Q 337
\textsuperscript{64} Q 248
\textsuperscript{65} Q 338
\textsuperscript{66} Qq 304-305
\textsuperscript{67}
We have taken no evidence on these measures.

17. The lack of bank lending remains the single most critical problem for the economy in the near term. The Government must ensure that the availability of credit, both to households and businesses, increases quickly. Without that increase in availability, the recovery of the economy will be placed in jeopardy. We recommend that the Lending Panel, or a suitable agency of the Treasury, provide regular updates on the actual lending by the banks to the real economy. We were very struck by the Governor of the Bank of England’s analysis that lending at the present time might not appear to be in individual banks’ interests even if it were in their collective interest. We note the Government’s proposals announced on 19 January 2009. We will monitor their implementation and effectiveness, both at the time of our inquiry into Budget 2009, and as part of our ongoing inquiry into the Banking Crisis. This is a matter we will discuss with the Chancellor in due course.

18. Some concern was also expressed that the terms of the bank recapitalisation scheme might be hampering the ability of the banks to lend. Mr Kirby explained that the bank recapitalisations were on “rather onerous terms with 12% preference shares”. He suggested that “making the terms less onerous is a more prudent approach because then banks might actually come forward to want to take the recapitalisation rather than going to foreign countries and trying to raise capital that way”. The Chancellor explained that the remuneration on the preference shares was “to stop us putting money into a bank simply to see it go out the other side straight to the shareholders without actually doing what we are wanting”. He noted that “The Government has made facilities available. Banks, of course, can go elsewhere if they want but some of them have found it is more expensive than coming to us.” In this context it is worth noting that Barclays, which did not accept the Government’s facilities, recapitalised via private capital at a rate of 14%. However, the Chancellor also promised to look again at this matter as part of his general review of how the Credit Guarantee Scheme was working. The Chancellor also noted that:

I remember there were a lot of questions in the House of Commons at the time with people saying, “Well, the tax-payer was doing this but are you getting a return for it?” The actual amount we charge, there is no magic number to that, the important thing is to get it right, although interestingly, as I say, £100 billion has already been subscribed, which does tend to suggest there is a demand for it at the price that we are offering but, as I say, it is one of a range of things we are looking at.

67 HM Treasury Statement on financial intervention to support lending in the economy, HM Treasury Press Notice 05/09 19 January 2009
68 Q 52
69 Ibid.
70 Q 308
71 Q 371
72 Barclays PLC, Press Notice, Barclays announces Capital Raising, 31 October 2008
73 Q 308
74 Q 249
On 19 January 2009, the Treasury announced that, in consultation with UKFI, the
Government had agreed to convert the preference shares the Treasury held in RBS into
ordinary shares, thus releasing RBS from paying the 12% coupon on those preference
shares.\footnote{HM Treasury press release 08/09, 19 January 2009} We have taken no evidence on this measure.

We are concerned that the terms of the original recapitalisation programme of the
banks may be hampering their ability to lend. We note the conversion of preference
shares held by the Treasury in RBS into ordinary shares. We recommend that the
Treasury continue to monitor the effectiveness of the recapitalisation scheme, and
whether further renegotiation of the original contracts will be required so that the
banks concerned can maintain and increase their lending.

**Crosby report**

On 9 April 2008, the Chancellor announced the formation of the Mortgage Finance
Working Group, led by Sir James Crosby. The Working Group’s remit was to “consider
options for improving the mortgage-backed securities market, including measures aimed
at broadening the investor base for mortgage-backed securities and improving the
robustness of the market”.\footnote{HM Treasury Press Release, Chancellor launches Mortgage Finance Working Group, 9 April 2008} The Chancellor said at the time that the “work will be an
important contribution to stabilising the cost and supply of UK mortgages”.\footnote{Ibid.} Sir James
produced an interim report on 29 July 2008 entitled *Mortgage finance: interim analysis.*\footnote{HM Treasury, Mortgage Finance: Interim Analysis, July 2008} His final report, *Mortgage finance: final report and recommendations,* was released with the
Pre-Budget Report 2008.\footnote{HM Treasury, Mortgage Finance: Final Report and recommendations, November 2008} The Chancellor in his Pre-Budget Report statement welcomed
the publication of the report, noting that its principal recommendation was that the
Government should support the mortgage market by providing for a temporary period of
guarantees for securities backed by new mortgages. Whilst the Chancellor shared Sir
James’s concerns about the availability of mortgages he noted one major obstacle:

> To implement Sir James’s recommendation, the Government would need to obtain
State Aid approval from the European Commission and resolve some technical and
practical considerations. But we will proceed to work up a detailed scheme based on
his recommendations and seek State Aid approval to proceed. I will also take into
consideration the interaction between this proposal and the Credit Guarantee
Scheme.\footnote{HC Deb Column 489, Pre-Budget Report - The Chancellor}

However, in the period between the publication of the interim and final Crosby
Reports, the Government announced the implementation of the Credit Guarantee Scheme.
The Governor told us that “Since [the publication of the Interim Crosby Report] we have
put in place the credit guarantee scheme which is designed for a time limited period to give
incentives to the banking system to make it possible for the banks to borrow money
irrespective of which kind of lending they want to use that borrowing to fund”. The Governor therefore appeared cautious towards the recommendations in the final Crosby Report. He suggested that the Report could not be looked at in isolation, but that the Credit Guarantee Scheme had to be taken into account as well:

It does not make sense to have two completely separate packages, so it would make sense to think how the credit guarantee scheme, which offers guarantees for unsecured borrowing, would fit with the Crosby proposals which offer guarantees for secured borrowing. They are different types of borrowing. The Crosby scheme is restricted to only one kind of lending. It is not obvious to me why you would want to discriminate in favour of mortgage lending as opposed to lending to small businesses, for example. It would be a big mistake to regenerate lots of lending for the housing market at the expense of crowding out lending to small businesses. What is most important now is to sit back and ask how these Crosby proposals would fit with the proposal for the credit guarantee scheme which I see as a broader based scheme which does not discriminate among different kinds of lending.

Mr Bootle also noted the potential for the Crosby Report recommendations to favour one type of lending. He remarked that “I am ... conscious of the danger of, as it were, shifting bank lending from one particular channel into another where what we should be wanting to do is increase or maintain overall bank lending”. He warned of the danger of a “piecemeal approach”, where “we guarantee a bit of this, we subsidise a bit of that, we encourage a bit of something or other else, all adding up to not all that much and, in the process, distorting the market.”

Mr Maxwell also noted the need to ensure an integrated approach between the Crosby recommendations and the Credit Guarantee Scheme. He indicated that there would be a report on their progress at the time of the Budget.

23. The Governor also raised a more specific concern about trying to reinvigorate the mortgage-backed securities market. He told us that “I am all in favour of finding ways of encouraging a sustainable rate of mortgage lending but I am not entirely confident that the best way to do this is to resurrect an instrument which, for rather good reasons, has fallen out of favour”. As evidence of this, he noted that “It is quite striking that in the last two or three days some of the American rating agencies have made clear that they would not be very enthusiastic about giving high ratings to mortgage-backed securities unless a lot more information were provided about who the borrowers were behind those pieces of paper, and one can understand that”. Mr Bootle shared the Governor’s concern over whether it would be desirable to reinvigorate the market for mortgage-backed securities, stating that “I think we have got to be quite careful about trying to resuscitate an aspect of the financial

81 HC (2007-08) 1210, Q 72
82 Ibid.
83 Q 33
84 Q 51
85 Q 232
86 HC (2007-08) 1210, Q 72
87 Ibid.
system which does not seem to have been particularly effective and was actually very dangerous”. 88

24. We have already noted the announcement by the Treasury on 19 January 2009 of the guarantee scheme for asset backed securities. This scheme, according to the Treasury, drew on the recommendations of Sir James Crosby. 89 This scheme will include, but is not limited to, triple-A rated mortgage-backed securities.

25. We note the creation of the guarantee scheme for asset backed securities. We will examine this proposal as part of our inquiry into the Banking Crisis.

Monetary policy

The recent path of interest rates

26. The worsening of the economic outlook has also seen the Monetary Policy Committee (MPC) cut interest rates. Before our hearings on the Pre-Budget Report 2008, the MPC had cut interest rates on 6 November 2008 by 1.5 percentage points, 90 and again on 4 December 2008 by 1.0 percentage points. 91 After our hearings had concluded, the MPC again cut interest rates by 0.5 percentage points on 8 January 2009, leaving the official Bank Rate paid on commercial bank reserves at 1.5%. 92 In our hearing into the November Inflation Report, the Governor highlighted three reasons why the outlook for inflation had changed so considerably, allowing the reduction in interest rates:

First, following the failure of Lehman Brothers, the turmoil that has affected financial markets over the past year intensified into the most serious financial crisis since the outbreak of the Great War. The flow of lending to households and businesses has been severely disrupted. Confidence has been badly affected. All this will hold back demand growth looking into next year. Second, the short-run indicators for activity have turned down sharply both at home and abroad. Surveys, reports from the Bank's Agents and indeed my own discussions with businesses suggest that there was a significant fall off in demand coming into the fourth quarter. As I remarked last month, the UK economy probably entered a recession in the second half of 2008. That is reflected in the labour market—unemployment has been rising at its fastest rate for 17 years. Third, although CPI inflation did rise above 5% in September, as we had expected, it has now started to fall sharply: to 4.5% in October. Oil prices have collapsed by around two-thirds since the summer, and the price of metals on world markets has halved. Measures of short-run inflation expectations have retreated. And

88  Q 33
89  HM Treasury press release, 05/09, Statement on financial intervention to support lending in the economy, 19 January 2009
90  Bank of England, News Release, Bank of England Reduces Bank Rate by 1.5 Percentage Points to 3%, 6 November 2008
92  Bank of England, News Release, Bank of England Reduces Bank Rate by 0.5 Percentage Points to 1.5%, 8 January 2009
the cut in VAT announced yesterday will also lower inflation in the short run. Given these three factors, the outlook for inflation has shifted down significantly. Over the next few months inflation will be markedly lower than we anticipated in August. It is likely that inflation will return to target at some point early next year, although the precise speed at which inflation falls back will depend on how quickly the recent depreciation of sterling feeds into consumer prices. As a result, the upside risk to inflation in the medium term, emanating from elevated inflation expectations that had been important for much of this year, has receded. And the downside risk, reflecting the possibility that weak demand might pull inflation below the 2% target in the medium term, has increased significantly.93

**The risk of deflation**

27. The focus of the MPC has changed from one of a concern about the impact of rising commodity prices, to anxiety about the implications of the economic slowdown on inflation and the economy in general. One of the potential risks we discussed as part of our inquiry was deflation. The Governor stressed that it was only a particular type of deflation that was of concern:

I think it is probably worth distinguishing between two different definitions of deflation in this context. One is simply a point of time when the inflation measure actually turns negative. That is very likely to happen to RPI [Retail Prices Index] inflation next year—in fact almost certain to happen now with the cut in VAT—and it may happen to CPI [consumer price index] inflation, though it is not our central view. The other definition of deflation is the one that economists worry about, which is a period of continuing, self-reinforcing falls in prices which then make it very difficult for real interest rates to fall to sufficiently low levels to get out of a downturn in spending. I do not think we feel that is the position that we are in or likely to be in, because the likely duration of the period when the measured inflation rate will be negative is likely to be pretty short.94

Mr Bootle however felt that there existed a very real danger of just this type of deflation:

I think the really awful risk in all this is that deflation gets into the mind and with the fact that we seem to be entering a period when the authorities are perceived to be weak (and I think are actually fairly weak in what weapons they have to deploy against a deflationary danger) the risk is that you enter into a depressive mood which affects consumption and investment expenditure. If people think that prices are going to be falling significantly for a prolonged period they put off consumption and they also put off investment projects.95

For the Treasury, Mr Ramsden maintained that the fall in prices would be temporary. He told us that the cut in VAT, and the reduction in interest rates, which would then feed into
the RPI measure of inflation, were both temporary, and therefore were not the start of a deflationary cycle. 96 He explained that both the reductions in interest rates and in VAT were designed to stimulate demand rather than the reverse, which was the implication of deflation.97 The Chancellor was also keen to suggest the temporary nature of the potential falls in prices. He pointed out that “If we look ahead, although now, for example, with oil at about $40 a barrel, it seems a long time ago, but in the summer they were way up approaching 150 but, as the economy starts to grow and the world comes through this, some of the inflationary pressures that we saw in the summer, I am afraid, have not gone away in relation to commodity prices”.98 While he acknowledged the risk of deflation, he told us that “the greater risk to our economy and the greater risk to the world economies is the need to maintain growth and the need to maintain bank lending”.99

28. One potential impact of deflation would be that in an effort to combat the deflationary spiral, the monetary authorities might lower nominal interest rates to close to zero. However, because prices are falling, real interest rates (interest rates adjusted for inflation) would remain positive. Nominal interest rates have already fallen close to zero in both the United States of America and Japan.100 Mr Bootle highlighted the problems a near-zero interest rate would cause:

   This is the danger, that you get to zero [level of interest rates], people know that rates cannot come down any further, deflation begins and perhaps even gets faster, so people see that the real rate of interest and the real cost of borrowing is actually rising and therefore that is a major deterrent to spending.101

However, Mr Bootle did suggest that “quantitative easing” might be used, should interest rates fall to close zero to combat a deflationary spiral.102 Quantitative easing refers to ways of boosting economic growth after traditional monetary policy tools, such as interest rate targets, have been exhausted. Central banks increase the money supply to the banking system by more than is needed to keep official interest rates at zero or a low rate, to shore up the financial system and promote lending, usually by buying up large quantities of assets from banks.103 The Governor of the Bank of England accepted that “close coordination between government and the central bank” would be needed if interest rates fell to zero.104 He explained that “it is very much a question of how the different types of instruments that the Government uses to finance itself are determined - whether they start to issue very short-term instruments in order to make more liquid the portfolios of the

96 Q 184
97 Ibid.
98 Q 247
99 Ibid.
101 Q 12
102 Ibid.
104 HC (2007-08) 1210, Q 7
private sector”. The Chancellor explained that interest rates were still at 2%, so the risk of interest rates was not immediate, but that “the situation is full of uncertainties”. Dismissing newspaper reports that the Government was considering quantitative easing, the Chancellor said that this was “just something that we are not looking at at the moment”.

29. The cut in VAT, instituted as part of the fiscal stimulus, discussed above, will also have the effect of reducing prices while in operation. Professor Talbot highlighted the problem this might cause with an example:

the VAT cut is deflationary and it is largely non-transparent to the public and in this situation where even on the Government’s projections we are bordering on deflation, the RPI is actually forecast to be going negative and the CPI only just remains positive. There is a real danger that the VAT cut could have the completely opposite effect of what is intended and that is to discourage people from purchasing in the short term. Certainly if I were buying a new car at the moment I would wait [until] the end of the VAT cut period and buy it then, on the grounds that prices are likely to have fallen by that time.

However, Treasury officials were keen to point out that the VAT cut was a temporary measure, and therefore not of concern. Mr Ramsden told us, “the VAT measure, by the very nature of being temporary, should give people reassurance that, whilst it will bear down on the price level in the short term, the price level will then go back up in the medium term, as highlighted in last week’s MPC statement that accompanied their interest rate cut”.

30. We have already noted the announcement by the Treasury on 19 January 2009 of the Bank of England asset purchase facility. This scheme will allow the purchase by the Bank of England of a wide variety of high quality private sector assets to boost the availability of corporate credit. We have taken no evidence on this measure.

The current forecast suggests that any future falls in prices will only be temporary. But the risk of a self-reinforcing deflationary cycle exists in the UK economy at present. The Treasury must be alert to this possibility. Nominal interest rates have already fallen significantly, and may soon reach a rate of zero percent or just above. We recommend that the Treasury prepare and publish the actions it may consider taking should a period of “quantitative easing” be needed. We note the creation of the Bank of England asset purchase facility, and would expect it to be included in such an analysis.

105 Ibid.
106 Q 246
107 Qq 375-382
108 Q 22
109 Q 184
110 HM Treasury press release, 05/09, Statement on financial intervention to support lending in the economy, 19 January 2009
31. This paper must also contain the actions that will be expected of, or have been recommended by, the other relevant public bodies related to the Treasury, such as the Bank of England and the Debt Management Office. We will continue to examine the need for, and design and function of, the Bank of England asset purchase facility in our future inquiries into the Budget 2009, and the Bank of England’s Inflation Reports.

**Impact on savers**

32. The reduction in interest rates, while beneficial to those who have borrowed money, reduces the income available to those who rely on the interest from their savings. One particular group of such savers are pensioners. Mr Ramsden told us that the recent fall in interest rates “is intended to ease the burden on borrowers”.

When we asked Treasury officials whether they were considering measures to assist those who suffered from interest rate falls, Mr Williams first pointed out that many pensioners had little savings, but that for those that did some measures were in hand:

[many] continue to receive their bank or building society interest with tax deducted in circumstances where they could fill in a form and get the tax not deducted or make claims to get some of the tax back afterwards. We are about to run a new campaign to raise awareness of the ability to get the interest paid gross or to get back some of the tax in circumstances where savers at the 10p tax rate apply.

The Chancellor pointed out that the desire of banks to maintain savings rates had to some extent limited the pass-through of reductions in interest rates to borrowers. The Chancellor acknowledged the problem that savers faced:

There are a lot of people who have saved for their retirement. They have got money in the banks and building societies and stocks and shares and when interest rates come down there are two sides to that. It depends whether you are a borrower or a saver. … I recognise that, which is why a number of the building societies and some of the banks were saying “Interest rates came down last time but we have also got to remember we have got to attract savers”, and that is particularly true in the building society sector.

33. Interest rate reductions, while favourable to borrowers, once passed through by financial institutions lead to a decrease in income for savers. While the need for lower interest rates to maintain economic growth is crucial at the present time, the needs of savers must not be forgotten. We recommend the Treasury consider measures that will provide support to savers at this difficult time.
Net trade and the exchange rate

Forecast for net trade

34. The Pre-Budget Report 2008 contained a forecast that net trade would provide a positive contribution to GDP growth from 2009.\textsuperscript{115} However, the Report also stated that net trade has not provided a positive contribution to GDP growth, on average, over the period 2000-2007:\textsuperscript{116}

Despite sluggish export growth in 2008 and 2009, the slowdown in import growth in 2008 and decline in import volumes in 2009 mean that net exports are forecast to contribute positively to overall GDP growth. At around ¾ of a percentage point in 2009, the contribution of net exports to growth would be of a similar order of magnitude to that seen in the past three UK recessions.\textsuperscript{117}

Mr Kirby thought that this was a positive development for the UK economy:

I can certainly give you one silver lining: in a sense, looking ahead, the decline in sterling is going to help rebalance the UK economy. We would expect to see competitive gains feed through to net trade having a more positive contribution to growth and that means basically that the rebalancing of the economy will be done partly through sterling rather than relatively weak income growth for households over the coming years. That possibly is the one silver lining you can get from that.\textsuperscript{118}

The Chancellor was also positive about the outlook for net trade, stating that “In volume terms, our exports actually went up by just over 2% in the three months to October”, and that “if you look at the performance of our manufacturers and the service industry in terms of its exports, we have done quite well over the last few years”.\textsuperscript{119}

The fall in sterling

35. The positive outlook for net trade stems in the main from the significant decline in sterling’s value against other currencies. The recent cuts to interest rates, and concerns about the overall state of the economy, have seen a marked decrease in the value of sterling against other currencies, as since 1 January 2007 the sterling effective exchange rate index has fallen by around 28%,\textsuperscript{120} As Professor Bean explained, these falls in the value of sterling against other currencies have both positive and negative effects. Falls in the value of sterling make UK exports cheaper in other countries’ currencies, allowing the UK’s exporting industries to compete more effectively in those countries. But, significant falls in sterling could pose a risk to the UK economy, as Professor Bean explained:

\begin{itemize}
\item \textsuperscript{115} Pre-Budget Report 2008, p 169, Table A4
\item \textsuperscript{116} Ibid.
\item \textsuperscript{117} Ibid., page 174, para A.103
\item \textsuperscript{118} Q 15
\item \textsuperscript{119} Q 284
\item \textsuperscript{120} Bank of England statistics website, www.bankofengland.co.uk, to 20 January 2009
\end{itemize}
An alternative scenario is one where external investors lose faith in the policy framework that the UK operates under and expect much faster rates of inflation in the future or something like that which results in downward pressure on sterling now, an old-fashioned sterling crisis, if you like. That, I have to say, I would be much more worried about, if there was a lack of support for sterling on the down side. I do not think that is the position we are in at the moment.\textsuperscript{121}

One such disadvantage from a depreciation of sterling is that it would import inflation, as the goods imported into the United Kingdom from other countries become more expensive as the value of sterling falls. The imported inflation counteracts the positive impact of a weaker currency on the UK’s exports.

36. A relatively recent major currency crisis faced by the United Kingdom was when sterling was withdrawn from the Exchange Rate Mechanism on 16 September 1992.\textsuperscript{122} The position faced by the UK at the current time is different, as sterling currently floats freely, a point Mr Ramsden made to us while explaining that the Government had no target rate for sterling.\textsuperscript{123} Mr Bootle told us that, at the present time, the floating exchange rate gave the UK “a massive competitive advantage against those currency areas and at the same time we are able to set our own interest rates”.\textsuperscript{124} Mr Bootle pointed out that sterling had, prior to the current devaluation, been “roughly stable at massively too high a level and much of what has gone wrong in our economy can be pinned on that”.\textsuperscript{125} Mr Ramdsen highlighted the advantages to the UK economy of its exit from the ERM, and how these might apply now:

\begin{quote}
At first we saw it in prices with exporters improving their margins and then it came through later on in volumes. What we have assumed in this forecast is that principally in the short-term the benefit effects will be from import substitution rather than from some big increase in export volumes, that UK consumers will switch more towards domestic production rather than imported production because the price of imported production will go up and then over time you will get the export volume effects.\textsuperscript{126}
\end{quote}

37. When questioned as to whether a further devaluation had been considered, Mr Ramsden replied that the Treasury examined “all kinds of scenarios for the economy to think about whether our forecast judgments are reasonable”.\textsuperscript{127} The Chancellor pointed to the recent volatility in exchange rates.\textsuperscript{128} He was then asked whether there was a level of sterling that would be harmful to the economy, and in such a scenario, whether the

\begin{thebibliography}
\item \textsuperscript{121} HC (2007-08) 1210, Q 48
\item \textsuperscript{122} HC (2006-07) 299-II, Ev 21
\item \textsuperscript{123} Q 118
\item \textsuperscript{124} Q 49
\item \textsuperscript{125} Q 17
\item \textsuperscript{126} Q 116
\item \textsuperscript{127} Q 119
\item \textsuperscript{128} Q 271
\end{thebibliography}
Treasury would be prepared to support the currency. The Chancellor confirmed that he would “do everything that I can to support our economy”.129

38. The recent fall in sterling is providing a stimulus to the exporting sections of the UK economy. However, the fall in sterling has its negative impacts, such as the risk of imported inflation, and we will continue to monitor the situation. We recommend that the Treasury include an update at the time of Budget 2009 about these negative impacts, and what mitigating measures, if any, it has taken.

*Risks to the net trade forecast*

39. One potential risk to the Treasury’s forecast of a positive contribution from net trade to GDP growth is the impact of protectionism. The Pre-Budget Report 2008 outlined the risk as follows:

Protectionism is a major risk to global economic prospects and to lifting developing countries out of poverty. As global growth slows while global imbalances remain significant, there is a risk that countries retreat to protectionism or trade-distorting subsidies in a futile attempt to support their domestic economies. Further economic cooperation will help to boost trade and investment flows to the benefit of global growth. A successful conclusion of the Doha Round of world trade talks is a matter of urgency in terms of boosting global trade, and reassuring markets that policymakers will not repeat the mistakes of past global downturns.130

Mr Ramsden however told us that he was “encouraged by the G-20 meeting back in mid-November where there was concern expressed about any return to protectionism”.131 He said that he hoped that he could see “through the G-20 statements and through other statements from policymakers—that the lessons have been learned from previous downturns and that if you have a shift into protectionist action that actually prolongs the downturn rather than encourages the recovery”.132 He then stated that the UK’s position as an open economy meant that the UK was “at the forefront, I think, of making a case for free trade, for wanting to see progress on Doha and for stressing the risks and costs to a return to protectionism”.133

40. However, the impact of a fall in sterling in providing a stimulus to exports depends on the size of the capacity of the exporting sectors of the country’s economy. Questioned as to whether the size of the UK’s manufacturing export capacity had diminished, and whether this had been taken into account, Mr Ramsden said that “Obviously our forecasts are based on the size of the manufacturing sector as is and we have tried to factor in that effect”.134 The Chancellor acknowledged that “There may be less manufacturing around—if you

129 Q 275
130 Pre-Budget Report 2008, page 180, para A.123
131 Q 134
132 Q 134
133 Q 135
134 Q 117
remember, it really suffered a great deal in the recession of the early 1980s and took a long time to continue,” but pointed out that “in engineering, pharmaceutical, the bio-tech industries, aviation, we have been able to compete pretty well”.

41. **The rebalancing of the UK economy will require healthy UK exports, along with adequate access to foreign markets. We endorse the Treasury’s anti-protectionist stance.**

**Business Support**

42. The ongoing dislocation in financial markets, and the economic slowdown, has begun to affect companies outside the financial sector. In November, newspaper reports suggested that the Secretary of State for Business, Enterprise and Regulatory Reform, Lord Mandelson, was considering whether to provide direct government support to industry. Mr Bootle was hesitant, but suggested such support could potentially be justified:

> If you believe in markets, and admittedly the number of people who do seems to be falling by the month, you would think that sort of issue is best left to the markets. Governments do not have a very good record in making that sort of judgment. I would hope that we did not go down that particular route, but perhaps in thinking about the agenda that I mentioned before and those industries which had some key strategic reason to continue but which for some reason or another the market would not support, if we tried to think about market failure, why would an industry that we thought was particularly significant not receive the support of the market, and in those circumstances it might be justified to support them.

When we asked the Treasury whether it had been involved with these discussions on supporting industry, Edward Troup, Director, Business and Indirect Tax, at the Treasury suggested that the Treasury and the Department for Business, Enterprise and Regulatory Reform were working together as follows:

> If you have had a chance to look at the Strategic Challenges document which we published alongside the PBR, you will see in paragraph 4.2 it says: ”The Government has an important role to play in recognising those business activities in which the UK has relative strengths. By working closely with industry sectors the Government could help identify barriers to growth.” I think that is almost exactly what the Secretary of State for Business, Enterprise and Regulatory Reform said at the Hugo Young lecture last week when talking about the phrase "industrial activism" when he said: ”It means recognising that by investing the right way in people and infrastructure and joining up the relevant decisions taken by government, we can dramatically improve our chances of coming out ahead. We need to focus on areas of policy like technology, skills, regulation, investment and export markets and how we set the relevant conditions for business success.” I think those two statements are
almost exactly the same and I think they reflect the way the Treasury and the Department for Business are working together on this.\textsuperscript{138}

The Chancellor did not dismiss suggestions that support might be available. He told us that “for understandable reasons, unless the person who approaches us chooses to make it public, we do not intend to make public people's approach if they think they might need assistance in difficult conditions, because it could be quite unhelpful, but what I am saying is we would look at all these things on the merits”.\textsuperscript{139} He also pointed to examples of support given to industry by the Government in the past, such as that provided to Vauxhall.\textsuperscript{140}

\textbf{43.} On 14 January 2009, the Government set out details of business support package announced in the Pre-Budget Report. The Committee noted that the package included the following measures:

- A working capital scheme for companies with a turnover of up to £500 million a year by guaranteeing 50 per cent. of the risk on existing and new working capital portfolios worth up to £20 billion.\textsuperscript{141}

- A new enterprise finance guarantee to support up to £1.3 billion of bank loans to companies with a turnover of up to £25 million by allowing these firms to borrow up to £1 million, of which the Government will guarantee 75%.\textsuperscript{142}

- A new £75 million fund to provide equity finance to companies with viable business models that have exhausted traditional forms of finance. The capital for fund will provide £50 million of Government funding with £25 million from major banks. It will be run by professional fund managers.\textsuperscript{143}

We have not taken any evidence on this package.

\textbf{44.} \textit{Support provided directly by Government to industry may be justified. Clearly, reasons of commercial confidentiality make it difficult for an open debate to take place over specific measures. However, we recommend that the Treasury, in consultation with BERR, should provide a consultation document setting out the criteria against which support packages would be considered.}

\begin{footnote}
\textsuperscript{138} Q 138 \textsuperscript{139} Q 280 \textsuperscript{140} Q 282 \textsuperscript{141} HC Deb, 14 January 2009, Col 217 \textsuperscript{142} Ibid. \textsuperscript{143} HC Deb, 14 January 2009, Col 218
\end{footnote}
3 The public finances

The fiscal framework

45. In its Code for Fiscal Stability, published in November 1998, the Government set out the principles by which it would conduct fiscal policy. These were:

   a. **transparency** in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts;

   b. **stability** in the fiscal policy-making process and in the way fiscal policy impacts on the economy;

   c. **responsibility** in the management of the public finances;

   d. **fairness**, including between generations; and

   e. **efficiency** in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.\(^{144}\)

The Government has two fiscal policy objectives, which are:

   over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and

   over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.\(^{145}\)

To achieve these two objectives, the Government has established two fiscal rules. These are:

   **the golden rule**: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and

   **the sustainable investment rule**: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40% of GDP over the economic cycle.\(^{146}\)

**Dating of economic cycle**

46. In order to assess performance against the fiscal rules, an assessment is needed of when the economic cycle began and ended. The Treasury explained in Budget 2008 some of the difficulties it had faced in ascertaining the timing of the end of the last cycle and concluded at that time that it was too soon to make an assessment.\(^{147}\) Alongside the 2008 Pre-Budget Report, the Treasury, *The Code for Fiscal Stability*, November 1998, p 5

144 Pre-Budget Report 2008, p 36, para 2.91
145 Ibid., p 36, para 2.92
146 Ibid., p 36, para 2.92
147 Budget 2008, p 177, para C.12
Report, the Treasury published *Evidence on the economic cycle*, which reached the following conclusion:

the evidence from the range of cyclical indicators supports the assessment that the economic cycle judged to have started in 1997H1 [first half of the year] ended during the second half of 2006. Uncertainties continue to surround this assessment, in particular those relating to further possible revisions to National Accounts data.\textsuperscript{148}

**Performance against fiscal rules over the last economic cycle**

47. According to the *Government’s Fiscal Framework*, published alongside the 2008 Pre-Budget Report, the fiscal rules were met over the last economic cycle which the Treasury estimated finished in 2006–07:

- the average current surplus over the economic cycle was 0.1 per cent of GDP, meeting the golden rule that the Government borrows only to invest and helping ensure sound public finances and fairness between generations; and
- public sector net debt was reduced from 42.5 per cent of GDP in 1996-97 to 36.0 per cent in 2006–07, meeting the sustainable investment rule that net debt be held at a stable and prudent level over the economic cycle, and meeting the commitment that, other things being equal, net debt would be maintained below 40 per cent of GDP over the economic cycle.\textsuperscript{149}

**Usefulness of fiscal rules over the last economic cycle**

48. The Chancellor gave his opinion of the benefits of the fiscal rules over the last cycle:

I think they are a pretty good discipline. It has helped us since 1997 to have rules that governed how much you could borrow and which were a discipline on us to reduce debt. As you know, debt came down quite substantially during that ten-year period.\textsuperscript{150}

According to the Chancellor, having a credible fiscal framework in turn led to further benefits:

- If you look at the long term gilt yields in this country and where they are today I think people do have confidence in us, but confidence comes from two things. One is that people want to know what rules you are operating under and also whether you are prepared to do what is necessary in order to ensure that you do stick to the objectives you set out.\textsuperscript{151}

\textsuperscript{148} HM Treasury, *Evidence on the economic cycle*, November 2008, p 3, Summary
\textsuperscript{149} HM Treasury, *Government’s Fiscal Framework*, November 2008, p 4, para 1.6
\textsuperscript{150} Q 318
\textsuperscript{151} Q 319
In written evidence, Professor David Heald told us he did not share the same level of enthusiasm, asserting that the Treasury’s action had “bred an air of cynicism about the fiscal rules”.  

**Departure from the fiscal rules**

49. The Chancellor confirmed that “the fiscal rules were important and fiscal rules remain important and will always be important”. Mr Ramsden, for the Treasury, maintained that even if the rules themselves were coming under pressure, their underlying principles remained valid. He explained that the rules were “a means to an end”:

> We set the two rules, the Golden Rule and the Sustainable Investment Rule for the last cycle … We always made clear that those rules were set in the way they were set for that cycle. Since then we have been hit by these two global shocks and the credit shock is intensifying. Against that backdrop, … it would be perverse to stick to rules that were not a means to an end, that actually required you to tighten fiscal policy during a recession”.

50. The Chancellor, in his Mais Lecture in November 2008, indicated that the Government would temporarily depart from the fiscal rules, and set out the reasons why:

> the fiscal rules we adopted over ten years ago—which target debt and promote investment—enabled us to triple public investment, at the same time as cutting debt to one of the lowest levels among the world’s major economies. But to apply these rules rigidly in today’s changed conditions would be perverse. We must respond to the challenges and uncertainty we face today—supporting the economy now and maintaining public investment—while at the same time ensuring that we live within our means in the medium term.

51. Mr Chote agreed, saying “there is no question but that they had to depart from [the fiscal rules] given where we were starting and the size of the adjustment that the economy has faced”. Mr Ramsden argued that, although the Treasury had had to depart from the rules, the objectives framing fiscal policy had not changed and were as set out in the Code for Fiscal Stability.

> The Government’s objectives for fiscal policy in the face of these shocks remain unchanged. The Government’s immediate priority is to continue to support the economy, while setting a path now for ensuring fiscal sustainability over the medium term. In these circumstances, the role of the fiscal framework is to ensure fiscal policy has the flexibility to respond appropriately, while remaining committed to clear,
transparent long-term goals. So, to achieve its objectives, and as provided for in the Code for Fiscal Stability, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.\textsuperscript{158}

52. In place of the Golden Rule and Sustainable Investment Rule, the Government announced a Temporary Operating Rule in the Pre-Budget Report:

\begin{quote}

to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.\textsuperscript{159}
\end{quote}

The Chancellor commented that:

\begin{quote}
The important thing is not just the rule but the way in which we would implement it, and, again, it is set out here, and that is that as we come through this from 2011 there is a tightening of about 0.5\% until 2015/2016. So I think the rules are important but also seeing evidence that you are prepared to take the necessary steps to stick to those rules are important as well … What I have done is to set out a temporary operating rule, but also, importantly, the way in which I intend to deliver on that.\textsuperscript{160}
\end{quote}

53. Mr Chote contended that the Temporary Operating Rule did “not provide much of a constraint or anchor at all”, but agreed with the Chancellor that the credibility of the public finances hinged on the actions to be taken by the Government in order to meet the Rule, not the actual Rule itself:

\begin{quote}
[The Treasury] have said that they want to see the cyclically adjusted position for borrowing improving year-by-year, which would be the case anyway as a result of fiscal drag if you had no policy measures, and they would like to see [the ratio of] debt to GDP falling at the end of a forecast horizon which if you are improving the current budget in that sort of way you would normally expect that to be the case anyway … Credibility at this stage relies crucially on the measures that have been announced on spending and taxation rather than on the fiscal targets per se. That is really what people are having to put their faith in.\textsuperscript{161}
\end{quote}

Mr Ramsden did not accept that the Rule offered no meaningful constraint on Treasury budgeting:

\begin{quote}
You would get some very small reductions relative to the reductions that we have judged appropriate from fiscal drag. Also, in the case of our forecast, because we expect the more tax-rich parts of the economy, which are taking a real hit through this recession … to recover, but over and above that, the reason that I think this is a credible consolidation plan and that over time, as we refresh it and as it is developed,
I think it will give enhanced credibility to the framework, is because, in addition to just those automatic effects, or those effects that come from judgement, we are announcing from 2010–11, the last year of the CSR [Comprehensive Spending Review] period, additional VFM [value for money] savings of £5 billion. Then beyond the CSR period we have set out what I think are achievable assumptions for real spending growth falling in terms of totally managed expenditure, which is current and capital, to an average of 1.1% a year. That is a significant slowdown in spending growth which is the major part of the consolidation. Then, in addition to that, we have set out specific tax-raising measures in PBR documentation which we think will contribute to the consolidation. 162

54. Mr Ramsden was confident that the Rule would enable the Treasury to “be judged over time on whether we achieve the kind of plans that we have set out. … That would be one way I would expect us to be held to account, just as we have been in the past on our track record, and we will be judged against whether these plans are achieved and if there are any departures from them”.163 He also pointed to the role of the market in providing a judgement on the Government’s stewardship of the public finances.

For fiscal policy, it is quite hard to come up with a summary measure of credibility … We tend to look at the ten-year bond yield. Over time that has come down successively and, as I have said, at the moment it is down at about 3.6%. So we suggest that people want to buy government debt and consider the position credible and sustainable.164

A return to the fiscal rules?

55. The Pre-Budget Report announced that the temporary departure from the fiscal rules would last “until the global shocks have worked their way through the economy in full”.165 Mr Ramsden, given the uncertainties involved, did not consider it appropriate to constrain that period definitely.166 Mr Chote commented that the Government was “unclear” about how long the fiscal rules would be temporarily departed from.167

56. Under the Code for Fiscal Sustainability, the Government could have chosen to change the fiscal rules, but instead chose to depart temporarily from them, implying that the original rules would, at some stage, be returned to.168 Mr Chote considered that the Treasury was unclear on this issue, saying that it had “not really said … whether they still believe in their original long-term assessment of what is a prudent level of government debt.” In the longer term, he argued, the Treasury “would need to think about whether the
targets that they had originally set themselves were the right ones”. The Treasury did say that “in advance of the public finances reaching cyclically-adjusted current balance, the Government will set out how it will apply the fiscal framework in future to continue to deliver its objectives”. Mr Ramsden refused to be drawn on setting a debt limit for a possible future revised Sustainable Investment Rule. The Chancellor confirmed that he did not have any immediate plans to consult on a future fiscal framework, but would “leave that option open”.

57. We accept the Chancellor’s argument that a rigid application of the fiscal rules in the current circumstances would have been damaging to the UK economy. The fact that a temporary departure from the fiscal rules has been required serves to reinforce our view that a revised fiscal framework is needed. The forthcoming period during which the Temporary Operating Rule applies provides a good opportunity to re-evaluate the fiscal framework for the future. We recommend that the Treasury conduct a full public consultation on the design of such a framework. We remain of the view as expressed in our previous Reports, such as on the Budget 2008, that it is our desire to see a credible framework which is more forward-looking than the fiscal rules used over the last cycle, which have been beset by problems surrounding the dating of the economic cycle.

State of the public finances

Current budget

58. At the time of the 2008 Budget, the Treasury forecast that the current budget would move into surplus in 2010–11. In our Report arising from that document, we noted the risks to that forecast:

There has been a further weakening of the Treasury’s forecasts of the current budget balance from 2008–09 onwards since last year and the latest forecasts for the fiscal position are based on forecasts for economic growth that are subject to considerable downside risks.

The Pre-Budget Report projected a significant further deterioration in the public finances, with the current budget in deficit throughout the forecast period, peaking at 5.3% of GDP in 2009–10, and then falling to 1.1% by 2013–14. The cyclically-adjusted deficit was forecast to fall from 4.4% of GDP in 2009–10 to 1.0% in 2013–14 “when the economy is projected to return to trend, driven by a recovery of tax receipts and lower spending growth”. The Pre-Budget Report noted that “a further adjustment of ½ a per cent a year in 2014–15 and 2015–16 would eliminate the deficit on the current budget by 2015–16”.

The Chancellor took the view that the appropriate response to the combined forces of the credit crunch, inflationary pressures in 2008, lower revenues from the financial services

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169 Q 30
171 Q 157
172 Q 317
173 Pre-Budget Report 2008, p 190, para B13
sector and the housing market downturn was to “support the economy at the moment”, with the intention of reducing the borrowings required to fund such a strategy as the economy rebounds.\textsuperscript{174}

**Public sector net debt**

59. The Pre-Budget Report projected public sector net debt would increase to well above the limit set by the Sustainable Investment Rule, of 40% of GDP over the course of the economic cycle. For 2008–09, the Treasury estimated that net debt would be 41.2%.\textsuperscript{175} Net debt is then set to increase each and every year of the forecast period reaching 57.4% of GDP by 2013–14.\textsuperscript{176} Most of this increasing debt burden results from rising public expenditure in recent years and from the operation of the automatic stabilisers; the contribution of measures in the Pre-Budget Report is relatively modest. We asked witnesses whether they were concerned about the sustainability of the public finances. Mr Chote defined sustainability as “the Government’s ability to meet the obligations it has”, explaining that the more debt taken on, the more future tax revenue would be needed to service that debt. In principle, the Government could reach the point at which the debt interest burden was so high that it would run out of economic resources to service its liabilities. Much earlier than that though, in Mr Chote’s view, the Government would face “the political constraint of … finding it difficult to persuade taxpayers to accept that burden”.\textsuperscript{177} The Chancellor did not think there was “a particular number [for the public sector net debt] beyond which you cannot go”.\textsuperscript{178} He accepted that public debt was “higher than we would like it to be”, but offered the following justification:

I had to reach a judgment at a time when we are being hit by the credit crunch by, earlier in the year, these very high inflationary prices. What did I do to support the economy? Firstly, and I think there is all-party agreement to this, you let the automatic stabilisers play their role. That is quite expensive actually in terms of rising benefits, but we have to do that. It does affect your borrowing. I also have to take account that our revenues, particularly from the financial services industry are going down quite dramatically: because we are such a big financial services centre we are being affected by it. We are being affected by the downturn in the housing market—that means that borrowing does rise. I had to allow that to rise, because if I had started to take money out of the economy now, or earlier than I am proposing to, I think it would make a difficult situation a lot worse. In addition to that, of course, we also have been maintaining investment, spending on transport and housing and capital projects, and so on, … of course, as we come out of this and we start to grow, then we need to be able to get that borrowing back down.\textsuperscript{179}

\begin{itemize}
\item[174] Q 313
\item[175] Pre-Budget Report 2008, p 190, Table B3
\item[176] Pre-Budget Report 2008, p 20, Table 2.2
\item[177] Q 3
\item[178] Q 313
\item[179] Ibid.
\end{itemize}
60. Mr Chote did not believe that people thought that the Government was at risk of default, but said that “the question of the degree to which the increase in debt makes it more expensive for the Government to borrow is a live one and is likely to be more important as a constraint over the next few years than it has been in the past”. Mr Bootle accepted Mr Chote’s explanation of the theoretical risks of unsustainable public debt, but pointed out that the actual reaction of sovereign debt markets to the Pre-Budget Report was very positive:

although there is this theoretical concern that the Government will find it more expensive to borrow actually what is happening in the markets with a vengeance is that the Government is finding it cheaper to borrow. The markets are falling over themselves to buy government debt.

Mr Ramsden confirmed that the price paid by the Government for raising debt had “continued to fall across all maturities”:

Short-dated gilts are currently at historically low levels and the 10 year benchmark is at 3.6%, so there is a lot of demand for government debt at the moment and in the economic conditions and credit conditions that we face we think it is appropriate to allow government borrowing and government debt to rise to compensate for the fact that private sector borrowing is being reined in sharply globally through the process of de-leveraging.

61. It is encouraging that at the present time the markets are supporting the Government in its raising of debt. We note the Chancellor’s acceptance that in due course the levels of public sector net debt need to be addressed.
4 Child poverty, Fuel poverty and the poverty trap

Child poverty

62. In 1999, the then Prime Minister committed the Government to the goal of ending child poverty “within a generation”. The pledge was underpinned by a series of targets and milestones to reduce the number of children in low-income households by at least half by 2010/11 and eradicate child poverty by 2020.

63. The Government has said it will judge its success in meeting the 2010 child poverty primarily through reference to the number of children in relative low-income households, defined as households with incomes below 60% of median income before housing costs. The Government has also said it will use two additional indicators to measure progress against tackling child poverty in the coming years:

- The number of children in absolute low-income households, defined as households with incomes of less than 60% of median income held constant in real terms from a 1998-99 baseline; and

- The number of children in relative low-income households and in material deprivation: the introduction of a material deprivation indicator for child poverty is designed to provide a wider measure of living standards and reflects the view that tackling child poverty is about more than simply raising income levels.183

64. The baseline for progress against the target to halve the number of children in relative low-income households by 2010–11 was the Government’s estimate that 3.4 million children were living in relative poverty in 1998-99.184 This meant that child poverty levels needed to be reduced to 1.7 million in order for the Government to meet its 2010–11 target.

65. Since 1998-99 600,000 children have been lifted out of relative poverty, whilst absolute child poverty has halved.185 The Government calculates that measures announced since Budget 2007 will lift a further 500,000 children out of relative poverty.186 This left the Government, prior to the Pre-Budget Report, needing to reduce child poverty by a further 600,000 children in order meet its 2010–11 child poverty target.187

66. The key child poverty measures in the 2008 Pre-Budget Report included:

183 HM Treasury, PSA Delivery Agreement 9: Halve the number of children in poverty by 2010-11, on the way to eradicating child poverty by 2020, October 2007, p 5
184 Ibid., p 21
185 Pre-Budget Report 2008, p 86, para 5.11
186 Ibid.
187 Q 192-193
• Bringing forward the Government’s commitment to increase the child element of the Child Tax Credit by £25 above indexation in April 2010 to April 2009; and

• Bringing forward the increase in Child Benefit from £18.80 to £20 a week for the first child and from £12.55 to £13.20 a week for subsequent children from April 2009 to January 2009.188

67. Mike Brewer, Director, Institute for Fiscal Studies, told us that “there were some measures for families with children announced in the PBR, but that they all take effect in 2009”. He went on to say that “there was nothing specific for families with children in 2010, which is the year the Government has the quantified target for”, concluding that “the small rise in the continuation of the rise in the personal allowance and the slight extension, have a negligible impact on child poverty, so essentially the PBR did nothing for child poverty in 2010”.189 In written evidence the TUC described the Pre-Budget Report as a “missed opportunity, leaving a lot still to be done in the Budget of next Spring”.190 The Child Poverty Action Group (CPAG) also referred to the 2008 Pre-Budget Report as a “missed opportunity” with respect to child poverty. They explained that the child poverty measures it contained would do little to reduce child poverty because:

The spending measures on poor families are limited. While bringing forward increases on child benefit to January 2009 and child tax credit to April 2009 will improve families’ positions, these will not affect the child poverty target (original plans would have had this spending in place by the target year).191

68. Treasury officials confirmed that the Pre-Budget Report would have only a negligible impact in terms of meeting the child poverty target, telling us that this was because “the measures announced in the PBR are about bringing forward increases which would otherwise have taken effect either in April 2009 or in April 2010”.192 Whilst the child poverty measures in the Pre-Budget Report will not significantly advance meeting the 2010 child poverty target, the Chancellor insisted it would provide additional support to families. He told us that:

People with children will benefit from the increased child benefit rate that will come in January [2009]. In addition to that the child tax credit increase has been brought forward so they will benefit from that as well, so I do not agree with your assertion that it [the 2008 Pre-Budget Report] is not helping people on low-incomes.193

69. Mike Williams, Director Personal Tax and Welfare Reform, rejected the suggestion that the Government would fail to meet the 2010 child poverty target. He told us that “as we [the Government] made clear in the PBR Red book, Ministers are going to take stock of

188 Pre-Budget Report 2008, p 86, para 5.12
189 Q 62-63
190 Ev 89
191 Ev 60
192 Q 195
193 Q 352
where we have to go on the 2010 and 2020 targets in the Budget". The Chancellor reaffirmed the Government’s commitment to tackling child poverty, telling us that the 2010 target “is an extremely important target to us”. The Chancellor went on to say that he could not make the decision now as to what additional monies the Government would spend on alleviating child poverty in the 2009 Budget, but would “make a decision in the Spring as to what I can do”. 195

70. The Pre-Budget Report states that the Government will introduce a child poverty bill in 2009. It intends to launch a consultation asking stakeholders how legislation in this area can best reflect its long-term ambition to eradicate child poverty. 196 The Chancellor referred to this proposed child poverty bill as further evidence that the Government remained committed to reducing child poverty. The TUC welcomed the Government’s “plans to put into law their commitment to eradicate child poverty by 2020” but went on to add that “a redoubling of efforts to deliver the 2010 target of halving child poverty on its level of 1998 is necessary. This is, after all, the foundation for this new legislation”. 197 CPAG also welcomed the commitment to enshrine the 2020 target in legislation, but cautioned that legislation “would be meaningless without more concrete steps to achieve the 2010 target”, noting that “time is running out” for the Government to meet the 2010 target. 198

71. Mr Brewer told us that the Government would need to spend an additional £2.8 billion if it was to meet the 2010–11 child poverty target. 199 CPAG broadly concurred saying that “reducing child poverty by half by 2010 will mean additional expenditure of around £3 billion invested in family incomes—a sum of money which they noted was “small indeed in the context of wider economic packages”. 200 Treasury officials explained that, whilst they themselves did not forecast such figures, they believed the Institute of Fiscal Studies estimate of £2.8 billion was in “the right ball park”. 201

72. We welcome the decision in the Pre-Budget Report to bring forward measures on Child Benefit and Child Tax Credit, including the reforms on Housing Benefit and Council Tax Benefit due this autumn, which will provide increased support to families with children. However, we note with concern that the Pre-Budget Report contains no policy measures which will significantly advance meeting the 2010 child poverty target. The Chancellor has told us that the Government remains strongly committed to meeting the child poverty targets, but this needs to be demonstrated through firm action on tackling child poverty in the 2009 Budget, including the deployment of additional resources. We recognise the fiscal position is strained and that resources are

194 Q 196
195 Q 310
196 Pre-Budget Report 2008, p 88, para 5.21
197 Ev 89
198 Ev 60
199 Q 64
200 Ev 60
201 Q 197
limited, but believe meeting the 2010 child poverty target must not be allowed to fall by the wayside.

**Fuel Poverty**

73. The Office for National Statistics estimates that excess winter deaths in 2007–08 totalled 25,300, the majority of these deaths occurring among the elderly. In his Budget statement last March, the Chancellor indicated that he would help pensioners who were facing pressures with higher energy bills by raising the winter fuel payment for over 60s from £200 to £250 and for the over 80s from £300 to £400, which would ensure that “9 million pensioner households will be better off”. The cost of the payments for winter 2008 was estimated at £575 million.

74. Mr Mervyn Kohler, Special Adviser for Help the Aged, said that the large number of winter deaths were a “continuing disgrace to a government which is there to protect the most vulnerable in our society.” Mr Kohler suggested to us that the Chancellor had missed many opportunities to address fuel poverty in the Pre-Budget Report:

surely this was the moment when he could really have done something significant with the construction industry to improve the energy efficiency of our whole housing stock, improve therefore employment opportunities in that sector and help towards reaching the climate change targets as well as eradicating fuel poverty on the way.

**One-year commitment**

75. The Budget 2008 announced that the additional winter fuel payment was a one-year commitment. When we asked Treasury officials in March what action would be taken to help those in fuel poverty in the coming years we were told that the Treasury continued to undertake discussions with the energy supply companies with a view to bringing “something forward for the winter following the winter coming.”

76. Mr Kohler told us that he was horrified that the increase in the winter fuel allowance had been described as a “one-off” payment by the Chancellor. He pointed out that the increases that people were facing in their energy bills had been higher than the winter fuel allowance and the additional one-off payment—“as “one-off” improvements are not really terribly helpful”.

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203 HC Deb, 12 March 2008, col 298
204 Budget 2008, p 9, Table 1.2; HC (2007-08) 430, Ev 31, Q 217
205 Help the Aged News Release, Cold kills 25,000 older people, 27 November 2008
206 Q 65
207 Q 216
208 Uncorrected Oral Evidence, Pre-Budget Report 2008, 4 December, Q 66


Monitoring Energy Costs

77. The Pre-Budget Report 2008 stated that “clear and transparent information” was needed for all consumers to “manage their own energy costs through engaging effectively with the energy market”.\footnote{Pre-Budget Report 2008, p 141, para 7.69} The Chancellor acknowledged that there was “widespread concern that the fall in the price of wholesale energy has not been reflected quickly enough in reduced household bills”.\footnote{HC Deb, 12 March 2008, col 297} The Chancellor told us he had asked Ofgem to publish quarterly reports over the coming year showing the relationship between wholesale prices, estimated hedged wholesale costs and average retail prices for gas and electricity in order to:

make it clearer when companies are passing the benefits of downward price changes through to their consumers and will ensure greater transparency over future price changes.\footnote{Pre-Budget Report 2008, p 141, para 7.69}

78. Mr James Richardson, Director, Public Spending, HM Treasury, said that the new requirements placed on Ofgem reflected “the fact that there is concern around this issue and the Government wishes to ensure that the full facts are in the public domain … so that the full information is available to people who are concerned about these issues”.\footnote{Q 218}

79. We asked Ms Teresa Perchard, Director of Public Policy, Citizens Advice, if she thought enough had been done to ensure that the fall in the global price of energy had been passed on to consumers. Ms Perchard acknowledged that Ofgem had undertaken a “major piece of work” which had “highlighted a lot of issues around pricing problems, tariff differentials, excessive pricing for certain things, the same sorts of questions as arise around bank charges and currently the extent to which interest rate reductions will be passed on to users of credit”. However, she reflected that the ball was “in the court of the regulator at the moment to act decisively and quickly to protect consumers and I do not think we have seen decisive, quick action by the regulator”.\footnote{Q 68}

80. Mr Richardson, for HM Treasury, cautioned that action was not straightforward as energy providers had engaged in hedging behaviour on the energy markets and therefore did not “necessarily buy their inputs on the spot markets at which we have seen prices fall, so understanding those relationships is a complex matter that Ofgem are looking into”. He stressed that the Treasury needed to have the facts “to establish whether there is a divergence between the prices that we might expect to be seen in the markets and those that we do see before leaping to conclusions”.\footnote{Q 218}

81. We note that the price of fuel has fallen considerably in recent months. Ofgem has a clear responsibility to ensure that energy providers are not taking advantage of British consumers. We expect the Government to act promptly on the Ofgem quarterly reports

\footnotesize{\begin{tabular}{l}
209 Pre-Budget Report 2008, p 141, para 7.69 \\
210 HC Deb, 12 March 2008, col 297 \\
211 Pre-Budget Report 2008, p 141, para 7.69 \\
212 Q 218 \\
213 Q 68 \\
214 Q 218 \\
\end{tabular}}
in order to ensure, by whatever means necessary, that consumers are not charged an inflated price for energy.

**Targeted assistance**

82. The Chancellor told the House in his speech on the Pre-Budget Report that “the most pressing energy problem for many families is paying heating bills”.\(^\text{215}\) As we discussed in our Report on the 2008 Budget, the Winter Fuel payment is not means-tested and currently it is paid by UK residents over the age of 60.\(^\text{216}\) Mr Peter Kenway, Director, New Policy Institute, pointed out “that two-thirds of the households in fuel poverty are single adult households, both pensioners and non-pensioners. With the non-pensioner households there is a big overlap with those on incapacity benefit, and so the idea that one should be directing attention towards that group I think is absolutely correct”.\(^\text{217}\)

83. In response to this concern the Government had “tripled cold weather payments for this year, up to £25 a week, for those on modest incomes”.\(^\text{218}\) The Government announced that it expected approximately 600,000 customers to benefit from discounted bills by the end of the year, “as a result of the agreement between the Government and the companies for an additional £225 million spending on reduced tariffs and other social programmes over three years. Around three quarters of these bills will be guaranteed not to have price increases this winter”.\(^\text{219}\)

84. Following the 2008 Budget, Ofgem announced in July that suppliers agreed to increase their investment in social programmes to help the fuel poor—those spending more than a tenth of their income on energy—by £225 million between 2008 and 2011. Ofgem released new guidelines to help fuel-poor consumers ensuring that energy companies’ social tariffs were equal to their cheapest deals available for customers. Ofgem specified that in future, a supplier’s social tariff must be as favourable as the lowest tariff offered to customers in any one area, including online deals. Therefore vulnerable and fuel-poor customers who struggle most to pay their energy bills should be assured of being on the best deal their supplier offers in their area.\(^\text{220}\)

85. The Chancellor was clear that “if sufficient progress is not made in the next few months in closing unfair gaps in pricing between payment methods—the Government will use statutory powers to end unjustifiable pricing differentials”.\(^\text{221}\) Mr Richardson stressed that the Government stood “ready to consult on legislation to tackle unfair pricing differentials between methods of payment for energy, should that prove necessary. Obviously, our hope is that the discussions between Ofgem and the energy companies bring that matter to a

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215 HC Deb, 24 November 2008, col 499
216 HC (2007–08) 430, para 55
217 Q 67
218 HC Deb, 24 November 2008, col 499
219 www.number10.gov.uk, Home Energy Saving Programme, Helping Households to Save Money, Save Energy
220 Ofgem press release, Social Tariffs must equal Suppliers’ cheapest deals, 25 July 2008
221 HC Deb, 24 November 2008, col 499
satisfactory voluntary resolution”.\textsuperscript{222} We note that Ofgem has recently begun a consultation on “new rules to end unfair pricing”.\textsuperscript{223}

86. We welcome the progress made to close unfair gaps in energy pricing. For too long vulnerable and fuel-poor consumers who should have been assured of receiving the best deal from their supplier have struggled to pay energy bills. It is important that the Government ensures that the energy companies take urgent steps to resolve this matter quickly and if necessary takes statutory powers to do so.

\textbf{Marginal deduction rates}

87. Our inquiry also focused on the issue of tax credits and high marginal deduction rates for low-income households. We examined whether low-income households should face such high deduction rates and whether Government reforms announced in the 2008 Pre-Budget Report would increase the number of low-income households facing marginal deduction rates of over 60%.

88. The Treasury defines the poverty trap as occurring “when those in work have limited incentives to move up the earnings ladder because it may leave them little better off”.\textsuperscript{224} Marginal deduction rates are used to measure how far people’s incentives to increase their incomes are being reduced. They show how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefits or tax credits. For instance, a marginal deduction rate of 70\% means that, for every one pound of additional gross income, 70 pence of that additional pound is taken away, either by taxes or a reduction in benefits. Marginal deduction rates provide one way to measure the extent of the poverty trap.

89. The Working Tax Credit supports low-income families with at least one working adult, including families without dependent children where one adult was working over 30 hours a week and aged 25 or over. As we noted in our Report on Budget Measures and Low-Income Households, the Government has made the tax credits system more generous over time. Reforms to the tax and National Insurance system in the 2007 Budget were accompanied by major changes to tax credits. First, the Government announced that, from April 2008, the income threshold at which Working Tax Credit was received in full would increase by £1,200, to £6,420 a year. This change meant that eligibility for tax credits extended in 2008-09 to those single adults without children with incomes up to around £12,900 and to those couples without children with a combined income up to around £17,500. This reform was accompanied by an increase in the tax credit withdrawal or taper rate by 2\% to 39\% (this means that an award was gradually reduced at the rate of 39 pence for every pound of gross income over the threshold). The effect of the increase in the

\textsuperscript{222} Q 219
\textsuperscript{223} Ofgem press release, Ofgem consults on new rules to end unfair pricing, 8 January 2009
\textsuperscript{224} Pre-Budget Report 2008, p 93, para 5.43
withdrawal rate is thus to make the rate of descent in payments as income increases slightly more marked, albeit from a higher threshold.²²⁵

90. Table 1 shows the number of households facing high marginal deduction rates in excess of 60% as well as how the number of households facing high marginal deduction rates has increased since the 2008 Budget as a result of subsequent policy measures, including the policy changes announced in the 2008 Pre-Budget Report. Almost two million households now face marginal deduction rates over 60%, whilst the number of households facing marginal deduction rates in excess of 70% will increase from 200,000 to 305,000. The number of households facing marginal deduction rates of over 90% has doubled from 30,000 to 60,000.²²⁶

91. Over time the number of households facing marginal deduction rates of over 60% has increased sharply—prior to Budget 1998, 760,000 households faced marginal deduction rates over 60% compared to 1,960,000 for 2009–10.²²⁷

Table 1. The effect of the Government’s reforms on high marginal deduction rates²²⁸ ²²⁹

<table>
<thead>
<tr>
<th>Marginal deduction rate</th>
<th>Before Budget 1998</th>
<th>2008-09 system of tax and benefits</th>
<th>2009-10 system of tax and benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 100 per cent</td>
<td>5,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Over 90 per cent</td>
<td>130,000</td>
<td>30,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Over 80 per cent</td>
<td>300,000</td>
<td>150,000</td>
<td>225,000</td>
</tr>
<tr>
<td>Over 70 per cent</td>
<td>740,000</td>
<td>200,000</td>
<td>305,000</td>
</tr>
<tr>
<td>Over 60 per cent</td>
<td>760,000</td>
<td>1,875,000</td>
<td>1,960,000</td>
</tr>
</tbody>
</table>

Source: Budget 2008, p 62, Table 4.2, Pre-Budget Report, November 2008, p 94, Table 5.2

92. The New Policy Institute (NPI) explained that the tax problem for low-income households had two linked but separate elements. One was the amount of tax paid by low-income households. The second was the marginal rate of tax faced by low-income households. NPI said that the key point was that a worker belonging to a family in receipt of tax credits faced a marginal effective tax rate of 70% on their earnings (a consequence of the 39% tax credit taper, combined with the normal rates of income tax and national insurance). They argued that:

²²⁵ Treasury Committee, Thirteenth Report of Session 2007-08, Budget Measures and Low-Income Households, HC 326
²²⁶ Pre-Budget Report 2008, p 94, table 5.2
²²⁷ Ibid., Table 5.2
²²⁸ Marginal deduction rates are for working heads of families in receipt of income-related benefits or tax credits where at least one person works 16 hours or more per week, and the head of the family is not receiving pensioner or disability premium.
²²⁹ Figures are cumulative
It is, quite simply, ridiculous for workers in the lowest income families in the land to be facing by far the highest marginal rates of tax.230

93. Treasury officials accepted that this year’s Pre-Budget Report would increase the number of households facing high marginal deduction rates, telling us “that if you look at the position for 2008 as compared to 2009, there has been some slight deterioration”.231 For the Treasury, Mark Bowman, Director Tax Strategy and Delivery, explained that this deterioration was the result of the measure introduced in Budget 2008 to disregard Child Benefit for the purposes of calculating income for Housing Benefit, which gives “increased support to low income families” but also has the effect that there are more people who are on the housing benefit taper and who as a result face these marginal deduction rates”.232 His colleague Mike Williams said that “there is not an easy way of avoiding the effect of the taper creating relatively high marginal deduction rates” and that it was a “consequence of focussing the support that is available on people on lower incomes”.233 Treasury officials were also asked about the consequences for those renting council properties of increases in their housing costs and the consequences in terms of marginal deduction rates for these people. Mike Williams told us that the Treasury “would need to do more research to see … the impact … in terms of putting more people on to [higher] marginal deduction rates”. He went on to suggest that the effect would “depend exactly where they are on the income distribution and exactly what rent change they would face”.234

94. The Chancellor defended the decisions made on tax credits and the consequences this would have for marginal deduction rates faced by some people.

If you increase people’s income through tax credits, through housing benefit or whatever, because these are benefits that get tapered out, when somebody comes off them there can be a problem with marginal deduction rates. Frankly, I think it is better though to provide that extra help for people on those low incomes.235

95. Mike Brewer explained that there was no simple solution to the problem of high marginal deduction rates and that “the only way that we cannot have the situation we have at the moment is if you adopt a different set of priorities from the current Government’s”:

The current Government wants to give large amounts of money to low income families with children and it does not want to give it to high income families with children. Change one of those two rules and you can have a system with lower marginal deduction rates, either by having higher universal child benefit and higher income tax rates; that would be one solution, or by having much less generous tax credits, in which case you would have fewer families on these high tapers.236
Peter Kenway, for NPI, told us that it was “an inevitable feature of the tax credit taper that it takes money away from people as their income goes up” but believed the key “question is why it should be that steep”. He suggested one way forward would be to reduce the taper rate and said “what strikes us is that this system has not been reviewed and the opportunities for lowering that rate do not seem to have been taken”. John Whiting, from PwC and the Low Incomes Tax Reform Group, agreed that one way to ease the problem of high marginal deduction rates on low-earners was to reduce the 39% taper, but also suggested that an alternative approach would be to begin the taper higher up the income scale which he believed would also alleviate the situation.

96. The increase in the number of households facing marginal deduction rates of over 60% is a direct consequence of decisions made by the Government as to how the tax and benefit system will work. We acknowledge that there is no easy solution to the problem of high marginal deduction rates, and that this results in part from the Government’s approach of targeting support on lower-income households. That said, we welcome the fact that the Government has ensured that no household now faces a marginal deduction rate of over 100%. However, we are concerned by the increase in the number of households facing high marginal deduction rates of over 60% and recommend that the Government examine ways to over time reduce the number of households adversely affected by high marginal deduction rates.

Take-up of tax credits and other mean-tested benefits

97. In our June 2008 Report Budget Measures and Low-Income Households we examined take-up rates for tax credits. We welcomed recent increases in take-up of Working Tax Credit amongst low-income individuals and couples without dependent children, but felt that there was considerable scope for the Government to do more to boost the take-up of Working Tax Credit amongst this group. That inquiry also suggested that there was scope to increase take-up of benefits such as Pension Credit, Housing and Council Tax Benefit. We discuss take-up of pension credit below in the context of measures to alleviate pensioner poverty.

98. The Pre-Budget Report gave an update on take-up figures, stating that take-up of tax credits is higher than for any previous system of income-related support, with 82 per cent of eligible families claiming what they are entitled to, rising to 96 per cent for those on the lowest incomes.

99. The Government announced in the 2008 Pre-Budget Report that it was taking steps to increase the take-up of tax credits. The Pre-Budget Report stated that the Government would build upon its initiative, launched last year where HMRC has been working in partnership with other organisations to promote working tax credit (WTC) in innovative ways. HM Revenue and Customs (HMRC) currently reaches over 500,000 employees in 40 organisations and in the coming year will aim to double this coverage, working with
employers’ Corporate Social Responsibility programmes and using the National Employment Partnership to raise employers’ awareness of the WTC. In addition, the Pre-Budget Report announced that HMRC has introduced four new services nationally over the last twelve months to assist customers to claim, renew and manage their tax credit awards. The Government says these initiatives will help up to 400,000 customers each year get the right tax credits award, and by the beginning of next year around 100 Children’s Centres will offer tax credits advice.²⁴⁰

100. A number of witnesses told us that problems with take-up of tax credits as well as benefits such as Housing and Council Tax Benefit went beyond raising awareness of their existence. According to Ms Perchard, for Citizens Advice:

One of the big problems that we see at the moment is that you are working with three separate bits of Government to assemble the support for your income … it is not joined up for the individual. The HMRC tax credits helpline does not say ‘you are eligible for Housing Benefit and Council Tax Benefit. I am going to fill in a form for you now and the council will complete this in a few days and the money will be in your pocket’.²⁴¹

John Whiting concurred with Ms Perchard that a more integrated and joined-up system between the various branches of Government for the administration of tax credits and other benefits would be a valuable step forward.²⁴²

101. We welcome the increased take-up of Working Tax Credit amongst low-income individuals and couples without dependent children, although there is clearly very considerable scope to increase the take-up of Working Tax Credit amongst this group. As we originally said in our Report on Low Income Households, whilst one of the reasons for low take-up of Working Tax Credit amongst this group—lack of awareness of eligibility for Working Tax Credit—can be tackled through publicity campaigns, other factors will be more difficult to overcome. These include making the system more responsive and user-friendly for those with volatile incomes and circumstances. To this end we welcome the increased resources that the Government is devoting to helping tax credit recipients to claim, manage and renew their awards. That said, awareness-raising measures do have a role to play in boosting take-up rates, particularly in correcting the perception that access to Working Tax Credit is restricted to those with dependent children. We will continue to monitor Government progress in this area, including the implementation of Housing Benefit and Council Tax Benefit reforms due this autumn, during our inquiry on the 2009 Budget.

²⁴⁰ Pre-Budget Report 2008, p 87, para 5.15
²⁴¹ Q 84
²⁴² Q 85
5 Public expenditure issues

Additional efficiency savings

102. The Treasury has reported that efficiency savings of £30bn were achieved by departments over the 2004 Spending Review period. The 2007 Comprehensive Spending Review announced that a further £30bn of efficiency savings would be generated by 2010–11. The 2008 Pre-Budget Report indicated that this 2010–11 target would be increased by £5bn to £35bn of efficiency savings.

103. The 2008 Pre-Budget Report offers no details as to where this £5bn will come from. Professor Colin Talbot, of the Manchester Business School, told us that he doubted the robustness of the figure:

this additional £5 billion that is being added on seems to me to be very much a sucking a finger and sticking it in the air exercise based on the fact that they have rolled forward spending from the end of that spending round period and now want to recap it towards the end.

104. When we invited him to respond to this criticism, the Chancellor acknowledged that the Treasury had not allocated the £5bn across departments when the figure was published but expressed confidence that it was achievable:

We had not allocated the £5 billion across departments at the time of the PBR. That is something that we will do over the next few weeks and at that stage I am sure the Select Committee will want to look at it. What I would say is this, that if you consider that we spend over £400 billion in public spending on departmental expenditure I defy anybody to tell me it is not possible to find £5 billion worth of efficiency savings. … I think in terms of our back office operations we do not really exploit our position as a bulk buyer of goods and services. I think we could do a lot more.

105. With regard to the scale of the £5bn additional savings, Professor Talbot told us that “we are talking about heroic numbers in terms of efficiency savings. I do not believe that they can be achieved without some serious impact on services.”

106. In a written submission to us, the TUC echoed this concern that efficiency savings present a threat to the quality of public services:

244 HM Treasury, 2007 Pre-Budget Report and Comprehensive Spending Review, Cm 7227, November 2007, p 4, para 1.12
245 HM Treasury, Pre-Budget Report, November 2008, p 122, para 6.32
246 Q 53
247 Q 335
248 Q 53
The TUC’s long-standing opposition to the so-called ‘efficiency’ agenda, which has led, as stated in the PBR, to a reduction of 86,700 civil service posts between 2004 and 2007, remains. Unfortunately, this agenda has led to a serious deterioration in service quality … Other concerns include falling morale and productivity in Her Majesty’s Revenue and Customs, and the cancellation of important initiatives, such as tackling knife crime, in the Ministry of Justice efficiency saving programme. In this context, we are concerned at proposals for an additional £5 billion ‘value for money’ target for 2010–11. We remain committed to genuine efficiency saving initiatives, such as better procurement. We will seek confirmation, in next year’s Budget, that none of the £5 billion will be achieved through staff cuts. 249

107. We note that the announcement of an additional £5bn of efficiency savings was made in the 2008 Pre-Budget Report without any supporting schedule showing the derivation of this figure. In order to demonstrate the robustness of this figure we recommend that the Government publishes details of where and how the additional savings will be made. In providing these details the Government should also set out the measures in place to ensure that public service delivery does not deteriorate.
Government support for small businesses

108. The deterioration in the availability of credit, particularly for small firms combined with the economic downturn has led the Government to outline a series of measures in the Pre-Budget Report to provide greater support for businesses, particularly smaller businesses. These include:

- Measures to help small and medium-sized enterprises (SMEs) facing credit constraints. The Government has said it will:
  - Launch a new Small Business Finance Scheme, a new temporary guarantee scheme, to help support up to £1 billion of bank lending;
  - Offer a separate £1 billion guarantee facility to support bank lending to small exporters;
  - Make available a capital fund of £50 million providing equity or quasi-equity to SMEs who are overleveraged; and
  - Introduce a £25 million regional loan transition fund for small firms.
- The introduction of a new HMRC Business Payment Support Service to allow businesses in temporary financial difficulty to pay their HMRC tax bills on a more flexible timetable;
- The introduction of more generous tax relief for businesses now making losses, by allowing temporary additional carry-back of up to £50,000 of losses to be set against taxable profits from the last three years; and
- The modification of a number of planned tax reforms, namely the deferral until 2010–11 of the planned rise in small firm corporation tax from 21% to 22%, and a temporary increase in the threshold at which an empty property becomes liable for business rates.

Additionally, the Pre-Budget Report announced that UK small businesses should also be able to benefit from around £4 billion of lending from the European Investment Bank between 2008 and 2011.

109. John Whiting told us “that small businesses are feeling very constrained in terms of credit and they see credit becoming more expensive to them, so various of the measures that are being discussed which might facilitate more credit flow will of themselves help, as will lower interest rates”.

110. John Whiting welcomed HMRC’s planned measures to allow greater flexibility in the scheduling of tax payments for small companies. He understood that HMRC was devoting considerable manpower resources to this initiative. Edward Troup, Director, Business and Indirect Tax, at the Treasury also drew our attention to the role of the Business

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250 Pre-Budget Report 2008, p 67-69, para 4.6-4.15, Box 4.2-4.3
251 Q 43
252 Ibid.
Support Helpline which was currently dealing with a surge in requests from businesses having difficulty in meeting payments. Mr Troup rejected the suggestion that new resources were required to implement the Small Business Finance Scheme. He noted that HMRC had in excess of 80,000 staff and that “an organisation [of] that size does have flexibility over reasonably short time periods to reallocate resources”. 253

111. Mr Troup went on to explain that the support line was already working well, telling us that “Over the last two weeks … 4,733 arrangements had been reached with individual business and there were another nearly 2,000 under consideration”. He also stressed that “this is not a new arrangement. It has always been open to businesses to do this but it has perhaps not being as widely publicised as it might have been, and very much part of the PBR announcement is to make sure that people are aware of the availability of this”. 254

**Deferred rise in small firm corporation tax**

112. The Pre-Budget Report announced that the Government would defer for one year the proposed increase in the small companies corporation tax rate from 21% to 22%, which was due to come into force in April 2009. 255 Mr Whiting stressed that the deferral of the planned rise in corporation tax would be welcomed by small firms. 256 The Association of Certified Chartered Accountants (ACCA) also supported the deferral in the rise in corporation tax stating that “given the challenging economic circumstances, we think it is right that no changes are made in these areas”. 257

**Temporary cut in VAT**

113. Our expert witnesses also discussed the impact of the temporary cut in VAT from 17.5% to 15% on small firms. Professor Talbot said that the change would adversely affect small firms because of the administrative cost of making pricing changes. 258 John Whiting expressed concern about the short-time period for firms to make the necessary changes, telling us that “business, I think, would have liked at least a month to prepare, possibly longer”. 259 Mr Whiting expanded on this point in written evidence:

> From a tax technical point of view, the main issue is the administrative effort that it requires. HMRC’s own estimate of a cost for business of £300m is not insubstantial in straitened times. It is, after all, the first general VAT rate reduction the UK has experienced; four working days’ notice is not ideal. For retailers, who nowadays mostly price to ‘price points’, there is a lot of repricing to consider; after all, they have been required to quote prices as ‘VAT inclusive’ for some time. For the service
sector, who in some sectors at least quote prices with VAT to be added, things are easier.\(^{260}\)

The Institute of Chartered Accountants in England and Wales (ICAEW) believed the Government had underestimated the cost to business of implementing the VAT cut:

\[\text{HM Treasury impact assessment for the VAT reduction policy, which estimates a total cost of £300m on businesses’ time using the standard cost model, may have considerably underestimated the true cost to business. For small businesses and retail businesses in particular, the administrative burden and transition cost of accommodating the change in the headline VAT rate is likely to outweigh any benefits which businesses might receive from increased sales.}\(^{261}\)

ACCA made similar points about the burden of the VAT change on business. They warned that “small and medium enterprises might be adversely affected by the additional administration for the temporary VAT cut” and that “forcing businesses to change their VAT, accounting, sales and purchase systems for just over a year is likely to cause significant and unwelcome additional costs, especially for SMEs”.\(^{262}\)

114. However, John Whiting pointed out that the VAT reduction also offered an opportunity to small firms who maintained existing price levels, thus potentially increasing their profit margins. Mr Whiting told us this that “is an option that I know many small businesses are considering”. He went on to describe how small firms would have to be careful if they went down this route because:

\[\text{many consumers as they walk through the shop door will be well briefed to know that VAT has been reduced so will ask, “Are you reducing your prices?” There may be a number of challenges to the shopkeeper around but it is certainly something that small businesses are considering.}\(^{263}\)

**Lending support for small firms**

115. The Government has also put together a package of measures to support small and medium-sized enterprises facing credit constraints during the current economic downturn. Our witnesses broadly welcomed the support that Government was providing to small firms in this area, although Mr Whiting cautioned that some small firms might not take advantage of such lending support:

\[\text{There is another small factor, and we are talking here of course about confidence and whether or not a small business actually wants to get further into debt. I agree with the fact that the money looking as if it is going to be more available is good but an awful lot of small businesses are inclined to put a blanket over their heads and hope}\]
that times are going to get better rather than go further into debt unless they really have to. 264

The ICAEW also supported the Government’s efforts to improve access to finance for smaller firms, but warned that:

given the relatively limited scale of intervention and the significant amount of time that it will take to set up and market new finance facilities, the ICAEW questions the overall impact on business confidence that the proposed measures will provide. 265

116. Simon Kirby, Research Fellow at the National Institute of Social and Economic Research, stressed that the Government had to be prepared to put more money into supporting small firms in the future. Mr Kirby argued that the Government’s assumptions “work on the basis that lending returns to some form of normality at the start of 2010 and if that does not happen then things like the Small Business Scheme will probably need to be extended”. 266

117. We asked Treasury officials about the progress of work being undertaken to get the Small Business Finance Scheme into operation. Edward Troup told us that the Treasury, together with the Department for Business and Enterprise, hoped “to get it “up and running “very early in the New Year”. 267 Mr Troup confirmed that the scheme offered £1 billion specifically to help small businesses who were having trouble with working capital and explained that it would “sit alongside the Small Firms Loan Guarantee Scheme which, as you know, is a long-running scheme which is designed to help businesses that start up and grow”. 268 Mr Troup also gave an indication of the timing of the injection of £4 billion from the European Investment Bank into the economy. He told us that four banks had already indicated to the Treasury their commitment to taking advantage of that facility and that the Treasury expected other banks to sign up early in the New Year. Mr Troup concluded that “there is no reason really why money cannot start flowing almost immediately”. 269

118. We asked Treasury officials whether, in the event that there is not a return to normal lending to small businesses in 2009, the Small Business Finance Scheme would be extended and increased. Edward Troup explained that the Government was:

forecasting a recovery beginning in the latter half of next year and the expectation is that this scheme and the recovery of the banks’ lending will be sufficient to see businesses who are struggling from the lack of working capital through this period. 270

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264 Q 46
265 Ev 84
266 Q 46
267 Q 149
268 Ibid.
269 Q 150
270 Q 149
The Chancellor told us that he would ‘keep under constant review’ the size of the lending support package for small firms:

We have a Budget in the Spring, we will have a Pre-Budget next autumn, and in between times, certainly in relation to the banks, this is something that, because of the urgency and importance of it, we will be looking at all the time. 271

119. **We broadly welcome the package of measures the Government has introduced to support small and medium-sized enterprises through the economic downturn and related credit crisis.** That said, the Government must keep the size and duration of the Small Business Finance Scheme under constant review given the possibility that bank lending to small firms does not return to ‘normal’ during the course of 2009.

120. **We also welcome the measures to ease the tax burden on small firms facing difficulties, but will continue to monitor whether HMRC are devoting sufficient priority to this initiative.** With respect to the impact on small firms of the temporary reduction in VAT, we note that businesses argued that the short notice caused an administrative burden. We trust that the Government will take note of the concerns that small firms have expressed in their assessment of how the exercise impacted on small firms.

**Unemployment**

**Forecast levels of unemployment**

121. The latest OECD forecast places unemployment at 6.8% by the end of 2009, and 8.2% at the end of 2010, up from 5.5% in 2008. 272 In its submission to us the NPI noted the absence of any Government forecast of unemployment levels:

Since maintaining employment is one of the two principal reasons for contemplating a fiscal stimulus (the other being to sustain investment), we would have expected the PBR to have addressed this question. There is no doubt that the Treasury has such forecasts. They are, after all, an input into the financial projections while they are also part and parcel of a GDP forecast. Yet as far as we can see, the only reference in the PBR to the likely scale of unemployment is to be found in a list of assumptions audited by the NAO on the likely scale of the increase in the claimant count. 273

122. The list of assumptions mentioned by the NPI can be found in Box B1 of the 2008 Pre-Budget Report. 274 The Treasury disclosed that, in preparing the 2008 Pre-Budget Report, it assumed that UK claimants of unemployment benefit would rise “from recent

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271 Q 339
272 OECD Economic Outlook, 84, December 2008, pp 114
273 Ev 76
274 HM Treasury, *Pre-Budget Report*, Cm 7484, November 2008, Box 81, ‘Key Assumptions Audited by the NAO’, p 188
levels of 0.98 million to 1.41 million at the end of 2009, and to 1.55 million at the end of 2010, based on the average of independent forecasts”.275

123. Treasury officials acknowledged to us that this assumption was used to generate forecasts:

We now publish an audited assumption which shows unemployment rising according to the independent average to 1.41 million at the end of 2009 and to 1.55 million at the end of 2010. That is the assumption. You have to make assumptions to produce forecasts and that is what is driving the forecasts that we have made.276

124. When invited to share his resulting forecast for unemployment with us, the Chancellor declined, insisting that “we do not publish Treasury forecasts, and no government has”.277

125. We note that the Government has published a list of assumptions, but declined to publish any official forecast of unemployment levels. We accept that this has been the established practice of all governments but believe that the current circumstances demand maximum transparency. Accordingly, we recommend that the Government publishes its forecast for unemployment.

Older people and the ‘grey pound’

126. The Pre-Budget Report included some increases to support for pensioners: the full state pension increased in line with prices and the pension credit was given an ‘above indexation increase’.278 An additional £60 payment for all pensioners was announced279 and age-related income tax allowances were also uplifted.280

127. In its public response to the 2008 Pre-Budget Report, Age Concern welcomed these measures but stated that more could be done:

The increase of £5 for a single person and £7 for a couple in the Pension Credit is welcome and will make a real difference for many of the poorest pensioners in Britain. However, about a third of the eligible pensioners are still not receiving the Credit and it will not help many more pensioners living just above the breadline.281

128. Mervyn Kohler, Head of Public Affairs for Help the Aged, suggested that the 2008 Pre-Budget Report represented a ‘truly skinflint’ package for older people.282 When invited to expand on this, Mr Kohler argued that the increases announced in the Pre-Budget

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275 Cm 7484, Pre-Budget Report 2008, Box B1, ‘Key Assumptions Audited by the NAO’, p 188
276 Q 204
277 Q 259
278 Cm 7484, Pre-Budget Report 2008, para 5.81-2
279 Ibid., para 5.82
280 Ibid., para 5.84
281 Age Concern, Response to the Pre-Budget Report, November 2008
Report reflected existing commitments and that the Government had missed opportunities to address fuel poverty:

The [use of the term] “skinflint” [reflects my view that] … really the only tangible contribution that was made was this £60 Christmas bonus which is going to be paid in January. The announcement about pension increases and pension credit increases were following more or less the statutory requirements, despite the fact that the Chancellor was presenting it as the largest rise that has ever been paid to our pensioner population.283

129. Teresa Perchard, for Citizens Advice, argued that one of the biggest gaps in the 2008 Pre-Budget Report was a commitment to increasing the take up of pension credit:

There is a huge issue underlying all of this about take-up of what is on offer. There is something in the PBR about promoting more take-up of tax credits for people in work and that is welcome. There is nothing about take-up of pension credit. There are 1.8 million pensioners missing out on pension credit at the moment. Getting maximum take-up of pension credit would improve the incomes of those pensioners by about £1,400 a year on average, so it blows the winter fuel payment apart, does it not? 284

130. We note that 1.8 million pensioners are missing out on pension credits which they are entitled to and which would offer them additional financial support at this time. We recommend that the Government takes further steps to increase the take up of the support available, and we will be taking further evidence about the rate of take up in due course.

Helping Homeowners

Homeowners in difficulty

131. In the 2008 “credit crunch” homeowners were faced with an unprecedented slump in house prices and sales coupled with the rising costs of food and fuel. The combined effect has left many homeowners struggling with mortgage payments. Press reports suggest that up to 45,000 homeowners were expected to have had their homes seized by the end of 2008 as workers lost their jobs and house prices continued to decline.285 House prices have fallen by 16.2 per cent in the past calendar year, according to Halifax house price index.286

132. The 2008 Pre-Budget Report stated that:

The long-term challenge remains to meet the housing needs of an ageing, growing population, while helping families and first time buyers priced out of the property market. The Government is committed to promoting the long-term stability of the

283 Q 65
284 Q 66
285 Banks agree to give mortgage holders more time to pay, The Times, 25 November 2008
286 Halifax House Price Index, December 2008, 2 January 2009
housing market and meeting the long term challenge of increasing the housing supply, including through releasing more public sector land for housing, while providing support to homeowners through these difficult times.287

133. When asked if the Pre-Budget Report had done enough to help homeowners, Teresa Perchard, pointed out that there had been many policy announcements relating to mortgages in the Autumn, although “a lot of it [had been announced] before the Pre-Budget Report”. The Pre-Budget Report set out the action the Government had taken in September 2008:

In September, as part of a £1 billion package to support homeowners, first time buyers and the house building industry, the Government announced a new suite of mortgage rescue schemes, which aim to reduce by up to 6,000 the number of reposessions of vulnerable households over the next two years. The Government also strengthened the Support for Mortgage Interest system by reducing waiting times and increasing the maximum value of eligible mortgages, which could prevent up to a further 5,000 to 10,000 repossessions. The 2008 Pre-Budget Report takes further steps to support home owners facing difficulties.288

134. The Chancellor also announced that that some of Britain’s biggest lenders had agreed not to repossess properties until at least three months after borrowers first went into arrears. In a series of measures designed to boost the ailing housing market and keep people in their homes, the Chancellor said that repossession would only be sought as a last resort after other alternatives, such as a minimum payment plan, had been pursued. Repossessions jumped by 12% in the third quarter of 2008 and are expected to continue to rise as increasing numbers of homeowners struggle to make their mortgage repayments. Figures from the Council of Mortgage Lenders (CML) showed that by the end of September 2008, some 30,200 properties had been taken into possession by lenders, compared with 26,200 in the whole of 2007.289

135. The Council of Mortgage Lenders (CML) welcomed the Chancellor’s announcement, stating it was “pleased that the Government has today acknowledged it has an increased role to play in helping lenders to minimise repossessions”,290 although it stressed that “the home guarantee scheme proposed by Government was not for everyone”, noting it would need careful development with lenders and the CML “to ensure it is properly targeted to those borrowers committed to sustain their home ownership through short term periods of financial difficulty”.291

136. Ms Perchard told us that Citizens Advice welcomed the three month moratorium on repossessions but that, in the experience of her organization, most lenders did not take

287 Pre-Budget Report 2008, para 5.47
288 Ibid. para 5.48
289 Council of Mortgage Lenders, Quarterly data, 21 November – 3 December
290 Council of Mortgage Lenders, Press notice, CML reaffirms its commitment to work with government on minimising possessions, 3 Dec 08
291 Ibid.
action to repossess properties until after four months of arrears. She noted that some individual banks were already offering six month periods before repossession proceedings began.\(^{292}\)

137. The Child Poverty Action Group (CPAG) supported the proposal on repossessions as well at the plan to increase further the capital limit for paying mortgage interest relief to £200,000 along with the previously announced shortening of the waiting period. They did though express serious reservations about “an unwelcome proposal to time limit relief to two years”. They noted that time limiting benefits had been historically resisted by the Government and expressed concern “about a proposal which will result in support being determined by how long you have claimed, not your need for support”. CPAG called on the Chancellor to “reconsider this move”.\(^{293}\)

**First time buyers**

138. The Pre-Budget Report states that “since 1997 110,000 households have been helped into home ownership through shared equity and shared ownership schemes”.\(^{294}\) In September 2008 the Government announced further support for first time buyers, it offering 10,000 more people the opportunity to purchase a home through a new shared equity scheme. The Government also announced a one year stamp duty holiday for all purchases of houses costing up to £175,000.\(^{295}\)

139. Mr Whiting told us that he viewed the concession in stamp duty as “a small gesture”. He suggested that the scheme should be reviewed “at Budget time as to whether it has had any effect or is worth continuing, given that so many properties are still, despite problems, priced above the £250,000 point … but I would say the availability of mortgage finance is a bigger issue”.\(^{296}\)

140. We recognise that steps taken by the banks to rebalance their assets following the banking crisis late last year has resulted in reduced credit lines being made available to the public. It is clear that schemes introduced in the Pre-Budget Report, and the stamp duty holiday announced earlier, are not having any widespread effect. We recommend that the Government takes all possible steps to ensure that the banks lend fairly and responsibly to each other and consequently to the public. We are concerned that piecemeal measures introduced by the Government may not be adequate in the face of the crisis in lending.

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292 Q 91
293 Ev 61
294 Pre-Budget Report 2008, p 94, 5.58
295 Ibid.
296 HC 27-i, Q 94
Debt Advice

141. The level of consumer debt in the UK is estimated at £1.3 trillion. In October 2008, the ITEM club’s forecast predicted that consumer debt problems were likely to increase proportionally with levels of unemployment despite the decline in interest rates.\textsuperscript{297}

142. In May 2008, the Governor of the Bank of England stated “For the time being, at least, the ‘nice’ decade is behind us.\textsuperscript{298} ‘The credit cycle has turned. Commodity prices are rising. We are travelling along a bumpy road as the economy rebalances.’\textsuperscript{299} As levels of employment fall consumers who have based their budgets on the availability of cheap and easy credit will struggle to keep up payments on their mortgages and other debts. When we discussed this with the Chancellor, he told us that there would inevitably be a lag between the recovery in the economy and a rise in employment.\textsuperscript{300}

143. The Pre-Budget Report published a commitment to ensure that every household struggling with debts could access free impartial debt advice.\textsuperscript{301} Since April 2006, BERR has funded a face to-face debt advice project which has assisted an estimated 169,000 clients with their debt problems. The Government also provides £2 million funding a year to support telephone debt advice, through the National Debt line. The Pre-Budget Report announced further measures which included:

- allocating an additional £5.85 million to increase the provision of free telephone debt advice which it estimated could assist 70,000 people each year with their debt problems;
- the provision of a further £10 million in funding for Citizens Advice Bureaux to expand local face-to-face advice capacity which could assist a further 335,000 people each year; and
- the establishment of an online webpage on www.direct.gov.uk to provide free and impartial sources of advice and support. Information on financial support, along with debt advice, would be further promoted from January 2009, as part of a campaign to promote www.direct.gov.uk services.\textsuperscript{302}

144. When asked if the additional funding allocated to Citizens Advice would be sufficient given the sort of demand that was predicted at this time, Mr Mike Williams, Director, Personal Tax and Welfare Reform, HM Treasury, reported that the money given to Citizens Advice Bureaux, which would be £10 million to March 2010, was “quite

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\textsuperscript{297} The Ernst & Young ITEM Club Autumn forecast, 20 October 2008:


\textsuperscript{299} Bank of England, Quarterly Inflation Report, Press Conference, Opening Remarks by the Governor, 14 May 2008

\textsuperscript{300} Q 258

\textsuperscript{301} Pre-Budget Report 2008, p 98, para 5.65

\textsuperscript{302} Ibid.
significant extra amounts”. The provision was designed enable local face-to-face advice capacity to be expanded.

We welcome the extended provision of free impartial debt advice outlined in the PBR through the Citizens Advice Bureaux, and through online and telephone services. Citizens Advice is well placed to offer advice to those struggling with debt problems and the public is certain to benefit from the funding allocated to increase its capacity.
6 Other tax measures

The environment: taxes on aeroplanes and automobiles

146. Presenting his 2008 Pre-Budget Report to the House, the Chancellor stated that he was “determined that the present economic uncertainty does not push aside the importance of protecting the environment and our long-term needs for a greener and secure energy future”. The 2008 Pre-Budget Report announced that £535 million of capital spending on energy efficiency, rail transport and adaptation measures was being accelerated. The Pre-Budget Report also, however, included changes to two of the Government’s environmental tax policies relating to vehicle excise duty and air passenger taxes.

Vehicle excise duty

147. The 2008 Budget announced the introduction of new Vehicle Excise Duty (VED) bands designed to impose higher rates on more polluting cars. The 2008 Pre-Budget Report, announced a change to this policy. Under revised arrangements, drivers of cars emitting over 225 g/km registered between 1 March 2001 and 23 March 2006 will be moved into the new band K in 2009 and remain there in 2010. This means that owners of the most polluting cars, who purchased their car prior to 23 March 2006, will pay less because band K cars are subject to VED of only £405 in 2009–10 and £425 in 2010–11, some £515 less than the maximum £950 to be paid on highly polluting cars purchased after 23 March 2006.

148. Mike Brewer, of the Institute for Fiscal Studies, told us that in the case of VED, the Government had used the recession as a reason to weaken its defence of the environment: reforms to VED which undoubtedly watered down their environmental impact and the reason the Treasury gave was that it did not want to raise the level of VED. They were ostensibly pointing to the recession as an excuse not to do an environmental measures

149. The interpretation offered by Mr Brewer was echoed by a public statement made by KPMG:

The Chancellor has effectively prioritised fiscal sustainability over environmental sustainability. Drivers of gas-guzzling 4x4s are getting off lightly as the expected...
increase in Vehicle Excise Duties and the so-called “showroom tax” for all cars will now be much lower even for the most polluting cars… The mere fact that in his speech he announced no new green taxes or tax rebates shows that changing the impact of people’s behaviour on the environment is not on the radar this year.\textsuperscript{312}

**Air passenger duty**

150. The 2007 Pre-Budget Report included a commitment to replace air passenger duty (APD), a duty paid per passenger, with a duty payable per plane from 1 November 2009.\textsuperscript{313} In a subsequent written statement, Angela Eagle informed the House that a per plane tax would “send better environmental signals, encourage the more efficient use of aircraft and ensure aviation makes a greater contribution to both environmental costs and the public finances”.\textsuperscript{314} In our report on Climate Change and the Stern Review, we welcomed the proposal of a per plane tax and recommended that the government should ensure that freight and private planes were included in any revised aviation tax.\textsuperscript{315}

151. In the 2008 Pre-Budget Report, the Government stated that “the Government has … decided to reform the air passenger duty regime rather than proceed with a per plane tax”.\textsuperscript{316} “This measure, according to John Whiting of PwC, came as “a surprise” to many who had been observing and participating in the debate.”\textsuperscript{317}

152. When questioned on whether the distance banding of APD would encourage passengers to fly via European hubs, Mr Troup acknowledged the difficulty but suggested that the per passenger approach would have less of a diversionary effect than a per plane approach:

we are actually making it more difficult to fragment flights [book flights via hub airports in separate components] because it does require passengers actually to buy two separate tickets. So, to the extent that there is a problem of diversion, it is actually a greater problem under a per plane tax than it is under a reformed, banded APD. While, as I say, we recognise that there is a risk of diversion fragmentation, actually these reforms carry a lesser risk and unless we are to give up on any attempt to band APD and air passenger taxation to try and ensure a proper contribution with a greater degree of proportionality to emissions, I think that problem will always exist.\textsuperscript{318}

\begin{footnotesize}
\begin{enumerate}
\item KPMG, *Chancellor sacrifices environmental sustainability for fiscal sustainability*, 24 November 2008, www.kpmg.co.uk
\item HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, Cm 7227, November 2007, p 123, para 7.56
\item Written Ministerial Statement by Angela Eagle, Exchequer Secretary to the Treasury, 31 January 2008.
\item HM Treasury, *Pre-Budget Report*, Cm 7484, November 2008, p 138, para 7.55
\item Ev 74
\item Q 190
\end{enumerate}
\end{footnotesize}
153. We note that Air Passenger Duty excludes freight flights and imposes comparatively low charges on private planes, maintaining an inconsistent handling of aviation emissions. We further note the risk that distance based bands of APD will encourage travellers to fly via European hubs. We are of the view that the disparity in fare level will indeed encourage passengers to fly via European hubs. We recommend that the Government monitors the impact of the introduction of higher banding Air Passenger Duty in order to ascertain the impact of APD on UK hubs, passenger preferences, and the financial consequences for airlines. If the recovery from recession is to be a ‘green recovery’, as the Pre-Budget Report has stated, this rhetoric has to be supported by an appropriate taxation strategy.

Fuel duty and the haulage industry

154. Budget 2008 announced that a 2 pence per litre increase in fuel duty would be postponed from April 2008 to October 2008. In March 2008, the Chancellor informed us that the decision to delay was due to the increased prices people were facing due to the high price of oil.319 The 2008 Pre-Budget Report announced that this increase would come in to place from the 1 December 2008.320

155. The Government observed that “as a result of the 2.5 per cent cut in VAT this December, the cost of petrol and diesel will fall for private motorists who should see no increase in the price they pay at the pump this year from this measure”.321

156. When challenged to defend the situation faced by businesses, particularly the haulage industry, that reclaim VAT and therefore will not feel a counterbalancing benefit from the cut in VAT, the Chancellor noted that their loss would be counterbalanced by falling fuel prices:

I understand that problem, and obviously for sometime we have been concerned about the road transport industry generally. However, they are benefiting from the fact that fuel prices are falling now, and you can see that at the pump, especially in petrol, slightly more slowly in diesel, which I understand is partly due to refining capacity, and prices are further apart than one would like but that is where we are. What I wanted to do with the VAT reduction was to benefit as many people as I could, but I do have to get some revenue in at some stage.322

157. We note that the Government is relying on falling oil prices to counterbalance the impact on businesses of the 2 pence per litre rise in fuel duty. We believe that the Chancellor has missed an opportunity to assist the road haulage industry, a matter we think the Chancellor should address at the time of the Budget. We recommend that the Government continues to monitor oil prices and adjusts the level of fuel duty in light of any future increase in oil prices.

319  Treasury Committee, Ninth Report of Session 2007–08, The Budget 2008, HC 430, Ev 55, Q 408,
320  HM Treasury, Pre-Budget Report, Cm 7484, November 2008, p136, para 7.39
321  Ibid.
322  Q 253
7 Timing and debate on the Pre-Budget Report

158. The timing of the Pre-Budget Report was only announced on 12 November, less than a fortnight before the Statement was made. In our reports on both the 2005 and 2006 Pre-Budget Reports we recommended that the Treasury should give at least 4 weeks’ notice of the date of the Report in order to enhance its usefulness as a vehicle for consultation and when this was not possible should indicate what factors underlay the delay. The previous year’s Pre-Budget Report was presented to the House with only 4 days’ notice.

159. We acknowledge that the circumstances surrounding the Pre-Budget Report this year made it difficult for the Treasury to offer much advance notice of its publication. Clearly, material in the Report was being modified and adapted up to the last minute. We accept that it may be unrealistic for the Government in the current climate to give any commitment to a particular notice period though we maintain that a longer lead-time would be helpful.

160. What does remain within the Government’s gift is the opportunity to allow the House ample time to debate the Pre-Budget Report once it has been published. This year’s Pre-Budget Report, together with its copious accompanying documents, represented a major public policy announcement. It was as perhaps as carefully scrutinised and analysed as a typical Budget. Pressed during the Business Statement on whether she would be able to find time for a full debate on the Pre-Budget Report the Leader of the House conceded that there was a case for this:

that there needs to be a statement with ample time, and an opportunity thereafter for debate, so that hon. Members can make speeches and the Treasury can respond. I will keep that under review.

161. We recommend that the Government makes available a full day’s debate for the Pre-Budget Report.

323 HC Deb, 12 November 2008, col. 55 W5
325 HC Deb, 13 November 2008, col. 957
Conclusions and recommendations

The Economy

1. The Treasury’s forecast in the Pre-Budget Report is for a swift recovery in economic growth for 2010, after a significant decline in output in 2009. The outlook for economic growth remains highly uncertain, but the balance of risks to the Treasury’s forecast is on the downside, as illustrated by the two packages which have since been introduced. (Paragraph 4)

2. The overall effect of the fiscal stimulus remains uncertain. The cost of the reduction in VAT is considerable and, in the view of the majority of commentators, the Treasury’s analysis of its impact is an optimistic one. We will continue to monitor its effect as part of our ongoing work, and will return to this issue at the time of the Budget 2009. (Paragraph 12)

3. The lack of bank lending remains the single most critical problem for the economy in the near term. The Government must ensure that the availability of credit, both to households and businesses, increases quickly. Without that increase in availability, the recovery of the economy will be placed in jeopardy. We recommend that the Lending Panel, or a suitable agency of the Treasury, provide regular updates on the actual lending by the banks to the real economy. We were very struck by the Governor of the Bank of England’s analysis that lending at the present time might not appear to be in individual banks’ interests even if it were in their collective interest. We note the Government’s proposals announced on 19 January 2009. We will monitor their implementation and effectiveness, both at the time of our inquiry into Budget 2009, and as part of our ongoing inquiry into the Banking Crisis. This is a matter we will discuss with the Chancellor in due course. (Paragraph 17)

4. We are concerned that the terms of the original recapitalisation programme of the banks may be hampering their ability to lend. We note the conversion of preference shares held by the Treasury in RBS into ordinary shares. We recommend that the Treasury continue to monitor the effectiveness of the recapitalisation scheme, and whether further renegotiation of the original contracts will be required so that the banks concerned can maintain and increase their lending. (Paragraph 20)

5. We note the creation of the guarantee scheme for asset backed securities. We will examine this proposal as part of our inquiry into the Banking Crisis (Paragraph 25)

6. The current forecast suggests that any future falls in prices will only be temporary. But the risk of a self-reinforcing deflationary cycle exists in the UK economy at present. The Treasury must be alert to this possibility. Nominal interest rates have already fallen significantly, and may soon reach a rate of zero percent or just above. We recommend that the Treasury prepare and publish the actions it may consider taking should a period of “quantitative easing” be needed. We note the creation of the Bank of England asset purchase facility, and would expect it to be included in such an analysis (Paragraph 30)
7. This paper must also contain the actions that will be expected of, or have been recommended by, the other relevant public bodies related to the Treasury, such as the Bank of England and the Debt Management Office. We will continue to examine the need for, and design and function of, the Bank of England asset purchase facility in our future inquiries into the Budget 2009, and the Bank of England’s Inflation Reports. (Paragraph 31)

8. Interest rate reductions, while favourable to borrowers, once passed through by financial institutions lead to a decrease in income for savers. While the need for lower interest rates to maintain economic growth is crucial at the present time, the needs of savers must not be forgotten. We recommend the Treasury consider measures that will provide support to savers at this difficult time. (Paragraph 33)

9. The recent fall in sterling is providing a stimulus to the exporting sections of the UK economy. However, the fall in sterling has its negative impacts, such as the risk of imported inflation, and we will continue to monitor the situation. We recommend that the Treasury include an update at the time of Budget 2009 about these negative impacts, and what mitigating measures, if any, it has taken. (Paragraph 38)

10. The rebalancing of the UK economy will require healthy UK exports, along with adequate access to foreign markets. We endorse the Treasury’s anti-protectionist stance. (Paragraph 41)

11. Support provided directly by Government to industry may be justified. Clearly, reasons of commercial confidentiality make it difficult for an open debate to take place over specific measures. However, we recommend that the Treasury, in consultation with BERR, should provide a consultation document setting out the criteria against which support packages would be considered. (Paragraph 44)

The Public finances

12. We accept the Chancellor’s argument that a rigid application of the fiscal rules in the current circumstances would have been damaging to the UK economy. The fact that a temporary departure from the fiscal rules has been required serves to reinforce our view that a revised fiscal framework is needed. The forthcoming period during which the Temporary Operating Rule applies provides a good opportunity to re-evaluate the fiscal framework for the future. We recommend that the Treasury conduct a full public consultation on the design of such a framework. We remain of the view as expressed in our previous Reports, such as on the Budget 2008, that it is our desire to see a credible framework which is more forward-looking than the fiscal rules used over the last cycle, which have been beset by problems surrounding the dating of the economic cycle. (Paragraph 57)

13. It is encouraging that at the present time the markets are supporting the Government in its raising of debt. We note the Chancellor’s acceptance that in due course the levels of public sector net debt need to be addressed. (Paragraph 61)
Child poverty, Fuel poverty and the poverty trap

14. We welcome the decision in the Pre-Budget Report to bring forward measures on Child Benefit and Child Tax Credit, including the reforms on Housing Benefit and Council Tax Benefit due this autumn, which will provide increased support to families with children. However, we note with concern that the Pre-Budget Report contains no policy measures which will significantly advance meeting the 2010 child poverty target. The Chancellor has told us that the Government remains strongly committed to meeting the child poverty targets, but this needs to be demonstrated through firm action on tackling child poverty in the 2009 Budget, including the deployment of additional resources. We recognise the fiscal position is strained and that resources are limited, but believe meeting the 2010 child poverty target must not be allowed to fall by the wayside. (Paragraph 72)

15. We note that the price of fuel has fallen considerably in recent months. Ofgem has a clear responsibility to ensure that energy providers are not taking advantage of British consumers. We expect the Government to act promptly on the Ofgem quarterly reports in order to ensure, by whatever means necessary, that consumers are not charged an inflated price for energy. (Paragraph 81)

16. We welcome the progress made to close unfair gaps in energy pricing. For too long vulnerable and fuel-poor consumers who should have been assured of receiving the best deal from their supplier have struggled to pay energy bills. It is important that the Government ensures that the energy companies take urgent steps to resolve this matter quickly and if necessary takes statutory powers to do so. (Paragraph 86)

17. The increase in the number of households facing marginal deduction rates of over 60% is a direct consequence of decisions made by the Government as to how the tax and benefit system will work. We acknowledge that there is no easy solution to the problem of high marginal deduction rates, and that this results in part from the Government’s approach of targeting support on lower-income households. That said, we welcome the fact that the Government has ensured that no household now faces a marginal deduction rate of over 100%. However, we are concerned by the increase in the number of households facing high marginal deduction rates of over 60% and recommend that the Government examine ways to over time reduce the number of households adversely affected by high marginal deduction rates. (Paragraph 96)

18. We welcome the increased take-up of Working Tax Credit amongst low-income individuals and couples without dependent children, although there is clearly very considerable scope to increase the take-up of Working Tax Credit amongst this group. As we originally said in our Report on Low Income Households, whilst one of the reasons for low take-up of Working Tax Credit amongst this group—lack of awareness of eligibility for Working Tax Credit—can be tackled through publicity campaigns, other factors will be more difficult to overcome. These include making the system more responsive and user-friendly for those with volatile incomes and circumstances. To this end we welcome the increased resources that the Government is devoting to helping tax credit recipients to claim, manage and renew their awards. That said, awareness-raising measures do have a role to play in boosting take-up rates, particularly in correcting the perception that access to Working Tax Credit is
restricted to those with dependent children. We will continue to monitor Government progress in this area, including the implementation of Housing Benefit and Council Tax Benefit reforms due this autumn, during our inquiry on the 2009 Budget. (Paragraph 101)

**Public expenditure issues**

19. We note that the announcement of an additional £5bn of efficiency savings was made in the 2008 Pre-Budget Report without any supporting schedule showing the derivation of this figure. In order to demonstrate the robustness of this figure we recommend that the Government publishes details of where and how the additional savings will be made. In providing these details the Government should also set out the measures in place to ensure that public service delivery does not deteriorate. (Paragraph 107)

20. We broadly welcome the package of measures the Government has introduced to support small and medium-sized enterprises through the economic downturn and related credit crisis. That said, the Government must keep the size and duration of the Small Business Finance Scheme under constant review given the possibility that bank lending to small firms does not return to ‘normal’ during the course of 2009. (Paragraph 119)

21. We also welcome the measures to ease the tax burden on small firms facing difficulties, but will continue to monitor whether HMRC are devoting sufficient priority to this initiative. With respect to the impact on small firms of the temporary reduction in VAT, we note that businesses argued that the short notice caused an administrative burden. We trust that the Government will take note of the concerns that small firms have expressed in their assessment of how the exercise impacted on small firms. (Paragraph 120)

22. We note that the Government has published a list of assumptions, but declined to publish any official forecast of unemployment levels. We accept that this has been the established practice of all governments but believe that the current circumstances demand maximum transparency. Accordingly, we recommend that the Government publishes its forecast for unemployment. (Paragraph 125)

23. We note that 1.8 million pensioners are missing out on pension credits which they are entitled to and which would offer them additional financial support at this time. We recommend that the Government takes further steps to increase the take up of the support available, and we will be taking further evidence about the rate of take up in due course. (Paragraph 130)

24. We recognise that steps taken by the banks to rebalance their assets following the banking crisis late last year has resulted in reduced credit lines being made available to the public. It is clear that schemes introduced in the Pre-Budget Report, and the stamp duty holiday announced earlier, are not having any widespread effect. We recommend that the Government takes all possible steps to ensure that the banks lend fairly and responsibly to each other and consequently to the public. We are concerned that piecemeal measures introduced by the Government may not be adequate in the face of the crisis in lending. (Paragraph 140)
25. We welcome the extended provision of free impartial debt advice outlined in the PBR through the Citizens Advice Bureaux, and through online and telephone services. Citizens Advice is well placed to offer advice to those struggling with debt problems and the public is certain to benefit from the funding allocated to increase its capacity. (Paragraph 145)

Other tax measures

26. We note that Air Passenger Duty excludes freight flights and imposes comparatively low charges on private planes, maintaining an inconsistent handling of aviation emissions. We further note the risk that distance based bands of APD will encourage travellers to fly via European hubs. We are of the view that the disparity in fare level will indeed encourage passengers to fly via European hubs. We recommend that the Government monitors the impact of the introduction of higher banding Air Passenger Duty in order to ascertain the impact of APD on UK hubs, passenger preferences, and the financial consequences for airlines. If the recovery from recession is to be a ‘green recovery’, as the Pre-Budget Report has stated, this rhetoric has to be supported by an appropriate taxation strategy. (Paragraph 153)

27. We note that the Government is relying on falling oil prices to counterbalance the impact on businesses of the 2 pence per litre rise in fuel duty. We believe that the Chancellor has missed an opportunity to assist the road haulage industry, a matter we think the Chancellor should address at the time of the Budget. We recommend that the Government continues to monitor oil prices and adjusts the level of fuel duty in light of any future increase in oil prices. (Paragraph 157)

Timing and debate on the Pre-Budget Report

28. We accept that it may be unrealistic for the Government in the current climate to give any commitment to a particular notice period though we maintain that a longer lead-time would be helpful. (Paragraph 159)

29. We recommend that the Government makes available a full day’s debate for the Pre-Budget Report. (Paragraph 161)
Formal Minutes

Tuesday 20 January 2009

Members present:

John McFall, in the Chair

Nick Ainger Mr Graham Brady Mr George Mudie
Jim Cousins Mr Michael Fallon John Thurso
Ms Sally Keeble Mark Todd Sir Peter Viggers

Pre-Budget Report 2008

Draft Report (Pre-Budget Report 2008), proposed by the Chairman, brought up and read.

Ordered, That the Chairman’s draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 161 read and agreed to.

Summary agreed to.

Resolved, That the Report, be the Second Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Written evidence was ordered to be reported to the House for printing with the Report.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 21 January at 9.30 am.]
Witnesses

Thursday 4 December 2008

Robert Chote, Director, Institute for Fiscal Studies, Roger Bootle, Managing Director Capital Economics, Simon Kirby, Research Fellow, National Institute of Economic and Social Research, Professor Colin Talbot, Professor of Public Policy and Management, Manchester Business School, and John Whiting, PwC and Low Incomes Tax Reform Group (LITRG).

Mike Brewer, Director, Institute for Fiscal Studies, Teresa Perchard, Director of Public Policy, Citizens Advice, Mervyn Kohler, Head of Public Affairs, Help the Aged, Peter Kenway, Director, New Policy Institute, and John Whiting, PwC and Low Incomes Tax Reform Group.

Tuesday 9 December 2008

Dave Ramsden, Managing Director, Macroeconomics and Fiscal Policy, James Richardson, Director, Public Spending, Edward Troup, Director, Business and Indirect Tax, Mike Williams, Director Personal Tax and Welfare Reform, and Clive Maxwell, Director, Financial Services, HM Treasury.

Wednesday 10 December 2008

Rt Hon Alistair Darling MP, Chancellor of the Exchequer, Dave Ramsden, Managing Director, Macroeconomics and Fiscal Policy, and Mark Bowman, Director, Tax Strategy and Delivery, HM Treasury.

List of written evidence

1. Child Poverty Action Group (CPAG) Ev 60
2. ACCA Ev 62
3. Association of Friendly Societies Ev 63
4. Professor David Heald, Specialist advisor to the Committee Ev 64
5. Professor Colin Talbot, Herbert Simon Institute, Manchester Business School Ev 71
6. John Whiting, PricewaterhouseCoopers LLP, the Chartered Institute of Taxation and the Low Incomes Tax Reform Group Ev 74
7. New Policy Institute Ev 76
8. Institute of Chartered Accountants in England and Wales Ev 79
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Oral evidence

Taken before the Treasury Committee

on Thursday 4 December 2008

Members present

John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Jim Cousins
Mr Stephen Crabb
Mr Michael Fallon
Ms Sally Keeble
Mr Andrew Love
Mr Mark Todd
Sir Peter Viggers

Witnesses: Mr Robert Chote, Director, Institute for Fiscal Studies; Mr Roger Bootle, Managing Director, Capital Economics; Mr Simon Kirby, Research Fellow, National Institute of Economic and Social Research; Professor Colin Talbot, Professor of Public Policy and Management, Manchester Business School; and Mr John Whiting, PwC and Low Incomes Tax Reform Group (LITRG), gave evidence.

Q1 Chairman: Good morning and welcome to the first of our Pre-Budget Report inquiry sessions. Can you introduce yourselves starting with Simon please?

Mr Kirby: My name is Simon Kirby and I am from the National Institute of Economic and Social Research.

Mr Bootle: Roger Bootle, Managing Director of Capital Economics.

Mr Chote: Robert Chote of the Institute for Fiscal Studies.

Professor Talbot: Colin Talbot, University of Manchester.

Mr Whiting: John Whiting, PricewaterhouseCoopers and Chartered Institute of Taxation.

Q2 Chairman: We have an hour for this session and we have an awful lot of questions so if we could have short questions and precise answers, thank you very much. First of all, when he was here last time the Governor said that “the single most pressing challenge to domestic economic policy is to get the banking system to resume lending in any normal sense”. Do you agree with that, Roger?

Mr Bootle: Yes, I most certainly do. If you ask yourself what the nature of the crisis is, it is surely a shock to the supply of credit from the banking system, that is what has caused the problem, and if one is thinking about solutions, I think you have to be aware that no matter how powerful the Government is in all this the Government’s balance sheet is fairly small compared to the balance sheet of the banks, so getting the banks lending again is absolutely critical.

Mr Chote: I think it does in one sense, that the Government at the moment has essentially abandoned the fiscal rules by which it was operating and has replaced them with a temporary set of rules that do not provide much of a constraint or anchor at all, so in that sense we are relying much more on the market verdict as an indicator of how effective things are. In terms of sustainability, you can define sustainability as the Government’s ability to meet the obligations it has, and obviously the more debt you are taking on the more you have to deploy future tax revenue to service that debt and, in principle, you could get to the point at which the debt interest burden is so high that you run out of economic resources to deal with it. Much earlier than that, you get to the political constraint of the Government finding it difficult to persuade taxpayers to accept that burden and then whether they instead resort to hitting the creditors, either directly through default, or through inflation, so in that sense creditworthiness does matter. We may be some long way away from people thinking that the Government is at risk of default, but the question of the degree to which the increase in debt makes it more expensive for the Government to borrow is a live one and is likely to be more important as a constraint over the next few years than it has been in the past, so to that extent it is true.

Q3 Chairman: The Government’s finances are said to be in far worse shape than was projected at the time of the Budget, only six months ago. To what extent does the sustainability of public finances depend on the creditworthiness of the UK Government and will that become an issue in the future?

Mr Bootle: If the cost of government debt becomes too high what are the implications for the UK economy?

Mr Chote: The implication would be that of course the cost of servicing it by the Government will be higher so the Government will then have to raise more taxes in order simply to pay the interest on the debt. Although I agree with most of what Robert said, I would just point out that although there is this theoretical concern that the Government will find it more expensive to borrow actually what is happening in the markets with a vengeance is that the Government is finding it cheaper to borrow. The markets are falling over themselves to buy
government debt, more or less around the world but including in the UK. This morning the 10-year yield on UK government debt was down below 3.4%.

Chairman: Does anyone want to add anything on that? If not, Michael?

Q5 Mr Fallon: Professor Talbot, you put a table in your memorandum to us showing that the recession will be slightly deeper here next year than the rest of the G7 but then growth will be higher than the G7 in 2010 and higher by a full percentage point in 2011. You call that a “live cat bounce”; I would call it fantasy. Is it really likely?

Professor Talbot: First of all, they are not my figures, they are the figures that are in the PBR. When you put them into a graphical format it makes it rather clearer the Government’s assumptions and the Government is assuming (and this affects the previous discussion about level of public sector debt) a pretty rapid return to growth levels pre the recession and one which is higher than for the other G7 countries. I am not convinced and I have not seen anything in the PBR which explains why that is likely to be the case.

Q6 Mr Fallon: All these figures depend on the Government’s assumption being right that the UK economy will grow faster than that of the other G7 countries in 2011?

Professor Talbot: Yes.

Q7 Mr Fallon: Robert Chote, on page 198 of the PBR at table B10 by my calculation they have revised the growth in tax receipts up from 2.8% to over 4% in 2011, giving themselves an extra £25 billion a year. What is the basis for that increase?

Mr Chote: In part, the basis is the fact, as you have said, that we are expecting to go into a deeper hole than was expected at the time of the Budget and therefore to have a steeper climb as we are coming out of it, so there has been an upward revision to both the nominal GDP growth rates for 2011–12 and 2012–13, so that would explain some of it. It still does look quite a “go-y” growth rate for revenue relative to what they are expecting for the growth rate of the economy. Presumably there is in there some expectation that the decline and the rise in revenue out of the financial sector will be even steeper, both down and up, than is the case for the economy as a whole, so I presume that is how the Treasury would explain that. It seems to me, though, that the greater risk over the path of the numbers as you are going is whether the decline in the economy is steeper and longer rather than the degree of revenue growth given the path of the economy, but if it is erring on one side or the other, it certainly looks quite optimistic. That is certainly something we would want to explore further in the next few weeks.

Q8 Mr Fallon: If economic growth, for example, was only 2.5% rather than 2% as they assume what would be the impact on tax receipts?

Mr Chote: If you have a lower growth rate particularly in money GDP terms (as it also matters what is going on with whole economy inflation) then you are going to see a weaker forecast for revenues. You would normally expect that revenue growth would outpace nominal growth in the economy because of fiscal drag and other things but whether by the degree to which you point is a pertinent question.

Q9 Mr Fallon: So what would be the impact on receipts?

Mr Chote: Roughly speaking, I think every 1% of GDP that is lost makes about 0.7% of GDP difference to borrowing of which that is a combination of revenue and spending effects.

Professor Talbot: Can I just add that if you look at table B14 on page 207, the Government is forecasting that net tax receipts as a proportion of GDP will return to the same level as 2007–08 by 2013–14 and, as Robert has just pointed out, in normal circumstances you would not expect tax receipts to return to that quickly during a recession, so that is a fairly strong assumption.

Mr Chote: If you look also at page 208, chart B1, you see the decline and rise in tax receipts that they are projecting looks much more similar to the decline and rise that we saw in the period of the stock market correction early in the second term than it does to the recessionary period previously and some people would say that the outlook for the economy is rather similar to the earlier period rather than the latter one.

Q10 Ms Keeble: I want to ask about deflation which I think, Roger, you have written about particularly. The Governor of the Bank of England has taken a fairly robust attitude towards it saying that it is not part of the central projection. Do you think that the Treasury takes deflation seriously enough as a possible risk to the economy?

Mr Bootle: I suspect not. It is one of those things where I would guess that the authorities would not want to give full public vent to their true feelings and fears about it because this is partly psychological, just like inflation, so for the Government or Bank of England to come out and say, “We are in serious risk of entering a deflationary spiral,” I am not sure they would think that was particularly helpful.

Q11 Ms Keeble: Could you say what the risks are as you see them, including to the tax take because of changes in consumption patterns?

Mr Bootle: Obviously this is a big topic but I think the really awful risk in all this is that deflation gets into the mind and with the fact that we seem to be entering a period when the authorities are perceived to be weak (and I think are actually fairly weak in what weapons they have to deploy against a deflationary danger) the risk is that you enter into a depressive mood which affects consumption and investment expenditure. If people think that prices are going to be falling significantly for a prolonged period they put off consumption and they also put
off investment projects. There is then a particular complication which I think is extremely important and very dangerous which is that interest rates cannot go below zero.

Q12 Ms Keeble: That is what I was going to ask about as well. Given that there is likely to be a reduction coming up shortly, what are the implications of interest rates not having the same sort of attraction and what other tools and weapons does the Treasury have at its disposal?

Mr Bootle: I think it is vitally important that central banks get interest rates down as far as possible (which means effectively zero) as quickly as possible. What happened in the Japanese case was that of course they finally did get interest rates down to zero but only once a deflationary psychology had set in so for people thinking about spending and borrowing the real rate of interest at that point was positive and rising. This is the danger, that you get to zero, people know that rates cannot come down any further, deflation begins and perhaps even gets faster, so people see that the real rate of interest and the real cost of borrowing is actually rising and therefore that is a major deterrent to spending. What else can they do besides cutting interest rates very far very fast? They can do what the US authorities are doing, so-called quantitative easing, that is to say getting the central bank to buy assets in the market, government bonds and bills initially, then private sector paper, ultimately maybe even equities; they will buy anything in order to get cash and liquidity out into the system.

Q13 Ms Keeble: I just wanted to ask one further question which might also apply to John as well: given that you have said that consumption goes down what are the implications for the tax take and for the consumption-related taxes, particularly given that VAT is being reduced, and I am not sure if all of that is being followed through, what are the implications for the international economy as well?

Mr Bootle: The implications are awful because of course the fact that consumption is going down in real terms is going to hit the tax take but also the nominal numbers, the money numbers are going down so the money receipts from tax will be going down. It is particularly dangerous at a time when if you are fixing public expenditure in nominal terms then of course there is a massive increase potentially in government borrowing because receipts are going down, expenditure is fixed nominally, and you would have to re-think the whole structure of how you controlled government spending if you thought you were entering a protracted period of deflation. I am not sure that there are international implications as such but I would just say that the dangers that we face are shared pretty much internationally: there is a serious risk in the United States and the eurozone: Japan looks as though it is falling back into deflation; China is not there quite. I think we could find a number of countries in this position and one of the classic responses—and this was true in the 1930s—to a combination of depression and deflation is to try to gain competitive advantage through the exchange rate which of course collectively we cannot do but individually we can. The further stage of that is to try and gain competitive advantage through protection. If we get into this position I think protectionism is a very serious danger.

Mr Whiting: Clearly tax revenues are very vulnerable here, VAT especially because that is all driven by spending. There is an international dimension here and to a certain extent it comes back to the line that Mr Fallon was pursing, because clearly a lot of the rise in the tax revenues of late has been helped by the financial sector. We have seen a certain leakage of business abroad. If international competition gets going even more for businesses to relocate abroad, never mind about less business being done, that in turn could take more business away from the UK. As this Committee is well aware, we have had a lot of tax revenues from the financial sector. Not only is that depressed but it is potentially mobile so there is a threat from the extra international pressures as well.

Q14 Ms Keeble: Just on the commodity prices, which is the one thing of which I was conscious, obviously Western economies that are aligned with ours are going to be affected by the same kind of pressures that we are. I was thinking of developing country economies as well because presumably they are going to get some of the back wash of sharp declines in commodity prices.

Mr Whiting: Yes, there is just going to be less money paid for them and that, in turn, if you are still thinking in tax terms, will undoubtedly affect the tax revenues of potentially any country because, you are right, developing countries are particularly dependent on taxes related to commodity extraction, if I could term it that.

Professor Talbot: I have just been rereading some of the research on the growth of the shadow economy and one of the issues particularly for developing countries is that there is very, very strong evidence that every time we have a major recession, the size of the shadow economy increases dramatically in developing countries and therefore tax take declines even further than it would simply because of the reduction in the economy, and then it tends to stay there when the economy starts to come back again, and that will have some effect here as well, I suspect.

Q15 Mr Todd: Is there any benefit in the fall in sterling? We are looking for silver linings in clouds.

Mr Kirby: I can certainly give you one silver lining: in a sense, looking ahead, the decline in sterling is going to help rebalance the UK economy. We would expect to see competitive gains feed through to net trade having a more positive contribution to growth and that means basically that the rebalancing of the economy will be done partly through sterling rather
than relatively weak income growth for households over the coming years. That possibly is the one silver lining you can get from that.

Q16 Mr Todd: Our terms of trade are broadly returning to the point they were after we left the Exchange Rate Mechanism; is that not right? We have had a period of about 10 or 11 years of really quite tough terms of trade for our export—

Mr Bootle: I do not think you should mix up terms of trade with the exchange rate. The terms of trade are a different thing altogether. I think what you were referring to was the average level of the exchange rate. If you look at the trade weighted index it is roughly, you are right to say, where it was just after we came out of the ERM. I am massively positive about this—it is about all I am positive about—in the sense that I think the exchange rate—

Q17 Mr Todd: —I was looking for something!

Mr Bootle: —We all are! It has been very high for some time. We had a long period of stability. The pound rose before Labour came to power in 1997, carried on rising immediately afterwards, and was then roughly stable for about 10 years. Some people took a lot of comfort from that but the problem is that it was roughly stable at massively too high a level and much of what has gone wrong in our economy can be pinned on that. This is very similar in type to what happened in 1992 and also, for those of us with longer memories in 1931, when Britain was the first to come off the gold standard. Although we know the succeeding years as the “Great Depression”, in fact in Britain they were not that bad compared to a number of other countries, notably America and also France and Germany, and a leading reason was that we came off the gold standard early, the exchange rate fell, interest rates fell to what became the lowest ever level of 2% (shortly I suspect to be beaten) and that helped to boost the economy, and similarly after 1992. I am hopeful that we will get some benefit in the same way this time.

Q18 Mr Todd: And that we do not need a World War to rebuild our economy as we did in the 1930s.

Mr Bootle: Indeed.

Q19 Mr Todd: The Industry Secretary is quoted as examining ways in which we might rescue industries and obviously he may be looking across the pond at some of the activities going on there. Is that something that any of you would encourage? I think I have heard remarks about protectionism which this borders on as well. I am assuming that you probably would not.

Mr Bootle: Can I make a quick remark about that. First of all, it goes against the grain for those of us who are dyed-in-the-wool free market people. However, there might well be circumstances when it is necessary. What I think is in favour of what the Secretary of State is saying is the idea of actually thinking about it before the event. It was very striking in the banking crisis that the world central banks and governments, not just this one, did not actually have a very clear idea of which parts of the financial system it was absolutely vital to save and so they were thinking about this on the hoof. You had this extraordinary situation where most observers now think it was a gross mistake to have let Lehman’s go bust but at the time over a weekend there you have these individuals bunged together in a room thinking about it on the hoof. That strikes me as not a very sensible thing. I think having an open debate about this now would be a good thing.

Q20 Mr Todd: To turn it back to the question with which I started, would perhaps one of the strategic drivers to be borne in mind is the need for globally competitive industries which could take advantage of the lower exchange rate that we currently have, that we want to make sure those survive into the future because those are going to be critical to our future wealth?

Mr Bootle: If you believe in markets, and admittedly the number of people who do seems to be falling by the month, you would think that sort of issue is best left to the markets. Governments do not have a very good record in making that sort of judgment. I would hope that we did not go down that particular route, but perhaps in thinking about the agenda that I mentioned before and those industries which had some key strategic reason to continue but which for some reason or another the market would not support, if we tried to think about market failure, why would an industry that we thought was particularly significant not receive the support of the market, and in those circumstances it might be justified to support them.

Q21 Mr Brady: Can I ask Robert Chote first of all, the PBR assumption is that the fiscal stimulus will reduce the depth of the downturn by about 0.5%. How plausible is that?

Mr Chote: I yield to my macro modelling colleagues on that. I think that seems to be in line with the sorts of multipliers that the Treasury, for example, laid out when it was looking at the use of fiscal activism in its studies for the euro and its 18 volumes of papers, so to that extent it does not look to me to be enormously out of whack. I guess an important issue is the degree to which it is accompanied by similar sorts of measures in other countries, and therefore the benefits of the stimulus are not, in a sense, leaking away—or rather the benefits of other people’s stimuli are leaking to us to the same degree that ours are leaking to them. If that were to be the case, and we were also in the situation where the fiscal authorities were trying to move in a direction in which the monetary authorities did not wish them to move and you have then got an offsetting change in monetary policy, that would be a concern. If both of those are not problems at the moment then it does not look implausible but, as I say, I think that is a macro modelling question.
Q22 Mr Brady: I think macro modelling colleagues would not demur from that.
Mr Kirby: Could I just add that from our perspective our estimates would suggest that the effect is slightly smaller. The more important fact behind this is that one of the main points of the stimulus is a VAT cut. In normal times work would suggest that that is the sensible route to go. However, the problem is that we are currently in a banking crisis and we have households and firms that are credit constrained. It is trying to stimulate spending without addressing the problem of credit constraints which may mean that the actual VAT cut has less of an impact than we or even the Treasury at first think. Fundamentally, if you are going to do a VAT cut you also need to address the problems of credit constraints as well and, unfortunately, that is not happening.
Professor Talbot: Can I add one point about that on the VAT cut which links back to the previous discussion and Roger Bootle's point about the dangers of deflation. Something which I am surprised very few people have discussed is that the VAT cut is deflationary and it is largely non-transparent to the public and in this situation where even on the Government's projections we are bordering on deflation, the RPI is actually forecast to be going negative and the CPI only just remains positive. There is a real danger that the VAT cut could have the completely opposite effect of what is intended and that is to discourage people from purchasing in the short term. Certainly if I were buying a new car at the moment I would wait under the end of the VAT cut period and buy it then, on the grounds that prices are likely to have fallen by that time.

Q23 Mr Brady: When we saw Mervyn King last week after the PBR he gave the same response which was that this contemporary cut in VAT, if it has a stimulus effect, it is loaded towards the end of the period and not the beginning which seems a very interesting logic. I take it from your comments, Professor Talbot, that you would have done something different and if you were going to go down the fiscal stimulus route you would not have done it through the VAT cut?
Professor Talbot: Probably not.

Q24 Mr Brady: What would you have done?
Professor Talbot: Okay, I would probably have gone for something which would have been a more direct and obvious cash benefit to individuals along the lines of tax cuts in the United States. I know the objection to that that was being raised last year was, “Look what happened, consumers spent half of it and put the other half into savings.” That does not seem to me to be a very profound objection, particularly in the current circumstances. If they spent half of it and put half of it into savings it would help considerably with the recapitalisation of the savings sector.

Mr Chote: If you look at the overall fiscal stimulus that we have got lined up for next year it is about 1% of GDP, as we have discussed, about £16 billion, and about half of that is the VAT change. Another £2.5 billion or so is the bringing forward of capital spending which one might, assuming it is brought forward (and it is not a huge amount of money which makes one less concerned than if they claimed they were going to be able to bring an enormous amount forward) assume would be there as well. In addition, you have the £3 billion that effectively is being spent renewing the one-off income tax cut that is in place this year. Whether you can really count that as a stimulus next year relative to this year is debatable. In terms of the effectiveness of the VAT cut, in a sense, Simon is absolutely right, there are lots of people around who are credit-constrained at the moment and dealing with the credit constraints is an important issue. It is of course the people who are credit-constrained and also those who are relatively short-sighted who are likely to spend the money that you give them rather than to save it. You have then got a group of people who will be not credit-constrained and who are more forward looking who may take the view they are going to save it or use it to run down debt or they are going to spend it but just dribble it out over a very long time period. They may be the people who are more likely to respond to the fact that the VAT cut means it is cheaper to buy now than it will be in the future. Turning to what might the alternatives have been, prior to the rush of leaks. I would have expected a larger proportion of the stimulus to come in the form of a permanent increase in the generosity of benefits and tax credits for relatively less well-off families — on the grounds that they are relatively likely to spend a higher proportion of it — and you would take it away from other richer households in the future.

Q25 Mr Brady: Some of us have struggled to see any really good reason why the decision to go with the VAT cut was taken instead of that. Can you see a good reason?
Mr Chote: There is a political issue which is that the alternative strategy gives to one group of people and takes it away from others, so you have a problem that the people you take it away from are angry and the people you give it to may be less than wholly grateful. The other issue is that the attraction of VAT is that it is not just giving income to people, it is a change in the price of buying today relative to buying tomorrow so therefore it is the argument that it shifts people's spending forward. Those are the two reasons I presume the decision was taken.

Q26 Mr Brady: You would agree that it has that effect at the end of the temporary cut period, not now?
Mr Chote: The point at which people see VAT about to rise is likely to be the focus. That is what we have seen when this has happened in the past, but imagining that overall consumer spending will be unchanged — so people will be buying 1% more stuff 1% more cheaply — does not look bad as a broad-brush guess.
Q27 Chairman: Colin, I have just had a whisper that one of our colleagues bought a car at the end of last week! It is pity we did not give you a ring after the Pre-Budget Report.

Mr Whiting: Could I make a final quick observation on VAT. One thing that was much underplayed was the actual cost and disruption to business on repricing and on making decisions on what is, after all, the first general cut in VAT that we have ever had (it has only ever gone up) and therefore the sheer logistics and administrative cost, that sort of burden. If you are looking for one stimulus, one of the stimuli that has come to me from a number of clients is the stimulus of staying up at night trying to sort out what to do.

Q28 Sir Peter Viggers: How resilient is the United Kingdom economy compared with other economies? If I may, rather than having a detailed dissertation may I please regard you as a panel and because of time constraints could you just give one sentence. You will recall that the Chancellor of the Exchequer in his Budget said that the UK economy is more resilient than others and indeed the Treasury produced a paper which backed this up. Can I ask each of you to comment on that literally with one sentence. Simon?

Mr Kirby: Yes the paper is relatively correct in what it says. The unfortunate thing is that the UK is not that resilient to a banking crisis due to the high level of debts that households have, and unfortunately in the paper for the period analysed the UK did not suffer a major banking crisis.

Mr Bootle: I think the key is that word “resilient”. I think you probably do not mean resilient; you mean how well or badly placed is it. I think it is badly placed because it has a massive housing bubble, housing is very important and we have a large financial services sector. On the precise meaning of the word “resilient” itself—that is to say ability to bounce back from what will be a worse position here than in many other countries—I think we probably are relatively resilient. We have the lower pound and we are fairly flexible as an economy where some on the Continent are not.

Mr Chote: I agree with that. The Treasury defined resilience in that paper as “not having big movements in the output gap in response to shocks”. They are having a much smaller movement in the output gap according to their forecasts because they have dramatically moved down the potential output of the economy, so that is not necessarily a good thing but it will show up as a relatively small change in the output gap.

Professor Talbot: I just have one thing on the housing market. The comparison with the United States is instructive because they also have a housing price bubble but theirs was based on an over-supply of housing which is going to make their problems much more difficult. We still have a massive housing under-supply problem and I think that will make the housing market more resilient.

Mr Whiting: Can I just make a comment about the risk? On the other hand, we have a widely flexible business sector that has got at least the opportunity to achieve Colin’s “live cat bounce”.

Q29 Sir Peter Viggers: Turning to the Pre-Budget Report, do you think that the PBR was sufficiently prudent in forecasting public finances?

Mr Chote: In the set of judgments that has been made the key one, and I think the most important driver of the long-term outlook for public finances, is what they have concluded about the loss of potential output in the economy. They have basically taken the view that the long-term output of the economy is going to be about 4% lower than it would have been expected to be prior to the announcement of the PBR, so in effect they are saying that for two years the trend growth rate of the economy will be 0.5% a year, not 2.5% a year. That knocks a £60 billion hole in the economy and means that you effectively have a permanent loss of about £40 billion in tax revenues and higher social security expenditure. Judging whether 4% is the right number in the middle of the two-year period in which you expect that adjustment to be taking place is a very difficult thing to do, but I have to say seeing the magnitude of that number in cold print it did not look to me as though they were being egregiously optimistic, it seemed to be a reasonable stab at that analysis at this stage. That is a key driver. Then there is the question of how far the economy falls below the newly lower level of potential output, how deep the recession is in output gap terms, and there the risks are presumably on the downside rather than the upside.

Mr Bootle: There are two issues here. One is, as Robert says, the demand factor, that is to say how far the economy falls below its potential output and the other is about the potential. On the first question, I think the Treasury is being too optimistic not about next year but about the year after. This is all about the length and severity of the recession. What we have in the forecast here is a recession that is not remarkable at all—it is fairly short and there is quite a nice bounce back in 2010 which strikes me as being rather odd. No-one knows and the uncertainties are massive, but if you think this is a once-in-a-generation or once-in-two-generations shock it seems to me rather odd that what you end up with is a “mouse” of a recession. I would expect something much much worse. On the second question of supply potential, again the uncertainties are enormous but my reaction to the 4% was to think how large the figure was particularly given the uncertainties. If you read the section of the PBR where they try to explain and justify this, it really is the worst sort of “Noddy” economics. It is all about the difficulty of co-ordinating inputs of labour and capital and there are no examples and no quantification. It really is a complete stab in the dark. No-one has a clue. My own guess—for what it is worth—is that this is much too high a figure and indeed that there are countervailing factors, there are good things to come out of recessions. Things get cleared out and
moreover if the shape of our economy changes along the lines that we have been speaking about, that is to say a shift away from consumption and, relatively speaking, from government spending towards export, we may well find a period in which those parts of the economy whose natural productivity growth is faster are the ones that are growing fastest. I would not be at all surprised to find that 4% figure a gross over-estimate.

**Q30 Sir Peter Viggers:** The Government was working by two guiding principles which it has now abandoned. Does it matter that we do not have a compass?

**Mr Chote:** I think it does. The Government is unclear. They have said that they are departing temporarily from the fiscal rules. Whether they end up departing temporarily for longer than they were actually adhering to them I think will be an interesting thing to see. There is no question but that actually adhering to them I think will be an example would just be a hostage to fortune at this stage. Credibility at this stage relies crucially on the fact that we are falling into a deep hole from which we will rise and therefore whether this 8% is going to be permanent. As I said, the loss of 4% of GDP, if they are right about that, as the loss of potential output implies, you have suddenly discovered you have an additional 2.8% structural deficit which needs to be got down. The way in which they are intending to get it down in terms of measures (that is on top of any natural rebound) is through a combination of tax and spending measures. The key thing to note there is that they are relying very much more on spending to do the work than they are on taxes. We have only got something like a £4 billion net tax increase at the end of the period of forecasting, which is minute in comparison for example to the tax increases that had to be announced in the 1993 Budget, and you are relying much more on getting spending down, so we have this cut in spending in 2010–11 and then the reduction in the growth rate of public spending thereafter. The question then is can you stick to that, which means are you prepared to accept the consequences for the quality of public services and your ability to redistribute income that those sorts of spending growth rates imply? Obviously if the situation ends up being worse then you will need to have more action on one or other of those dimensions.

**Q32 Mr Crabb:** If one of the achievements of the Golden Rule, as claimed in paragraph 95 of the PBR, was to address an historic bias against capital spending, following the abandonment of the Golden Rule is there now a risk that capital spending will lose priority?

**Mr Chote:** Yes, the Government has reduced the long-term goal in terms of what it is looking for in capital investment. We have the announcement that they are shifting forward £3 billion of capital investment but then once that has happened you have a permanent reduction thereafter. We are looking at something like 1.8% of national income as the figure furthest out as distinct from 2.25%, so it does look as though capital spending is taking the brunt of the adjustment and a bigger proportionate part of the adjustment than current spending, but, that said, you are still not reducing it to rates anything like as low as those that were inherited at the end of the Conservative term and to which they fell even further in the Government’s first term. It is being reduced back but not to its lowest.

**Q33 Jim Cousins:** I suppose I should ask Mr Bootle this question: the Governor of the Bank of England, if I can use a sort of shorthand language, was pretty sniffy when he appeared in front of the Committee about the Crosby Report’s proposal for guarantees for mortgage-backed securities and pretty sniffy about the idea of mortgage-backed securities in general. Do you think that was the right reaction?

**Mr Bootle:** I am not sure. Two things really—first of all, I think we have got to be quite careful about trying to resuscitate an aspect of the financial system which does not seem to have been particularly effective and was actually very dangerous. Do we...
really want to go back to that world and do we think we can? I am also conscious of the danger of, as it were, shifting bank lending from one particular channel into another where what we should be wanting to do is increase or maintain overall bank lending. There is also a trend in a lot of the commentary on this aspect where any sort of intervention at all is pooh-poohed on the grounds that it is somehow distorting the market—the market that is not working! So I feel it is all hands to the pump, belts and braces and so on and so forth but faced with a free hand would this be the form of lending I would want to be stimulating, the answer is probably no.

Q34 Jim Cousins: Yesterday of course the Prime Minister began with the “small cuddly bear” of guarantees for certain kinds of mortgage possessors in difficulty. Do you think that was the right thing to be doing or will this small cuddly bear grow into the great giant bear of British Freddie Mac?

Mr Bootle: I take it as a political gesture essentially which is on a pretty minor scale and I do not think, frankly, it will achieve very much. The major task, if I may extend the question, is to get the banks lending.

Q35 Jim Cousins: In general?

Mr Bootle: In general and my concern is that a model under which we give them more capital, we capitalise them and implicitly say, “If things get really bad we will give you even more capital,” but we do not take control of bank lending and they do not do very much individually in order to pursue the collective interest, is fundamentally wrong. I think we are in a position where if we are putting public money at risk then it is right and proper and appropriate that the Government should get the result that it wants; namely more bank lending.

Q36 Jim Cousins: If I could ask you and your colleagues just to follow that point, the banks so far seem to be resisting the sternest warnings from Lord Mandelson. What should and could the Government be doing to force the banks to lend?

Mr Kirby: I think the history of banking crises tells us that their costs are significant. The average cost of a banking crisis is around 10% of GDP. Currently we have put in around 2.5% of GDP into a number of banks, so the Government perhaps wants to think about moving more towards putting some more money into banks, changing slightly how they do it, perhaps less onerous but taking more control over the banks themselves. Another 2.5% of GDP might move us towards the point where we can actually get the banks lending because at the end of the day that is what we need to do to get the economy moving.

Q37 Jim Cousins: Mr Bootle, let us hear it from the marketeers.

Mr Bootle: I do not think this is only a matter of the money. You could be putting in lots of money and having no control and getting not much result. Equally, you could put in not that much money and take control and get a big result. I do not think it is necessary to own all the banks in order to direct their lending. I would point out to the Committee that in the years immediately after the Second World War it was normal in this country and other so-called capitalist economies for a weapon of monetary policy to be direction of bank lending. It was quite normal and it seems to me that we cannot go on for very much longer just encouraging banks. There is a difference here between the self interest and the collective interest. I do not blame the banks here. If Peter Mandelson came along to me as a chairman of one of these nationalised banks and said, “Be a jolly good boy and lend some more money,” I think I would be inclined to say, “Why should I?” because I have the interests of my bank at heart and my own bank will be interested in protecting its own position. The interest of the collectivity of the economy overall is not in that; it is in these banks lending. Each individual bank—this is pure market stuff—acting in its own interests will collectively bring about the very result that they fear, namely a very weak economy where asset values fall and they are thoroughly justified in not lending.

Q38 Jim Cousins: So what is the answer to that?

Mr Bootle: They have got to be told to lend.

Q39 Jim Cousins: They have got to be told to lend?

Mr Bootle: I mean forced to lend; I do not mean encouraged.

Q40 Jim Cousins: So your bet is not on Karl Marx; it is on Mr Attlee?

Mr Bootle: You go beyond my field of competence; I am an economist.

Q41 Chairman: Do we just get them into one room and tell them to lend?

Mr Bootle: I think just telling them, as it were, is not going to be enough. You are parliamentarians and you have to pass a bill under which the Government takes Parliamentary authority to instruct the banks as to how much they should lend. We have done this before. There will be a file somewhere in the Treasury which should be dusted down on how you control bank lending. You tell them how much they should lend.

Mr Todd: It is a very dusty file!

Chairman: Stern words indeed. Nick?

Q42 Nick Ainger: Following on from the lending issue, obviously small businesses are facing real problems and, as members of the Committee know from their own surgeries, we are getting small businesses complaining vociferously, and rightly so, about the new terms that are being imposed on them by their banks or in fact banks trying to terminate their loan arrangements. Do you think the £7 billion package in its various forms that has been put together by the Government is the most effective way of actually maintaining and lending financial streams to the small business sector. Perhaps Professor Talbot?
Professor Talbot: Sorry, I was looking at something else; you caught me out. I think it is John’s question.

Q43 Nick Ainger: I do not know who else was listening to my question.

Mr Whiting: I was certainly listening and I am framing a comment in tax terms which obviously is my main area. Firstly, I would certainly echo your underlying comment that small businesses are feeling very constrained in terms of credit and they see credit becoming more expensive to them, so various of the measures that are being discussed which might facilitate more credit flow will of themselves help, as will lower interest rates. One of the interesting facets of the package was obviously in getting HM Revenue & Customs to be better at discussing with businesses how the business might, shall we say, ease it tax payment profile. I think that is quite an important one because very often delaying the tax man is used as an informal credit route by an awful lot of small and micro businesses (not necessarily the big plcs). It is not necessarily a good route and of course HM Revenue & Customs has a history of being forced to take action against small businesses when things are taken too far. I think this is an important initiative. I am told by HM Revenue & Customs that they are putting quite considerable manpower resource into this rescheduling. I would like to see it really well staffed up and really well advertised. One or two people have asked me: “Does this mean HM Revenue & Customs becomes the new ‘bank that likes to say yes’?” I do not know. I do not think they will be extending credit as such but actually encouraging this rescheduling of tax payments is quite important. I think the measures could go further into a detailed tax point perhaps. When you think that one of the biggest issues small businesses are facing is paying tax bills now in respect of good profits at a time when life has turned down, to make it easier for them to establish a loss now, which of course can carry back and eliminate last time’s profit, just that sheer mechanics of speeding up the loss claim process would help a lot as well. There are some good ideas in here. There is still a bit more that could be done but generally I applaud the Government for at least taking some useful initiatives.

Q44 Nick Ainger: Does anybody else want to comment on the Small Business Finance Scheme which was asked for by the Federation of Small Businesses?

Professor Talbot: No, but I would just add on the VAT point which we discussed earlier the obvious effect of using VAT as a policy instrument is to transfer the cost from HM Revenue & Customs to businesses and that disproportionately affects small businesses a lot more because of the administrative costs of making the changes are not being borne by HMRC, which they would have been if, for example, we took Robert’s suggestion about changing other forms of allowances.

Q45 Nick Ainger: Does it not offer an opportunity for a small business, a plumbing business or whatever, that has been charging its customers 17.5% VAT to maintain its prices and keep the 2.5%? Is that not a real benefit to small businesses?

Mr Whiting: Yes, that is an option that I know many small businesses are considering. In these very competitive times they have got to be very careful about it, not least because many consumers as they walk through the shop door will be well briefed to know that VAT has been reduced so will ask, “Are you reducing your prices?” There may be a number of challenges to the shopkeeper around but it is certainly something that small businesses are considering. I know that from personal experience. I think it is fairly being described that with this VAT cut one of the options is that small businesses could see it as a possible bit of re-financing.

Q46 Nick Ainger: We have spoken about the £12.4 billion, or whatever it is, that the VAT cut represents but there is £7 billion here available to small businesses but nobody seems to want to comment on that. No?

Mr Kirby: The one thing I would say from a slightly different perspective is I think the Government has to be prepared to put more money in in the future. Their assumptions work on the basis that lending returns to some form of normality at the start of 2010 and if that does not happen then things like the Small Business Scheme will probably need to be extended. I think the Government do need to be aware of that in their thinking.

Mr Whiting: There is another small factor, and we are talking here of course about confidence and whether or not a small business actually wants to get further into debt. I agree with the fact that the money looking as if it is going to be more available is good but an awful lot of small businesses are inclined to put a blanket over their heads and hope that times are going to get better rather than go further into debt unless they really have to.

Q47 Mr Love: Roger Bootle, I am stunned so I am going to ask you the question just once against to get the absolutely clear answer. You are suggesting that we have to return to the credit controls of the 1960s and 1970s that were swept away in the early 1980s?

Mr Bootle: What I am saying is that it is absolutely vital that lending should be restored to a level consistent with decent performance—

Q48 Mr Love: You are prepared to take measures as serious—

Mr Bootle: I am prepared to take that, yes. It seems to me to be not adequate to give the banks money to back up their balance sheets and then expect them individually to behave in the collective interest; they cannot. Any self-respecting bank management, not having confidence that the others were going to do the same, would baton down the hatches and be cautious—to the point of recklessness from the point of view of the collective interest.
Q49 Mr Love: I understand that. We are somewhat limited in time. I want to take you on to another controversial area. You were talking about exchange rates earlier on and the danger of what happened in the 1930s where we had competitive devaluations. I understand that if you make the comparison on purchasing power parities, the exchange rate with the dollar at the present time of 1.50 is about right. What would be the balance of advantages and disadvantages at that rate to us joining the euro?

Mr Bootle: I think you could argue that the pound has been at a rate where it would have been madness to join the euro for many years, so if you thought the overall political and economic advantages were in favour then this would be quite a good time. There is also the point about the difficulties and instabilities in international financial markets. One argument is that at times like this you do not want to be a medium-sized currency like the pound, you should be part of a large bloc like the euro or the dollar where you have some sort of protection. Then there is another argument that I am not altogether convinced of either in terms of the bail-out capacity of a larger entity as opposed to a smaller one. Those points are valid, however, there is one enormous point, it seems to me, pointing in precisely the opposite direction which is that we have just lived through a period when you have had the clearest demonstration possible of the benefits of having your own currency because the pound has just plunged against the euro and the dollar giving us a massive competitive advantage against those currency areas and at the same time we are able to set our own interest rates. This is a very big advantage.

Q50 Mr Love: I understand and I have very great sympathy for that argument but do you think there is any possibility that the European authorities in the ERM will see the action that we have taken to respond to the recession as encouraging the markets to devalue the pound? In other words, they will see it as a competitive devaluation and may feel that they need to respond?

Mr Bootle: One of the advantages of a floating exchange rate is that of course the Government does not need to take any action. The Government in all this has not taken any action. Indeed, I do not even think it has necessarily encouraged the fall of the pound, at least not openly, so I think they would have difficulty. What has happened is that it has emerged that the UK position is much weaker than many people thought it was, the potential for house price falls is greater, the state of public finances is much worse, the likelihood of having interest rates is much lower, and all of that has persuaded the markets to think that the pound is a "sell" without the Government doing anything at all.

Q51 Mr Love: Does anybody else want to comment on the euro or shall I move on? Very wise, if I may say so! Can I come again to Mr Bootle, I am sorry to focus on you but I was rather surprised that you agreed with the Governor of the Bank of England in his response to the Crosby Report, and while I would agree that perhaps it is not the ideal way to increase credit in the mortgage market, do we really have any alternative? Do we not need to hold our noses and go down this route if we are going to actually get credit availability in the mortgage market back to the sort of levels that the Government is asking for?

Mr Bootle: I do not think I did straightforwardly agree. I think I said I was ambivalent. It did not seem to me to be the best of all possible measures. I have already indicated that I favour a global solution in the sense that I favour the Government having an overall view of the appropriate level of bank lending and even a view as to roughly how it should be divided between different sectors and taking action to ensure that actually happens. As against that sort of outcome what worries me is a piecemeal approach where we guarantee a bit of this, we subsidise a bit of that, we encourage a bit of something or other else, all adding up to not all that much and, in the process, distorting the market. That seems to me to be second best. However, if the alternative were doing absolutely nothing, and if we were to sit here and do absolutely nothing, and you are saying to me would it be better as against that comparison to adopt Crosby's proposals, then I think the answer would probably be yes.

Q52 Mr Love: Can I turn to Mr Kirby, you mentioned earlier on about the credit constraint problem which I think we are all very concerned about and the Governor was exceptionally concerned about. What should be our response to that problem? As always, we are all great at highlighting what the difficulties are but we then fracture when it comes to what the solutions are. What is your solution to this?

Mr Kirby: I return to my point that further recapitalisation of the banking system is, unfortunately, going to have to be the way forward, with a change in the way they actually implement recapitalisation. Currently we have got rather onerous terms with 12% preference shares and, aside from that, we have also got the arm's length approach to it as in they have put a significant amount of public money in but basically let them run themselves. I think making the terms less onerous is a more prudent approach because then banks might actually come forward to want to take the recapitalisation rather than going to foreign countries and trying to raise capital that way. Also the fact that if the Government has some more control over the banks they are putting the money into may be the way that we can get the banks lending.

Q53 Mr Love: I notice that you did not go down the Bootle line. Can I turn to Professor Talbot on a completely different subject. The Government is asking for £5 billion of additional efficiency savings over and above the £30 billion that has already
Witnesses: Mr Mike Brewer, Director, Institute for Fiscal Studies, Ms Teresa Perchard, Director of Public Policy, Citizens Advice, Mr Mervyn Kohler, Head of Public Affairs, Help the Aged, Mr Peter Kenway, Director, New Policy Institute, and Mr John Whiting, PwC and Low Incomes Tax Reform Group, gave evidence.

**Mr Kenway:** Peter Kenway from New Policy Institute.

**Mr Whiting:** John Whiting, PricewaterhouseCoopers and the Chartered Institute of Taxation.

**Professor Talbot:** The short answer to that would be no. Just to take a slight step back, the net increase in public debt over the next spending round period after this one is completed is about a quarter of a trillion pounds, about £250 billion or just under. That is including, cumulatively, £95 billion-worth of efficiency savings over the same period. That £95 billion is approximately twice the level of claimed cash savings made in the previous efficiency round. In the previous efficiency round the £16.5 billion of cash savings has been subject to some considerable doubt both from the NAO and the Public Accounts Committee's analysis of them, which I agree with.

The idea that you can double that amount in the next spending round seems to me incredible and this additional £5 billion which is being added on seems to me to be very much a sucking a finger and sticking it in the air exercise based on the fact that they have rolled forward spending from the end of that spending round period and now want to recap it towards the end. We are talking about heroic numbers in terms of efficiency savings. I do not believe that they can be achieved without some serious impact on services.

**Q55 Chairman:** So there is no more fat really, is there?

**Professor Talbot:** No. On my crude estimates, Chairman, if you reduced public sector real growth to zero and implemented these efficiency savings, which I do not think you can on that sort of level, we would only begin to make a dent in the accumulated public sector deficit. You would have to, on my estimate, cut public spending in total by about 5% in the next spending round to remove the accumulating extra deficit.

**Mr Chote:** It is worth making the point that the Treasury claims to have identified a set of efficiency savings over the same period. That £95 billion is approximately twice the level of claimed cash savings made in the previous efficiency round. That £95 billion is about two times the level of efficiency savings described in the previous round and now want to recap it towards the end. We are talking about heroic numbers in terms of efficiency savings. I do not believe that they can be achieved without some serious impact on services.

**Q56 Chairman:** We have got the sub-committee inquiry into efficiency savings next year on that. Does anybody want to say anything before we finish up? If not, Roger. Andy was asking you about credit controls. I did not get the impression that you want credit controls brought back in but you want lending to be improved and directed so there could be legislation there for that. How would that work? Would it be defining lending practices and a monitoring regime?

**Mr Bootle:** I think it could be any or all of those. The key point is that there is a public interest issue in all this. Keeping the economy away from depression and deflation is a public good. We seem to be in the position where the Government has just about recognised that and in the process has put large sums of public money into private organisations but we are at the stage at which it is expecting those private organisations, acting competitively, to deliver the public good and I think that is a contradiction in these circumstances; they cannot do it. Each individual bank, no matter how good they are, cannot do it, so we have to have some way of getting that result. It may be full nationalisation. It may be that we do not need to do that. It may be, as I indicated, a Treasury representative on the board; it may be a Bill, but the vital nettle that has to be grasped is that we cannot expect these people to act as though they were mini governments.

**Q57 Chairman:** So it cannot be done by exhortation and the Government needs to stiffen its spine here; is that it?

**Mr Bootle:** Yes.

**Chairman:** Thank you very much for that. It was a fascinating evidence session that will help us a lot.
cadre of people who were still losing out as a result of the changes despite the extra personal allowance. Within my memorandum, thanks to the Low Incomes Tax Reform Group, I have put in a little appendix of still winners and losers. Much of this depends on exactly how you count the figures but it does look, on some figures that I think are reasonable, that there is still a small cadre of people who lose out purely in income tax terms. National insurance savings, if these people are working, might just cover them so they might be just about on a level, but we are thankfully talking about a relatively small number of people and relatively small amounts. All of that said, there is still more to be done in this and I think a lot could be done to help not only these but also the people generally who might be losing out with the Revenue taking more action on matching of, as it were, unclaimed taxes. There is a particular issue, for example, that one of the compensations that is already in the system is the 10p rate maintained on savings income. Of course, that is not automatically given to people. It will have to be reclaimed because the banks can only deduct 20% or nothing, so some of those who the system was designed to compensate, even before these winners and losers, will have to put in a reclaim. It would be very helpful if more effort were put in by Revenue and Customs into identifying that possibility—advertising it, making sure as much as possible is done from tying up loose ends that they know about, and that will further reduce the numbers who have lost out.

Q61 Chairman: From April 2011 how will the picture change with the introduction of national insurance and income tax changes?

Mr Whiting: There will by then be further rises in the personal allowance, we assume, and that will further help the extra national insurance situation. The extra 0.5% generally will, of course, be a cost. At the same time the national insurance threshold will be going up, so those at the very lowest end will probably be protected. The clawback effect of these extra national insurance rises will be to take away some of the general benefits higher up the scale, so, coming back to your core concern about the low income group who have lost out, as was well known, if the income was over about £16,500, going back a year, people were protected anyway, so on this low income group I think we can just about work it out of the system although it very much depends on how you look at it.

Q62 Chairman: The Child Poverty Action Group said that the PBR takes us no nearer to the 2010 target to halve child poverty than we had expected before today, before the Pre-Budget Report. Mike, do you agree with that?

Mr Brewer: Yes, that is absolutely right. There were some measures for families with children announced in the PBR but they all take effect in 2009. There was nothing specific for families with children in 2010, which is the year the Government has the quantified target for, and the changes the Government did announce affecting the tax and the benefit system in 2010, this small rise in the continuation of the rise of the personal allowance and the slight extension, have a negligible impact on child poverty, so essentially the PBR did nothing for child poverty in 2010.

Q63 Chairman: So it did not take any additional children out of poverty?

Mr Brewer: It may have had a negligible effect through that small rise in the personal allowance but nothing at all significant, and I presume that is why the Government said it would be looking at child poverty in the next Budget.

Q64 Chairman: Give us a global figure: what will the Government need to spend to achieve its target of halving child poverty by 2010–11?

Mr Brewer: When we came to see you in May we said the Government needed to find £2.8 billion to spend on child tax credit. The PBR did nothing, so the answer is still £2.8 billion.

Q65 Chairman: Still the same? Okay. Mervyn, when you came in to see us at the time of the Budget you made public your view that the PBR offers a “truly skinflint” package for older people. Why be so shy?

Mr Kohler: I have been struggling, Chairman, to find what the derivation of “skinflint” is since Monday afternoon of last week. The “skinflint” is about really the only tangible contribution that was made was this £60 Christmas bonus which is going to be paid in January. The announcement about pension increases and pension credit increases were following more or less the statutory requirements, despite the fact that the Chancellor was presenting it as the largest rise that has ever been paid to our pensioner population, and there were so many other opportunities which he seemed to be missing to address issues like fuel poverty, which is a very serious, dire concern amongst the older population at the moment. There was £100 million to supplement the Warm Front scheme, which, of course, is welcome, but surely this was the moment when he could really have done something significant with the construction industry to improve the energy efficiency of our whole housing stock, improve therefore employment opportunities in that sector and help towards reaching the climate change targets as well as eradicating fuel poverty on the way.

Q66 Nick Ainger: Following on from that, are you surprised that the increase in the winter fuel allowance this year is described as a “one-off”?

Mr Kohler: I am not just surprised; I am horrified. The increases, of course, that people have been facing in their energy bills have been much higher than the total of these two one-off increases anyway, and as to providing people with a sense of confidence and stability going forward, the announcement of these as “one-off” improvements is not really terribly helpful.
Ms Perchard: Could I add to this but also perhaps two-thirds of the households in fuel poverty are on disability benefits. Some distribution of extra help to some of those households would give us some idea that it is possible to do extra help until this Christmas bonus comes along. People are worried that they will not get this one-off at the moment.

Ms Perchard: Could I add to this but also perhaps bridge the child poverty and pensioner poverty and fuel poverty issues? There is a huge issue underlying all of this about take-up of what is on offer. There is something in the PBR about promoting more take-up of tax credits for people in work and that is welcome. There is nothing about take-up of pension credit. There are 1.8 million pensioners missing out on pension credit at the moment. Getting maximum take-up of pension credit would improve the incomes of those pensioners by about £1,400 a year on average, so it blows the winter fuel payment apart, does it not? The Christmas bonus—it is very good to see something happen with that, but if it had been uprated since 1972 it would now be £97.50, so the £60 is not even bringing it up to date with what it ought to be.

Mr Whiting: If I could comment on that, if there is one thing that I have had questions on, apart from VAT which we talked about earlier, it is the exact status of the payments, how much they are getting. There is a terrific amount of confusion, partly because these things are described as one-off—“How much am I getting? When am I getting it? How do I claim it?” If it was all baked in and known that this was a set amount and there might be then a little increase, that would just make it much easier to follow. People are worried that they will not get this one-off at the moment.

Ms Perchard: Could I add to this but also perhaps bridge the child poverty and pensioner poverty and fuel poverty issues? There is a huge issue underlying all of this about take-up of what is on offer. There is something in the PBR about promoting more take-up of tax credits for people in work and that is welcome. There is nothing about take-up of pension credit. There are 1.8 million pensioners missing out on pension credit at the moment. Getting maximum take-up of pension credit would improve the incomes of those pensioners by about £1,400 a year on average, so it blows the winter fuel payment apart, does it not? The Christmas bonus—it is very good to see something happen with that, but if it had been uprated since 1972 it would now be £97.50, so the £60 is not even bringing it up to date with what it ought to be.

Q67 Nick Ainger: It is not a Christmas bonus, is it? Christmas on my calendar does not happen in January. Is it not just bringing forward the increases that are coming in in April?

Ms Perchard: It is an elderly bit of the benefits system, long forgotten, left to wither on the vine, which has certainly been identified to use to distribute some extra money, not just to pensioners. There is quite a long list of people on disability benefits who get it. That is what has been quite interesting to see because there is a big debate about the winter fuel payment and who is getting that. If you are a pensioner living in the Bahamas you will get it because it is age related; it is not means tested. Mervyn and others involved with the Fuel Poverty Advisory Group have supported greater targetting of the winter fuel payment on those most in need and as a consequence extension to other groups. People on disability benefits have not been getting extra help over the summer with frightening increases in their forward consumption estimates from their energy companies. People in their forties and fifties who are on a low fixed income are not getting any extra help until this Christmas bonus comes along and that gives us some idea that it is possible to do some distribution of extra help to some of those groups.

Q68 Nick Ainger: Could Ms Perchard, could I ask you about the fact that we have now seen crude oil prices fall from $147 a barrel at the end of July now down to $50 a barrel and yet I still have constituents who are receiving indications that their prices are going to go up? Do you think the Government is doing sufficient to make sure that those global energy prices which are falling are being passed on as quickly as possible to consumers?

Ms Perchard: It seems to be rather a slow process of the regulator exercising powerful influence over pricing within the market. There has been a major piece of work done by Ofgem they call “the probe”, which has highlighted a lot of issues around pricing problems, tariff differentials, excessive pricing for certain things, the same sorts of questions as arise around bank charges and currently the extent to which interest rate reductions will be passed on to users of credit. I think the ball is in the court of the regulator at the moment to act decisively and quickly to protect consumers and I do not think we have seen decisive, quick action by the regulator.

Q69 Nick Ainger: Have you seen any evidence of the social tariff which a few weeks ago the Chancellor was talking about in discussions he was having with the energy suppliers? Have you seen anything on the ground that indicates that there is a significant change there where the energy suppliers are pushing the social tariff?

Ms Perchard: I do not think we have. There is this thing called the ICSO, which is the Informal Compulsory Social Obligation. It is supposed to cost £225 million; it was announced in the Budget, and companies are supposed to spend it on their social tariffs. I have not seen a full sweep of the impact that is going to make on the social tariffs.

Q70 Mr Fallon: Mr Brewer, coming back to national insurance, in your distribution analysis you said that the increase of 0.5 percentage points means that all working-age employees, all employers and all self-employed people will pay more. Is that right?

Mr Brewer: The rise in the rate will mean that, but not when you take into consideration the change in the threshold as well, so there are two reforms going on—the rise in the primary threshold, the point at which you pay national insurance, and a rise in the rate. All employers will be paying more because their threshold is not changing and their rate is going up. For employees there are some people paying more, some people paying less, and the cut-off point is around £20,000.

Q71 Mr Fallon: So over £20,000 what would the average loss be in 2011?
Mr Brewer: I do not know is the answer. The losses are proportional to income. They start at zero at £20,000. They are unbounded; it depends on your earnings, so somebody earning a million pounds a year is paying half a per cent more on practically a million pounds a year. I am afraid I do not know what the average loss is.

Q72 Mr Fallon: But who are the main losers from this change?

Mr Brewer: People earning more than £20,000 a year and the more you earn the more you lose. It is a tax change that takes more money away from the rich than from the poor.

Mr Whiting: Inevitably the greater losses will be, as is obvious, I am sure, further up the income scale but I think it will hit hardest at about the £40,000 level where you are still paying national insurance at what will become the standard rate of 11.5%.

You are then facing going into the 40% income tax bracket as well, so it is that sort of level that will see the greatest loss.

Q73 Mr Fallon: Could you let us have a note on the average loss for those on £20,000 a year?

Mr Brewer: On £20,000 a year it is zero.

Q74 Mr Fallon: Above that.

Mr Brewer: I am sure we can tell you something useful, yes.¹

Q75 Mr Fallon: I think it was the Institute of Directors who suggested this was quite a serious new tax burden on employment. Do you share that view, either of you?

Mr Brewer: It is an increase in the tax wedge, the gap between what employers have to pay employees and what employees take home. That is going to have some effect on the labour market. It can have two effects. It can either mean that employers hire fewer people or it might mean that employers lower people’s wages.

Q76 Mr Fallon: But at a point where there is such pressure on jobs is this not the wrong time to be increasing the cost of employing people?

Mr Whiting: It is. National insurance is often called a tax on jobs and because there is a wider burden on employers, the 12.8% going up to 13.3% uncapped on whatever employees are paid, it will increase their costs, so you get the effect that Mike has alluded to. It might promote efficiency, it might just promote fewer profits for the employers, it might promote, dare we say, less hiring. It is one of the risks, but national insurance is, after all, our second biggest tax. It is a natural route by which to try and raise more money.

Q77 Mr Fallon: One of the risks then is that it might deepen unemployment.

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50–65 year olds with relatively small amounts of income. They, of course, have stopped work and by definition will not be benefiting from national insurance adjustments, so there are still some there and, obviously, as my basic analysis from the Low Incomes Tax Reform Group shows, they can lose out on their relatively small incomes.

**Mr Kenway**: Can I just come back, Mr Crabb, on the way you opened with that question? Perhaps (or perhaps not) this has solved the immediate short-term problem. The way I read the whole 10p thing when we finally woke up to it was that it is actually a sign of a much deeper problem, which is this problem generally of in-work poverty, the extent to which families with and without children are below the poverty line despite all that has been done and are working. That problem remains with us, and to the extent that we have recent data (it is only up to April 2007) it suggests that that problem at that time was continuing to get worse. There is the immediate problem, yes, but the underlying problem which I think that might have been symptomatic of is not at all dealt with. We need in our view a strategic approach to deal with that.

**Q80 Mr Crabb**: And you see nothing in the PBR that hints at tackling the deeper-seated problem that you have just described?

**Mr Kenway**: No, I do not. There are two sides to the issue. One is the amount of tax. Part of the problem is that these households are not paying tax, so obviously that is going to happen. One aspect of it is the level. The other aspect of it that you might want to come on to is the effective marginal tax rate that some of these low income households face. I do not want to pre-judge your questions. I think we really do have a crisis with in-work poverty. The irony perhaps is that the recession might abate that crisis but for all the wrong reasons.

**Ms Perchard**: The take-up point is part of this. In the discussion you had about the 10p tax issue back in the spring there was a particular focus on a low take-up rate of working tax credit amongst families without children, which is still only 22%, but the eligibility for that is over 25s so this group of remaining out-of-pocket people cannot qualify for that at the moment. There is a long way to go on the over-25s. Somebody earning only the minimum wage would be about £1,500 a year better off if they were getting working tax credit. That is a huge amount for somebody on £9,000 a year and more needs to be done to get that money that people are entitled to it in their pockets. There is a lot to do on families with children as well but families without children really have not been targeted enough for the help that is in the system.

**Q81 Jim Cousins**: Mr Kenway, Ms Perchard, can I come directly to the points you have just now been making? Mr Kenway, why do you think that we have got now, according to the Government, knocking on two million people on low incomes facing marginal tax rates of over 60%? Why do we have that? What features of the system produce that and what can we do about it?

**Mr Kenway**: The first point to make, and Mike is really the expert on this, is that I believe that table 5.2 in the PBR might be a little overly clever. I think we have a lot of people on 70% but the table is defined as “over 70”. However, coming to your point, even if we accept the table there are two million on over 60%. It is, I think, an inevitable feature of the tax credit taper that takes money away from people as their income goes up. That is inevitable and quite clearly I think it would be regarded as proper. The question is why it should be that steep. You cannot do away with the fact that there will be a taper unless you want to have universal benefit, but one could have a lower rate. What strikes us is that this system has not been reviewed and the opportunities for lowering that rate do not seem to have been taken. If I may say one final thing which I hope is clear, if you want to put more money into tax credits there are two ways of doing it. You could increase the maximum amount, which has been what the Government has done up until now, or you could hold the maximum and in some sense put the money in lower to reduce the taper. I think we have reached the point where at least the second option should be seriously considered. There are judgments to be made and I am not making them here but at the moment we have only ever, I think, gone down the road of increasing the maximum.

**Q82 Jim Cousins**: Mr Brewer, do you have views about that?

**Mr Brewer**: The only way that we cannot have the situation we have at the moment is if you adopt a different set of priorities from the current Government’s, and in a sense that is really your decision. The current Government wants to give large amounts of money to low income families with children and it does not want to give it to high income families with children. Change one of those two rules and you can have a system with lower marginal deduction rates, either by having higher universal child benefit and higher income tax rates; that would be one solution, or by having much less generous tax credits, in which case you would have far fewer families on these high tapers. There is no magic solution to getting rid of these high marginal deduction rates. You have to decide to give money to different people from the ones the Government is choosing to give to at the moment.

**Mr Whiting**: One small point, of course, is that the personal allowance has come up by more than inflation in this PBR, which is helpful at the lower income end, but when you have 20% basic rate, 11% national insurance and 39% taper you get to the inevitable result. The only solution I can come up with is to reduce that 39% taper or, of course, start it higher up the income scale, which would at least alleviate the situation. Basically, it is starting roughly about where the personal allowance is at the moment.
Q83 Jim Cousins: Ms Perchard, you were the advocate of more take-up.
Ms Perchard: Yes, absolutely.

Q84 Jim Cousins: I can see the force of that, but do you see the difficulty? People on low incomes that have multiple sources of income that are not secure week-to-week protect themselves from these high marginal deduction rates by just not claiming it.
Ms Perchard: How realistic the table is is another issue because it does assume full take-up of council tax and housing benefit and for people in work that is only 60%. How much you can rely on those numbers I am not too sure. I think people protect themselves from the system. One of the big problems that we see at the moment is that you are working with three separate bits of government to assemble the support for your income—the tax credit system, you are moving from DWP as well, you might have some other benefits from DWP, and local government. This sounds terribly jargonised but it is not joined up for the individual. The HMRC tax credits helpline does not say, “You are eligible for HB and CTB. I am going to fill in a form for you now and the council will complete this in a few days and the money will be in your pocket”.
Mr Whiting: That would be a very good reform.
Ms Perchard: People come out of the benefit system and go into work, go into the tax credit system and they do not go back to the council and get a bit of HB or CTB or both, and there are people in the tax credit system who are being underpaid—900,000 underpaid. The rules about the rate at which there are deductions from benefits and tax credits are one thing but it cannot be wrong to want more people to get more money in their pockets. There is £2.3 billion unclaimed on child tax credit at the moment, £2.6 billion unclaimed on working tax credits. That is nearly a million underpaid who are in the system and that is a scandal, and only 22% of working adults without children are getting working tax credit. There must be more that can be done there which will improve people’s take-home pay.

Q85 Jim Cousins: Ms Perchard, you are absolutely right. The Government is meeting its fiscal rules this year by not paying people benefits they are entitled to, which is a slightly odd point, but we I think have been in that position now for two or three years. The fiscal rules have been paid for by people on very low incomes not claiming means-tested benefits, but what would you do to resolve these bureaucratic difficulties and these week-by-week assessments that people on low incomes absolutely dread and that terrify them?
Ms Perchard: The resumption of fixed periods for awards in tax credits—

Q86 Jim Cousins: Slab payments, like the US and Canada.
Ms Perchard:— would be much more predictable and less variable because the administration of having to notify changes of circumstance to more than one provider of income top-ups is quite tedious. It is about bringing it all together into one system for the individual to massively simplify it.
Mr Whiting: That would be my vote, to get DWP and HMRC working together to deliver it.

Q87 Mr Brady: Mr Whiting, who benefits most from the cut in VAT? Is it the rich or the poor?
Mr Whiting: There is a very good question that we have already touched on, the “Maybe it will help small businesses who might retain it”. Clearly, the people who benefit are those who go out and spend, find that the prices have been reduced and therefore pay less for whatever it is they are buying. I understand, and probably Mike is better qualified to comment than I, that of course there is the classic argument that VAT is regressive, that those on smaller incomes pay a greater proportion because they are stuck with VAT despite the fact that it does not apply to basic foodstuffs, for example. They will benefit but I just wonder whether what they are buying will see prices change by as much as the 2.5% or 2.1%, depending which way you look at it, that the cut implies, simply because a lot of the retailers they are dealing with will be stuck with pricing point decisions, will keep some prices and reduce others. I do not know. You deduce that probably what I am thinking is that a lot of the benefit will flow through into those who are slightly better off, who are perhaps going for the goods that have enough leeway—cars were alluded to earlier, and electronic goods—that we probably will see a reduction in, although many of those will be hatched up in price-slicing campaigns as well. Let us also not forget that this will translate into the service sector, whether it is repairs to the house, whether it is the meal out, both of which are likely to be undertaken by those who are better off. Insofar as there is a benefit, therefore, my guess, and I am afraid it is only a guess, is that it will flow more to the better off.

Q88 Mr Brady: You were fairly clear in your submission, and I think as well earlier, that seven days was not a long enough period for businesses to introduce it. What kind of period would have been sensible?
Mr Whiting: Seven days? One or two of my clients have said it was not seven days; it was four days but it turned into seven because they had to work the weekend as well. For an awful lot of tax changes we hear about, for example, the personal allowance that has just been announced, the tax authorities have given four months because we bring it in from April. Business, I think, would have liked at least a month to prepare, possibly longer. I realise that that detracts from the immediate psychological impact. Business might also have liked a bit more time to prepare simply because then they can work out and economise on the costs. A lot of business also says, “It is only 13 months so at least we have got 13 months to prepare for putting it back up again”, but, as one vehement commentator to me said, “I will just have finished putting it through when I have to think about putting it back again”.
Q89 Mr Brady: Finally, on VAT, clearly not all businesses are going to pass it on. Do you have a sense of what proportion will pass it on and what proportion will not?
Mr Whiting: Nothing that I can really quote, Mr Brady, I am afraid. All I can say is that all businesses are thinking carefully about it, certainly in my experience. Many, as I have said, will sweep it into general price-cutting campaigns or decide to just cut some items. Some will undoubtedly, particularly at the smaller end, just decide that that gives them a little more leeway but will probably use it in promotions of one thing or another.

Q90 Mr Brady: Just moving briefly on to the aviation duty proposal, which was abandoned, I am not sure who is best to answer on this but it seemed that one of the principal reasons why a large part of the industry was so angry about the proposal was that it was going to lead to a diversion of flights to European hubs. Is it not the case that the new increased passenger duty bands will have precisely the same effect?
Mr Whiting: Yes, I think that is the case. There are some anomalies within the pricing, as I have alluded to in my memorandum, as to the way the bands will operate, but then again I suppose any increase in air duty, if you go back to the proposals for the plane operating that process and about having some consistency of approach as well.
Mr Brewer: One difference between what the Government were proposing to do and the current proposals is that its original proposal, a per plane tax, would have affected air freight and the current proposals do not, so there is no longer the risk that air freight’s decisions have been distorted by the tax. I think what is potentially much more important for aviation is the inclusion of aviation in the ETS scheme. If the quotas are set tightly enough and enough are auctioned, will have a much more substantial effect on emissions from aviation than any kind of tax the Government is thinking about would have.

Q91 Sir Peter Viggers: If I may address housing and mortgages, which is where our problems first manifested themselves, Ms Perchard, has the Pre-Budget Report done enough to help homeowners?
Ms Perchard: It has been a very busy autumn for policy on mortgages, a lot of it before the Pre-Budget Report, and we have welcomed everything that has been announced. The changes to the ISMI scheme, first announced in September, and then a further change in the capital limit are good. Some more people can get help from the income support scheme. The three-month moratorium is good, although in our experience most lenders do not go to court within four months of arrears arising but it will round up some of the stragglers, and some individual banks have made six-month moratorium announcements. RBS, I think, Bradford & Bingley, possibly Northern Rock; I am not sure. The two-year deferral yesterday, the mortgage rescue scheme £200 million, the promise to regulate sale and rent-back scams, which have been thriving on mortgage distress which we highlighted about a year ago, and the OFT looking at cleaning up the second charge mortgage market a bit through guidance are all good. We are quite happy with the consumer protection elements that have come out and the support elements that are there for people who are in distress.

Q92 Sir Peter Viggers: Are the measures predicated on a recovery in the housing market which causes you some concern if there is not a recovery in the housing market?
Ms Perchard: Certainly the two-year deferral must be. Our anxiety about that is that in the intervening period lenders who are deferring interest or moving their customers onto an interest-only loan during the duration might be storing up a problem of basically two years’ mortgage payments at the end of the two years and a big bill for the customer. Some people will need to make decisions much sooner than two years about perhaps downshifting their financial responsibilities, perhaps moving into renting rather than owning, so we would like to see very early independent advice for individuals who are presented with that option. It really does take a load off people’s minds to think that there might be a two-year payment holiday maximum in it, but actually it might not be serving all those customers well to give them a two-year mortgage bill at the end of the period. We are keen to talk to the mortgage lenders about what they will be doing when they are operating that process and about having some consistency of approach as well.

Q93 Sir Peter Viggers: The Pre-Budget Report did not extend the one-year stamp duty holiday for all purchases of houses costing up to £175,000 announced in September. Will the housing market have recovered sufficiently by September 2009, do you think?
Ms Perchard: I am not sure Citizens Advice is qualified to comment and estate agents seem to have a variety of views on this, depending on where they are. I am not competent to comment on that at all.

Q94 Sir Peter Viggers: How important is the stamp duty concession? How does it grade in the overall scale of things compared with the difficulty of getting mortgages?
Mr Whiting: I would put it as pretty low from my point of view. It is a small gesture. It is something to be reviewed, I would have said, at Budget time as to whether it has had any effect or is worth continuing, given that so many properties are still, despite problems, priced above the £250,000 point when you suddenly face 3% stamp duty. That is arguably more of a barrier if you want to do something on stamp duty. But I would say the availability of mortgage finance is a bigger issue.
Ms Perchard: On the price of property, I am old enough to remember the early 90s when mortgage repossessions were in the news every single day and...
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Auction rooms were full and a lot of people got on the housing ladder when prices went down. Someone's failure in property owning is another person's opportunity and many first-time buyers who have been waiting and have not been able to afford it, if they are in good jobs may find this is their opportunity to afford to buy something. The price of the property is the key thing.

Q95 Mr Todd: The measures the Government has taken on small businesses are largely temporary in nature, deferring changes that were planned for the future, although we have touched on the VAT reduction which may have some benefits for small businesses as well, as we have explored. Were there other measures that could have been taken?

Mr Whiting: Let us be clear: the measures that were taken were welcome and particularly the possibility of negotiating with the Revenue when you can pay. That is arguably one of the most valuable measures. The deferral of a 1% increase in corporation tax is good news because that was feared. The virtual abandonment of income shifting, which was a big problem hanging over an awful lot of businesses, is good. The loss relief sounded good but it was a bit of a souffle because when you pricked it it collapsed. It is only a one-year thing; it is only for £50,000. Yes, it is helpful but it would have been so much better had they just looked at mechanisms whereby the business could agree its loss much quicker, get the loss carryback established much more quickly and either just negate a tax payment or generate a tax repayment much more quickly. It is a seven out of 10 package, I think.

Q96 Mr Todd: But that last point could be addressed perhaps by negotiation, could it not?

Mr Whiting: It could be but it is quite a difficult one. What I am really after is a simple mechanism that allows a business faced with its tax payment to say, “I am making a loss. Here is the evidence from interim accounts to show it. Please can I not just have more time to pay; it is not about that, but can we establish now, here in November/December, that for this current year I am going to make a loss and therefore, the tax payment I am due to make at 1 January or whatever there is no point in paying because I will only claim it back”? Too many businesses get into this sequence of having to pay it and then claim it back.

Q97 Mr Todd: It is well worth our making a note to pursue that later because that is the kind of thing which maybe we could address. Is this a time when green measures can be taken? Aviation tax disappeared off the horizon. Do you think that recessions are points where everyone forgets about that kind of stuff?

Mr Brewer: The other change in PBR affecting the environment was reforms to VED which undoubtedly watered down their environmental impact and the reason the Treasury gave was that it did not want to raise the level of VED. They were ostensibly pointing to the recession as an excuse not to do an environmental measure, but environmental changes are all about giving people incentives and incentives do not have to be sticks; they can be carrots. The Government could have chosen to give money away in an environmentally friendly way rather than VED where it proposes to take money away in an environmentally friendly way, so I do not agree with your basic proposition that recessions and care for the environment are contradictory.

Mr Whiting: I would totally agree. In some ways it is disappointing that green measures have perhaps been pushed to one side. There is an argument that it is a good time to look at that, not least because if you do the incentives that Mike has alluded to, you are perhaps stimulating a particular area of the economy to insulate houses more or whatever else.

Ms Perchard: There is the billion pounds on the Home Energy Savings Programme although that is mainly coming from customers through bills. That will involve a lot of capital expenditure on the CERT and CESP programme around insulation of various kinds and central heating, and there are some jobs in there as well, but that is all about CO₂ reduction. It does have a benefit on how much people will be paying but also has a climate benefit.

Mr Kohler: This should give us the opportunity to invest in the renewable technologies that we will need going forward to look at the improvement of energy efficiency. We have got some colossal targets to try and reach and the longer we delay even starting the programme the more difficult they are going to be.

Q98 Mr Todd: And the change on fuel duty as well—what we have done there is simply balance the change in VAT with a change in fuel duty, bearing in mind the price has been dropping.

Mr Whiting: Yes.

Mr Whiting: Indeed, and it is relatively small beer, but, of course, as the haulage industry has often made clear, for them that balancing is not correct because, as the VAT reduces and duty goes up to balance for you and I at the pump, they have less VAT to recover; therefore, their costs are going up. Many have asked whether the increase in duty will be a temporary one, and as far as I know it is intended to be permanent and obviously escalating. Maybe that is an intentional green measure. I suspect it was actually an accident.

Q99 Mr Todd: That is an interesting point because that has not been highlighted too clearly, that those businesses that recover VAT—

Mr Whiting: It has actually increased their costs. It is one of those unlooked-for side effects which, coming back to the point Mr Brady was pursuing on the timing of the VAT change, when people had those few days it suddenly clicked what was happening to the costs of those businesses that basically buy a lot of road fuel.

Q100 Mr Todd: So I think your conclusion is lost opportunities here?
Mr Whiting: Yes.
Mr Brewer: There is no reason for the Government to not make the environment a more important part of the PBR.

Q101 Chairman: Just a final question on lost opportunity. We note the PBR had substantial fiscal stimulus but, Peter, in your submission you said that they have done next to nothing on employment. Given in this recession that unemployment is going to go up, is the Government culpable as a result of this omission?
Mr Kenway: I think it is. It is remarkable, given that what is at the heart of the recession, the heart of the concern, is unemployment. I have scoured it, and I even took advice from the IFS on this. We cannot find a forecast of unemployment and in our view as it is set out—and I obviously do not wish to give a long answer here—there are two things. First, the Government should be coming quite clean about unemployment, what it expects to happen, and, secondly, it should be looking at a way of supporting people, and it does have a way of doing that. We are not calling for something new. We are calling for the Government to look once again at the contribution base, jobseekers’ allowance, which is the insurance-based benefit that is still there in the system. It is not very big but it is still there in the system and the principle about that is that it is a benefit that people get because they have contributed; they are entitled to it. As far as one can tell, given the great popular support for the state retirement pension, that is a principle that, if it is explained, the public is quite comfortable with. It is not at all the same as a means-tested handout. Our view is that the Government as a minimum must start to look at unemployment and be open about it and look for ways to support people who become unemployed because they are the losers in the next period. In some sense questions about pennies and even pounds here and there for people who are still in work are now second order issues.

Q102 Chairman: Thank you very much. Are there any final comments before we meet the Treasury officials and the Chancellor?
Mr Kohler: Yes, Chairman. Just to follow the line of your last question, the reduction in value added tax was a very poor policy response from the point of view of the older population, obviously, because they are spending the majority of their money on things which do not incur VAT, and it is the lack of an opportunity to do other things, to create new industries in the area of tele-care and tele-health, things of that nature, to support the disabilities facilities grants which currently runs at a risible rate of about £140 million a year, in order to improve people’s lives and create employment.
Mr Whiting: If I may just go to a different end, Chairman, large business taxation, I just want to make the point that it is very welcome that this PBR saw some announcements as to how large business taxation is to be reformed in the area of foreign profits, which has worried a lot of large businesses and created the uncertainty and the “Should we leave the UK?” sort of attitude. It is good that something has happened. There is still more work to be done and pressing on what is the timetable for that is of something that you may want to pursue.
Chairman: You are not on that side, are you, John, which is good? That is what we need when you come along here. Thank you very much. It has been very helpful to us in preparation for the officials and the chancellor coming. We are grateful.
Q103 Chairman: Mr Ramsden, good morning to you and your colleagues. Welcome. Can you introduce them for the shorthand writer, please?  
Mr Ramsden: Good morning, Chairman. On my right I have got Mike Williams, Director of Personal Tax and Welfare Reform and then James Richardson, Director of Public Spending. On my far left is Clive Maxwell, Director of Financial Stability and Edward Troup, Director of Business and Indirect Tax. I am Dave Ramsden, Chief Economic Adviser to the Treasury.

Q104 Chairman: For individual banks it makes sense for them to keep their capital and not lend collectively, but that is what the banks need to do, lend together and take that first step collectively. The Governor of the Bank of England when before the Committee said: “the single most pressing challenge to domestic economic policy is to get the bank system to resume lending in any normal sense”. Do you agree, and what is happening?  
Mr Ramsden: We certainly agree that getting the banks lending is a critical factor, that is why the Lending Panel is meeting tomorrow and that is why, as we stressed in our PBR forecast, the return of credit conditions, both in terms of the price of credit and the quantity of credit, to what might be considered a more normal position is absolutely critical to achieving the forecasts that we set out. Indeed, it is the key assumption on which the forecasts were based.

Q105 Chairman: Given the huge increase in public borrowing of the Government over the past six months and the future projections on that, how worried are you about the creditworthiness of the UK Government as we go forward?  
Mr Ramsden: Our assessment is that the public finance position as was set out in the PBR is one of sustainability. As you heard from the experts that you had before you last week, the price that we pay for raising debt has continued to fall across all maturities. That has been an established trend that has continued since the PBR. Short-dated gilts are currently at historically low levels and the 10 year benchmark is at 3.6%, so there is a lot of demand for government debt at the moment and in the economic conditions and credit conditions that we face we think it is appropriate to allow government borrowing and government debt to rise to compensate for the fact that private sector borrowing is being reined in sharply globally through the process of de-leveraging.

Q106 Chairman: It has been reported that the UK has seen the biggest rise in credit default swaps on sovereign debt of any major economy in the last two weeks. Some of these figures seem quite striking. It says it costs £110,000 to insure £10 million of UK debt against default over five years, £50,000 more than the middle of last month, and if you go back to February it cost £8,000, so it is a rise from £8,000 to £110,000 to insure £10 million of UK debt. Is that not quite alarming?  
Mr Ramsden: Our assessment is that the most important indicator of credit risk is an entity’s credit rating and the UK Government remains at a Triple A. Some commentators have drawn attention to conditions in this new derivatives market for credit default swaps on sovereign debt. This is an incredibly thin market, quite often with the prices quoted not really reflecting even any traits but notional traits, so I do not think we would consider prices in this market to be an accurate reflection of a risk of a credit event for the UK.

Q107 Chairman: You still have great faith in the ratings of the credit rating agencies?  
Mr Ramsden: All I am trying to give you is some background information on how this credit default swaps market has developed.

Q108 Chairman: The debate in the past weeks has moved from savers to borrowers in terms of interest rates, or at least that is coming on the agenda. Is there anything in the Pre-Budget Report to counter the redistributive effect of interest rate cuts with resources moving from savers to borrowers?  
Mr Ramsden: I might ask Clive Maxwell to give you more detail on that. The whole macro picture is predicated on the fact that early on in this recession unlike, for example, in the early 1990s recession we are seeing very sharp cuts to very low levels of interest rates. This is intended to ease the burden on
you are a borrower or a saver, and also for di
have distributional impacts depending on whether
but at the micro level we do recognise that this will
I have set out what the position is at the macro level,
instrument that we want to see working at this time.
That is the key macroeconomic
borrowers. That is the key macroeconomic
sure you have had many letters to that e
weighed on households' purchasing power and I am
prices are falling back. Earlier this year that really
data on producer prices how sharply now producer
will feed through into lower inflation rates as we
half of next year. These are four factors which have a
just amplify on that in terms of talking about our
Q109 Chairman: I have had a few emails on that from pensioners particularly.
Mr Williams: On pensioners, I think we need to bear
in mind that many pensioners, unfortunately, have
either no or relatively little in the way of savings and
for them the pension credit provides additional
support because it is being increased by more than
indexation to £130 a week for a single pensioner
from April 2009. You will be aware, Chairman, that
many pensioners continue to receive their bank or
building society interest with tax deducted in
circumstances where they could fill in a form and get
the tax not deducted or make claims to get some of
the tax back afterwards. We are about to run a new
campaign to raise awareness of the ability to get the
interest paid gross or to get back some of the tax in
circumstances where savers at the 10p tax rate apply.
Q110 Mr Fallon: Mr Ramsden, the Chancellor told
the House at column 492 that the economy would
start to grow again on 1 July next year. Which other economic forecasters agree with that?
Mr Ramsden: Well,—
Q111 Mr Fallon: Could you just name them.
Mr Ramsden: I can tell you that the shape of our
forecast is very similar to the shape of the Bank of
England’s forecast which was published at the
beginning of November which also expects to see the
economy picking up through the second half of next year, which is consistent with our judgment. Can I
just amplify on that in terms of talking about our
forecast in particular. There are four factors that we
think are going to underpin a recovery in the second
half of next year. These are four factors which have a
strong bearing on our judgment. The first is the very
sharp fallback in commodity prices that we think
will feed through into lower inflation rates as we
have forecast, and you have seen in this Monday’s
data on producer prices how sharply now producer
prices are falling back. Earlier this year that really
weighed on household’s purchasing power and I am
sure you have had many letters to that effect. That
factor is going to unwind which will support household incomes through next year and really give
a boost to purchasing power. Second, as I have
already mentioned, the very sharp fall in interest
rates where we have seen interest rates having
coming down by 75 basis points over the 10 months
from last December and have now come down by an
additional 300 basis points since October, that is just
in the last nine weeks. Third, there is the fiscal
stimulus and the discretionary measures that we
announced at PBR which amount to 1% of GDP. Fourth, there is the factor that you discussed last
week with the experts, the significant depreciation in
sterling which we think will contribute to a
rebalancing of the economy and in particular
stimulating activity away from imports. None of this
is to underestimate the recession’s impact. We are
forecasting a pretty sharp fall in output intensifying
in this quarter and then we see output continuing to
fall in the first half of next year, and we recognise
that is going to have a significant impact on
businesses and individuals but we do think there are
forces there which will lead to recovery from the
second half of next year. As I said at the outset of my
answer, the Bank of England is also forecasting a
recovery from the second half of next year.
Q112 Mr Fallon: Thank you. That is a very long
answer but it has not given you time to name any
other independent forecasters who think the recession is going to end on 30 June.
Mr Ramsden: The last time I looked the Bank of
England was independent.
Q113 Mr Fallon: That is the only forecaster, is it,
that agrees with you?
Mr Ramsden: No. Morgan Stanley, and David Miles
is the chief forecaster there, he is a well-respected
forecaster, is expecting growth of about 13⁄4% in 2010
the last time I looked. We set out in the Budget
document that there are—
Q114 Mr Fallon: But I asked you about 2009, not
2010. The Chancellor said that the recovery would
start on 1 July 2009.
Mr Ramsden: We forecast half-year by half-year, so
the Chancellor said that the recovery would start in
the second half of 2009 for the reasons I have given
you and gather pace into 2010. In response to this
Committee’s recommendations we have tried to set
out a lot more detail, including the risks to that
prospect, and we are not underplaying those risks at all.
We are conditioning our forecasts on credit
conditions returning to a new norm, as I said at the
outset of this hearing. Also, we have published at the
back of Annex A a lot of detail on the risks and we
have set out forecasters who do not think recovery is
going to be as strong in 2010. There are forecasters
such as Citigroup, HSBC, who have a much weaker
recovery. We recognise there is a very significant
range of views on 2010 because of the exceptional
uncertainty we are dealing with.
Q115 Mr Fallon: I was asking you about 2009. Let
us move on now to 2010–11. Your PBR shows that
growth in the UK is faster than all the other G7
countries. What is the evidence in this book to
support that assumption? Why will our growth be
faster than the rest of the G7?
Mr Ramsden: If you go through the factors that I
have just highlighted, those apply to the UK and
they also apply to some extent to the G7 economies
but, for example, as your witnesses told you last
week, in the four factors I emphasised we have seen
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compared to the euro area a more significant fall in interest rates. Also, other countries such as France over the weekend have announced fiscal stimulus and Germany before them. Our fiscal stimulus is already in play with VAT reduced from last Monday and we have seen the depreciation in the exchange rate that I mentioned. We see all these factors, including the fact that in the UK we saw significant increases in inflation and we now see inflation going down further, so that will boost real incomes in the UK, meaning that we can make that forecast judgment that we have made. The experience of the UK is that we do have relatively flexible markets and that means it is reasonable to assume that they will adjust relatively quickly following a recession with growth picking up, but I do not think that our forecast of growth in 2010 of 1½ to 2% in 2010, while I am happy to acknowledge it is at the top end of the range of outside forecasters and is close to the Bank of England’s, is anything other than achievable.

Q116 Mr Breed: Mr Ramsden, in response to Mr Fallon’s question you indicated that you felt depreciation in sterling would actually assist the rebalancing of the economy. To what extent do you think that will happen bearing in mind that on previous occasions when we have had significant depreciation in sterling exporters have tended to increase their prices to build their profits rather than being seen in increased export volume? Are you not placing too much reliance upon any significant contribution from the depreciation of sterling?

Mr Ramsden: I think that is a fair point. In the economy annex, again as part of trying to explain the judgments underlying this PBR forecast, we set out in Box A6 on page 176 what were the potential factors at play and the effect that you allude to does seem to have been what happened after the UK dropped out of the exchange rate mechanism in the early 1990s. At first we saw it in prices with exporters improving their margins and then it came through later on in volumes. What we have assumed in this forecast is that principally in the short-term the benefit effects will be from import substitution rather than from some big increase in export volumes, that UK consumers will switch more towards domestic production rather than imported production because the price of imported production will go up and then over time you will get the export volume effects. We have tried to reflect those factors.

Q117 Mr Breed: But in the last 16 years or so domestic manufacturing of products and such has declined even further so the ability to purchase, if you like, home-grown products rather than import them has literally declined significantly. Your ability to go and buy potentially domestically produced goods as opposed to them being imported is significantly less.

Mr Ramsden: Obviously our forecasts are based on the size of the manufacturing sector as is and we have tried to factor in that effect.

Q118 Mr Breed: What are the prospects of the alternative scenario that Mr Bean, the Deputy Governor of the Bank of England, outlined to us of an old-fashioned sterling crisis occurring? We are seeing sterling fall even more in 2009 than is currently the case, we are about 20% down and it is still going down.

Mr Ramsden: We have a freely floating exchange rate that moves about on the international exchanges according to how the fundamentals and perceptions drive sterling, so we have seen the depreciation in sterling over the last year after a period of 10 years when the global economy was pretty stable and sterling moved within a very low band. It has fallen out of that recently and that can happen because it is flexible. We know that the Government does not have any kind of policy or target towards sterling, unlike some of the previous episodes you have talked about. We had a discussion of this in paragraph A48, page 159, the various reasons why we think sterling has depreciated: UK growth prospects were being revised down; over the last year there has been increased expectation of substantial easing in interest rates in the UK relative to some of our main competitors, as I mentioned earlier, and also increased risk premia demanded on sterling assets. We have set out the potential factors. I am not going to give you a forecast of sterling for next year, that is not something that we would do.

Q119 Mr Breed: Have you done any scenarios? We are down about 20%, have you done any scenarios if sterling was to fall another 10% or 15%?

Mr Ramsden: We look at all kinds of scenarios for the economy to think about whether our forecast judgments are reasonable.

Q120 Mr Brady: The PBR assumes that the fiscal stimulus will reduce the size of the downturn by around half a percentage point. Why was that degree of reduction targeted?

Mr Ramsden: We started from a forecast that clearly showed, as I said earlier, the UK already on the data had moved into recession and we saw that recession intensify in Q4 of this year and then continuing into the first half of next year. Looking at that outlook one has to make a judgment as to the role of fiscal policy alongside monetary policy, as this Committee has emphasised and discussed with the MPC a couple of weeks ago. We looked at the economic and fiscal prospect and judged and advised ministers on this basis that a stimulus package of about 1% of GDP in 2009–10 on top of the stimulus already introduced in 2008–09 was appropriate and the key aspects to that stimulus package should be that it should be temporary so that you get the maximum effect over the period, something that the Governor of the Bank of England has raised, that it should be timely, which was why we went for the VAT reduction of 2½% that could be introduced immediately as well as bringing forward existing investment projects rather than starting new ones. We wanted it to be targeted, so we saw that VAT could actually impact
Mr Ramsden: No, not at all, that is to completely consolidate the public finances in the medium-term?

Mr Ramsden: No, it is not what I just said at all. That is what you just said.

Q124 Mr Brady: Misinterpret—

Mr Ramsden: It would depend on what you think would be the overall impact of the fiscal consolidation on the public finance position and, if it was seen as credible, what that would therefore do to long-term interest rates.

Q125 Mr Brady: Turning to that longer term consolidation, we know that consideration was given to introducing a higher rate of VAT in the near future. What were the pros and cons in deciding whether that was appropriate?

Mr Ramsden: As I said in response to an earlier question, we look at a range of different scenarios, a range of different options within those scenarios, for which policy to implement. Just as for the stimulus part of the policy we weighed up the advantages of a reduction in VAT alongside other measures that had been suggested, so for the consolidation phase I think you would expect us, rather than just to settle straight away on one instrument or on tax or spending, to look at a range of options. Where we ended up was with a consolidation package which I think, as Robert Chote described to you last week, is predominantly addressed towards reducing the real growth rate in spending beyond the CSR years and also there are some tax increases.

Q126 Mr Brady: I have no difficulty at all with you looking at a range of options, and obviously that is what we would expect you to do, but what I am asking is specifically regarding the possibility of an increase of VAT to 18½ or 20%. What were the pros and cons in evaluating whether that was a good thing to do or not?

Mr Ramsden: The Chancellor in his Pre-Budget Report speech highlighted that we looked at that range of options and he concluded the judgment was made to go for the option that was fairest, and that has been set out very, very clearly.

Q127 Mr Brady: Yes, I realise that, but in terms of evaluating what the effect of an increase of VAT in a year’s time would have been, what do you think the positives or negatives would have been had that been done?

Mr Ramsden: In a sense it would have been some of the opposite of the reduction in VAT except that any increase in VAT presumably would have been permanent so it would have increased prices for a temporary period and it would have potentially had wider impacts on the economy and on distribution.

Q128 Mr Brady: You would have expected a slow growth presumably?

Q129 John Thurso: Mr Ramsden, can I just go back to the Chairman’s opening question about the banks and the need, above all, to get credit flowing and ask you one supplementary. What, if any, steps are being taken by the Treasury to put in place some kind of agreement, concordat, memorandum of understanding, call it what you will, between the
Government and the banks on the principles for lending and lending costs over the period that the Government is a major shareholder in the bank?  

Mr Ramsden: If it is okay with you I will hand over to Mr Clive Maxwell who has been leading on these issues.  

Mr Maxwell: It might be worth me taking a step back and running through the steps that are underway at the moment. As you say, in order for banks to lend they need the financial resources to be able to do that. That requires them to have access to capital and also to have access to funding. The recapitalisation scheme that the Government has introduced has been an important contributor to allowing some banks to raise capital. Other banks have raised capital through the markets. On the liquidity side, the funding side, the Bank of England has played a critical role in providing liquidity to the markets through open market operations, then through the special liquidity scheme and more recently the Government has introduced a credit guarantee scheme to allow banks to borrow on the wholesale markets with a form of government guarantee. The FSA has also clarified the arrangements for capital to make clear that the new capital levels the banks have are deliberately designed to allow them to have a usable buffer of capital into which they can eat over the coming period. That is the financial arrangements that banks require to be able to carry out their lending. There are then a series of issues about how banks deal with their customers, and that applies both to retail customers and to their business customers.

Q130 John Thurso: Can I save you a bit of time. All of that we know. My question is very specific. The Government, Chancellor and other ministers have expressed the aspiration that banks should maintain levels of credit, should continue to offer mortgages, loans to small businesses and should pass on interest rate cuts. Banks, on the other hand, have pointed out that as Libor is their cost they cannot do that and they are doing their own thing. Without a formal agreement on the principles involved we will have an aspiration on one side and the banks doing their own thing individually on the other side. We need a collective agreement. Has anything been done by the Treasury to achieve that?  

Mr Maxwell: I point to two things that are being done. The first thing that Dave Ramsden mentioned was the establishment of a Lending Panel and other arrangements to pull the banks together. These sorts of arrangements to pull the banks together. These sorts of agreements about how they will act with respect to existing borrowers and potential new borrowers are exactly the sorts of things that the Lending Panel will look at. The second thing in relation to those banks which have raised new capital that has been underwritten by the Government is that those banks have made commitments to maintain lending in certain key respects and that will be monitored by UKFI.

Q131 John Thurso: Can we expect a document that sets out these headlines that we can look at?  

Mr Maxwell: On the latter or all of that together?  

Q132 John Thurso: Any agreements that are reached.  

Mr Maxwell: I do not know, I am afraid. I would expect statements and comments to be made if things are agreed.

Q133 John Thurso: Can I turn to the question of imbalances, and I am not sure who to direct this to. The recent path of the economy has seen several imbalances develop in both the domestic and global economy. To what extent do you think the current crisis sees those imbalances unwinding?  

Mr Ramsden: I will start with the global economy and then I will come on to the UK economy. It is clear, as I said in earlier comments, that there is a process of deleveraging and of the shrinking of balance sheets taking place across the global financial system. This reflects, as we set out in chapter 3 of the document, our analysis of how the global financial system and global financial crisis has developed, which I think drew on earlier work that this Committee did, and that analysis is also shared by others, which sees asset prices having really been growing at what, with hindsight, look like unsustainable rates. What we are now seeing is that the adjustment to that has taken a very sharp turn for the worse since the summer, and since September, and that is now globally feeding through into the real economy, so that just in the last few days we have seen this very significant fall in US payrolls and an intensifying recession there, German manufacturing output down 2% yesterday, Japanese GDP has overnight been revised down, and global confidence indicators are very negative. The Purchasing Managers Index is either at record lows or nearly at record lows for 27 countries. We are clearly seeing the impact of this global financial crisis now feeding through and we are going to see next year, at least on our forecast judgments, G7 GDP fall 0.75% and that is the first fall since 1982, so it is clear that we are in the middle of a global recession where we will, I think, through the way that it plays out, through the way that policymakers respond to it to try and limit its extent, expect to see rebalancing as part of that. That is certainly true when you then come back to look at the UK economy, as I have said. Our forecasts show rebalancing taking place throughout the forecast period. If you look at table A4 on page 169, contributions to GDP growth, we are expecting that UK private consumption, which contributed 2% of the 2.75% GDP growth between 2000 and 2006, is going to be —0.75% in 2009, whereas net trade, which in 2007 made a negative contribution of —0.75%—and this picks up on the earlier question from Mr Breed—that by 2009 we think that net trade for the UK will be making a positive contribution to growth, so we do think that there will be rebalancing. It is worth stressing that as we went into this period and before the global shocks hit, although the UK, like other countries, was...
experiencing strong asset price growth, actually the UK economy was pretty much on trend: inflation was not that far away from target and interest rates were only at about 5% or so. Unlike, say, the late 1980s where there was an unsustainable boom in activity, this time around it has been more of an unsustainable position on asset prices rather than on activity. I think that will also have a bearing on how the rebalancing plays out.

Q134 John Thurso: What do you think are the possibilities for protectionist action as a result of the unwinding of imbalances and the stresses that you have described that come from that? We have heard noises from America and we have heard noises from other countries.

Mr Ramsden: I was encouraged by the G-20 meeting back in mid-November where there was concern expressed about any return to protectionism. In a sense, this is an analogue more generally to how policymakers respond to this downturn, both in terms of macro policy and micro policy. One would hope—and I think that you see that, as I say, through the G-20 statements and through other statements from policymakers—that the lessons have been learned from previous downturns and that if you have a shift into protectionist action that actually prolongs the downturn rather than encourages the recovery.

Q135 John Thurso: The UK is particularly vulnerable to action by others because we are one of the most globalised and outward-facing economies and therefore we stand to lose more than we gain from any protectionist action.

Mr Ramsden: Which is why we are always at the forefront, I think, of making a case for free trade, for wanting to see progress on Doha and for stressing the risks and costs to a return to protectionism.

Q136 John Thurso: Doha leads me neatly to the Business Secretary where it has been suggested that he is drawing up a potential list of industries that should be saved from the current downturn. There have been various articles with the criteria that are being considered. Has the Treasury been involved in any of these discussions?

Mr Ramsden: What the Treasury has been involved in and what we have set out in the PBR are the steps that we are taking to support all businesses across the UK economy. That starts with the macro-level policy, investment and export markets and how the financial sector plays a systemic role in enabling the economy at the macro level to grow at the kind of rates that we have seen in the UK, and so it has been absolutely right that government action has been comprehensive in trying to stabilise the banking system and the financial sector. The Department for Business, Enterprise and Regulatory Reform, as you would expect, is in very close and on-going touch with sectors right across the UK economy during times when the economy is in recession, as we are now. I am not really sure I can add anything. I do not know if Edward wants to say anything.

Q138 John Thurso: So far I think the answer is No but keep going.

Mr Troup: If you have had a chance to look at the Strategic Challenges document which we published alongside the PBR, you will see in paragraph 4.2 it says: “The Government has an important role to play in recognising those business activities in which the UK has relative strengths. By working closely with industry sectors the Government could help identify barriers to growth.” I think that is almost exactly what the Secretary of State for Business, Enterprise and Regulatory Reform said at the Hugo Young lecture last week when talking about the phrase “industrial activism” when he said: “It means recognising that by investing the right way in people and infrastructure and joining up the relevant decisions taken by government, we can dramatically improve our chances of coming out ahead. We need to focus on areas of policy like technology, skills, regulation, investment and export markets and how we set the relevant conditions for business success.” I think those two statements are almost exactly the same and I think they reflect the way the Treasury and the Department for Business are working together on this.

Q139 Mr Breed: Can we just turn to the national debt now. The PBR forecasts that public sector net debt will increase over the forecast period and then begin to stabilise at around 57% of GDP in 2013–14.
I think you would agree that there are a number of people who believe that the forecast for economic recovery might be a little over-optimistic. If that proves to be the case, what might be the upper limit of the national debt which would be sustainable, and by that I mean the Government being able to meet its planned obligations?  

**Mr Ramsden:** I must admit that my reading of the hearing that you had with experts last week was that they felt that the allowances that we had made in our economic forecasts for the impact of credit conditions, where, for example, relative to some estimates, we have assumed the impact will be a permanent 4% of output, whereas some other estimates are rather larger than some estimates, were realistic. My reading of, for example, the Institute of Fiscal Studies’ reaction to that was that seemed like a realistic allowance, and actually Roger Bootle, who has been mentioned in the previous discussion, felt that that was rather an over-estimate. The reason I mention that is because those estimates of the economy’s productive potential are what drive our fiscal estimates and our fiscal judgments, so I would argue that in addition to those kinds of assumptions and also the other assumptions that we have made, some of which are audited by the NAO, we have got a realistic set of fiscal forecasts and I believe the peak in debt that we are forecasting is a realistic assessment.

**Q140 Mr Breed:** In the past you have operated your forecasts on the basis of having fairly strict fiscal rules. Those have all been abandoned now so therefore you cannot pray in aid those and we have a completely fluid situation now, but you still believe that even within that your figures for economic recovery will not prove over-optimistic. If they did—and you must have done something on that—where is the national debt likely ultimately to become unsustainable?  

**Mr Ramsden:** I am not sure I agree with the premise of your question because although we have moved to applying a Temporary Operating Rule on fiscal policy, and we have had to depart from the previous rules, actually the objectives which are framing fiscal policy have not changed and are as set out in the Code for Fiscal Stability, so sustainability of the public finances in the medium term, as I emphasised in response to earlier questions, and as I emphasised again in response to an earlier question, we think that the fiscal path that we have set out, which is underpinned by our new operating rule, is sustainable. It shows us that debt does increase sharply through the recession and in the early stages of the recovery. We think that it is the right thing to do as private sector borrowing is being reduced for government borrowing to come in. That is also happening in other countries. We are going to see US borrowing at a very high level. We are going to see other countries’ debt rising. Our debt is going to rise, which means that we are going to go up, as we forecast, to 57%, but we do not think that that is in any sense unsustainable and, as I pointed out, there is a lot of demand for government paper at the moment as shown by very low levels of yields on government paper. I just think that we are in a position where our public finances are sustainable and are based on realistic forecasts and realistic assumptions.

**Q141 Chairman:** But on that 4% phased reduction to the trend level of productivity, when Roger Bootle was here last week, he said that was “Noddy economics” and no-one has a clue and he looked at the PBR for justification. What sophisticated answer do you have for us on that?  

**Mr Ramsden:** I do not know if Noddy would have had a footnote (page 162) which said that: “External estimates of the impact of the credit and commodity price shocks on the level of trend output range from 2% up to around 6%, depending on the assumptions used. See, for example, The budgetary implications of global shocks to cycles and trends in output: impacts of housing, financial and oil shocks, Barrell & Kirby, October 2008, and then there are references there to analytical work by the OECD and the European Commission”. That is a footnote to a passage where we try and set out transparently in paragraph A58 the assumptions that we have made and then there is a whole box, A4, with lots of references to economic shocks and potential outputs. Actually I think we in the Treasury, just as the Bank of England have done, have not only taken account of the demand side impacts of these shocks but also the supply side impacts of these shocks. If you compare that to debates in other countries you may find that they have not yet started to take account of the supply side impacts of these shocks, so I would not call that Noddy economics at all.

**Q142 Chairman:** So it is unfair to say, if you look at the footnote and the footnote says that the trend level of output ranges from 2% to 6%, that the Treasury might say, “Okay, we will go for half way”?  

**Mr Ramsden:** We went for what we thought was an appropriate judgment. We have been criticised in the past for making this book too long. We could certainly make it longer if you wanted us to spell out these kinds of references.

**Q143 Chairman:** We do not want it longer but we want a sharper analysis. Maybe that is what it is.  

**Mr Ramsden:** I think we have provided a sharper analysis, Chairman.

**Q144 Chairman:** Our experts do not agree with that but, there you are, we will move on.  

**Mr Ramsden:** Economists do not agree on everything as we know.

**Q145 Chairman:** But that is why we have got them here so that we can question you so that we can get decent answers from you.  

**Mr Ramsden:** I hope at least on that question I have given a decent answer.  

**Chairman:** I think the jury is open on that. Nick?  

**Nick Ainger:** Mr Ramsden—
Mr Mudie: You cannot ask him; he is in the bad books!

Nick Ainger: Perhaps I will direct my question at Mr Maxwell.

Mr Mudie: It will be safer!

Q146 Nick Ainger: Mr Maxwell, Mr Ramsden in a reply to the Chairman’s opening question said that return to normal levels of bank lending was absolutely critical. Last week and the week before the RBS and HSBC announced that they were going to do everything they could to assist the small business sector. Who is monitoring their performance?

Mr Maxwell: Performance of those two particular banks or more broadly?

Q147 Nick Ainger: All banks across the piece?

Mr Maxwell: As I mentioned earlier, I think this new Lending Panel will play a very important role in working with the banks and other interested parties, and that one of its roles will be to make sure it has sufficient information to actually understand what is happening. There are some issues about confidentiality. Clearly individual banks will not want to share data about precisely what they are doing with other banks, and that is understandable, but we will ensure that the Government has sufficient information to be able to understand what is actually going on in these markets.

Q148 Nick Ainger: I think it was on the floor of the House that the Chancellor, in response to a question from myself, said that he was prepared to publish the arrangements that have been made by the individual banks who had received substantial taxpayer funding. What progress has been made on publishing those deals?

Mr Maxwell: I understand that the agreements with the individual recap banks are available in the House Library. I will check that and confirm that in writing but that is what I understand. The Government will set out in more detail how the new body, UK Financial Investments, is going to work with the banks and other interested parties, the Lending Panel will play a very important role in working with the banks and other interested parties, and that one of its roles will be to make sure it has sufficient information to actually understand what is happening. There are some issues about confidentiality. Clearly individual banks will not want to share data about precisely what they are doing with other banks, and that is understandable, but we will ensure that the Government has sufficient information to be able to understand what is actually going on in these markets.

Q149 Nick Ainger: The PBR set out that there was approximately £7 billion available for funding small businesses from the new Small Business Finance Scheme, £4 billion from the EIB, another £1 billion from the Export Credits Guarantee Scheme and various other schemes administered by RDAs and others. If the lending panel and monitoring does not actually produce a return to normal lending to small businesses, do you expect particularly the Small Business Finance Scheme to have to be increased to make up the shortfall?

Mr Troup: We hope to get the Small Business Finance Scheme up and running very early in the New Year. The details are being worked out between the Treasury and the Department for Business and Enterprise. Obviously we will want to see how that goes over the first few months of its operation. As you say, it has £1 billion in it specifically to help small businesses who are having trouble with working capital. It sits alongside the Small Firms Loan Guarantee Scheme which, as you know, is a long-running scheme which is designed to help businesses that start up and grow. As Mr Ramsden has explained, we are forecasting a recovery beginning in the latter half of next year and the expectation is that this scheme and the recovery of the banks’ lending will be sufficient to see businesses who are struggling from the lack of working capital through this period.

Q150 Nick Ainger: The £4 billion that is available through the EIB scheme will be coming through the high street banks. When do you expect that to start kicking in?

Mr Troup: We have already got four banks who are committed to taking that facility who will be on-line by the end of the year and we expect others to sign up early in the New Year, so there is no reason really why money cannot start flowing under that almost immediately.

Q151 Nick Ainger: But do you expect that if lending does not return then you are going to have to start increasing the size of these packages? That was the original question.

Mr Troup: We will have to see what happens and see how the path of the economy turns out. As is said on several occasions in this document, it is at a time of very considerable uncertainty.

Q152 Nick Ainger: In his evidence to us last week, Mr Whiting from PwC and the Low Incomes Tax Reform Group welcomed the package in relation to easing the tax burden on small businesses or the way that they pay their taxes. He indicated that he had been told by HMRC that they were putting quite considerable manpower resources into this rescheduling package. Mr Whiting told us that the success of that scheme will be contingent upon the human resources actually being put in to do that. Bearing in mind the announcement last week of further significant cutbacks in HMRC tax offices (which directly affected my own constituency and that of Mr Crabb) where are these resources coming from?

Mr Troup: HMRC have quite considerable resources available for their various helplines and call centres. The support to which I think Mr Whiting has referred is the Business Support Helpline which is part of the debt management unit in HMRC. What they have done is to reallocate temporarily the responsibilities of individuals there to allow them to deal with requests from businesses who are having difficulty in paying. It is not clear how long the demand will continue, and no doubt HMRC will look at their resourcing over time. What I can tell this Committee is that the support line has worked very well over the last two weeks. I would say that this is not a new arrangement. It has always been open to businesses to do this but it has perhaps not being as widely publicised as it might have been, and very much part of the PBR announcement is to
make sure that people are aware of the availability of this. Over the last two weeks I am told—and I think this is to the close of business on Sunday—that 4,733 arrangements had been reached with individual business and there were another nearly 2,000 under consideration, that the lines had been busy but not overwhelmed, so depending on how the flow goes I think this will be manageable within existing HMRC resources.

Q153 Nick Ainger: But in relation to staff resources, if you put more resources into the helpline and into these rescheduling packages, then presumably something else is deprived of resources. Are you telling us that there are no new resources to deal with this; it is just literally transferring staff from other duties?

Mr Troup: I cannot answer for the detailed issues of HMRC staffing. There is no additional resource in HMRC overall but HMRC have in excess of 80,000 staff. I believe a few hundred are involved on the helpline and I think an organisation that size does have flexibility over reasonably short time periods to reallocate resources.

Q154 Nick Ainger: That is not what the trade union was telling us that everyone is under very serious pressure and that 70% of HMRC staff have got rock-bottom morale and are dissatisfied with the way their department is run. Do you not think, bearing in mind this is an important issue, that in fact there should be additional resources allocated rather than a transfer of resources?

Mr Troup: As I say, HMRC appear to be performing very effectively the task which the Business Support Helpline is designed to do and have been over the last two weeks.

Q155 Mr Crabb: Mr Ramsden, back in March you told this Committee that you saw the Sustainable Investment Rule as a “strict rule”. What is your current view of the rule?

Mr Ramsden: My current view is that we have temporarily departed from it.

Q156 Mr Crabb: Is it your belief that the fiscal rules, that is the Golden Rule and the Sustainable Investment Rule as well, have bolstered the Treasury’s credibility and, if so, how?

Mr Ramsden: As I set out in answer to a previous question, since 1998 when the Code for Fiscal Stability was produced and appended to that year’s Finance Bill, we have tried to frame fiscal policy by achieving three objectives: supporting monetary policy in stabilising the economy, and that is a particular issue now given that the monetary transmission mechanism is impaired; second, as I have stressed, the emphasis on sustainable public finances in the medium term; and then also protecting investment. I have always seen the rules as a means to an end to achieve those objectives. We set the two rules, the Golden Rule and the Sustainable Investment Rule for the last cycle. On the Sustainable Investment Rule we actually tightened the rule in 2003 when we moved from saying that debt had to be at 40% over the cycle to saying that debt had to be a maximum of 40% in each and every year. That was appropriate for that cycle. At this PBR the NAO has audited, as we told you that they would, whether that was a reasonable judgment about that being a complete cycle; they have concluded it was reasonable. We always made clear that those rules were set in the way they were set for that cycle. Since then we have been hit by these two global shocks and the credit shock is intensifying. Against that backdrop, as the Chancellor made clear in his Mais Lecture, it would be perversive to stick to rules that were not a means to an end, that actually required you to tighten fiscal policy during a recession. We have, as I said in my previous rather briefer answer, temporarily departed from those rules. We have the new Temporary Operating Rule consistent with what the Code for Fiscal Stability allows. I think it is paragraph 11 of the Code for Fiscal Stability which sets out the conditions under which you can temporarily depart and we have set out a new rule. We have said in this PBR the period over which it will apply in the sense that we see it applying until the shocks have worked through the system. Given the uncertainty we have not felt that it was appropriate to constrain that period definitely until the period when our forecasts showed that we were back on trend, which is 2013–14. I am very happy to accept that these judgments are—

Chairman: We have time constraints and we want briefer answers.

Q157 Mr Crabb: I have a question to ask you about the Temporary Operating Rule in a moment, but the fact that it is a Temporary Operating Rule would imply, and indeed your answer a few moments ago would imply that you are thinking about a return to the previous fiscal rules, or do you think that once we emerge from the current downturn that a new set of fiscal rules will be required?

Mr Ramsden: By invoking the Code for Fiscal Stability that is very much in terms of a temporary departure. That is going to be over quite a long period. We are not saying now what will be the debt limit, for example for the Sustainable Investment Rule at some point in the future. What we have tried to set out now, as I set out in answer to a previous question, is what we see as the credible consolidation path, which is what the Temporary Operating Rule underpins, to get debts back onto a declining path, which we see as a critical factor, and to get the cyclically adjusted current deficit back into balance, again a critical factor, both of which are consistent with the three objectives which have been the basis for Government fiscal policy since 1997.

Q158 Mr Crabb: DeAnne Julius, writing about the Temporary Operating Rule, described it as “a hope based on an optimistic assumption about GDP growth, not a financial framework.” Can you convince us that she is wrong?
Mr Ramsden: I have already said that I do not think it is an optimistic forecast. I think it is a realistic fiscal forecast. There is a debate about whether you use rules in fiscal policy as in other policies or whether you allow for complete discretion. What we have done with this Temporary Operating Rule is to be very clear, and this applies to how we have used it through this PBR. It is operational. The way we applied it—and this is set out in the fiscal forecasts for the medium term—was in a way that it has delivered a consolidation of at least 0.5% of GDP in terms of the cyclically adjusted balance in every year from 2010–11 when we think the recovery has started. That is sufficient to get us back into a deficit of 1% of GDP by 2013–14. I would argue that that is, as I have already argued, a sustainable fiscal position and that it is a credible consolidation plan, and that the Rule has underpinned and helped to deliver that.

Q159 Mr Crabb: Would you not expect successive reductions of the cyclically adjusted current balance as the economy comes out of the downturn anyway, without having a Temporary Operating Rule?

Mr Ramsden: You would get some very small reductions relative to the reductions that we have judged appropriate from fiscal drag, as your experts told you last week. Also, in the case of our forecast, because we expect the more tax-rich parts of the economy, which are taking a real hit through this recession, as we have set out in detail in Annex B, to recover, but over and above that, the reason that I think this is a credible consolidation plan and that over time, as we refresh it and as it is developed, I think it will give enhanced credibility to the framework, is because, in addition to just those automatic effects, or those effects that come from judgement, we are announcing from 2010–11, the last year of the CSR period, additional of VFM savings of £5 billion. Then beyond the CSR period we have set out what I think are achievable assumptions for real spending growth falling in terms of totally managed expenditure, which is current and capital, to an average of 1.1% a year. That is a significant slowdown in spending growth which is the major part of the consolidation. Then, in addition to that, we have set out specific tax-raising measures in PBR documentation which we think will contribute to the consolidation. Obviously, time will tell on these things but from where we are now in this PBR, I think this is a credible consolidation plan and that we have a credible fiscal framework.

Q160 Mr Crabb: Do you consider that your understanding within your Department of the cyclical behaviour of the economy at this current time is sufficiently robust for this Rule to stand the test of time?

Mr Ramsden: It links back to an earlier exchange prompted by Roger Bootle’s comments. I think there are a range of views on the cyclical behaviour of the economy, both in terms of on the demand side, which is what people typically look at, and then on the supply side, ie, the degree of productive capacity, which, because of our focus on trend output, has always been something we have focused on. I do think our understanding is appropriate. I think it is adequate to do the job that we are being asked to do in terms of providing advice on both the fiscal framework and how it is implemented through fiscal judgements. That is not to say that we cannot enhance our understanding. Through reading all the other literature, such as the ones I referred to in the footnote, we have very intensive engagement with the National Institute, with the IFS, with the international organisations, and the National Audit Office, which I mentioned a minute ago, which assesses our assessment of the cycle, is also I think in future going to be taking a closer look at the way that we do our cyclical adjustment. The way we assess the cyclical part of the economy. One of the principles underlying our fiscal framework is to try and be as transparent as possible. We have tried to set out in the document and in supporting documents our analysis but we are very open to discussing that, to trying to enhance our knowledge, so that we can develop our understanding of the economy and the fiscal position.

Q161 Mr Crabb: Aside from the general guide around reducing the current Budget by 0.5% per year, there are no other constraints that the Rule implies for the Treasury?

Mr Ramsden: If you think that the rules are a means to an end, we will be judged over time on whether we achieve the kind of plans that we have set out. That is quite common, if you think about the track record for an institution in terms of whether it has a track record of credibility. That would be one way I would expect us to be held to account, just as we have been in the past on our track record, and we will be judged against whether these plans are achieved and if there are any departures from them, why. Secondly, as I mentioned right at the outset of this discussion, there is the market’s judgement on the fiscal position. If you look at our end-year fiscal report, which we publish every year, which is one of our contributions to transparency, I think that shows how the yield... For fiscal policy, it is quite hard to come up with a summary measure of credibility. With monetary policy, you can look at inflation expectations. We tend to look at the 10-year bond yield. Over time that has come down successively and, as I have said, at the moment it is down at about 3.6%. So we suggest that people want to buy government debt and consider the position credible and sustainable.

Q162 Mr Fallon: Mr Williams, table 5.2 shows that you have increased the number of people facing marginal deduction rates of over 70% from 200,000 in the Budget at March up to 305,000. That is an increase of 50%. Why have you done that?

Mr Williams: It is the effect of one of the childhood poverty measures that were announced in Budget 2008 and which came into effect in 2009 and therefore are reflected in that number. It is the measure, which I think you will recall we discussed after the Budget, where we disregarded Housing
Mr Williams: The effect of that is to give the benefit of Housing Benefit to more people and that then has the effect of putting more people on the Housing Benefit table.

Q163 Mr Fallon: Do you regret that increase?  
Mr Williams: I think the increase is a consequence of the fact that we are giving our support through Housing Benefit to more people. There is not a way of doing that at the cost of that change that does not have the effect of increasing the marginal deduction rate for people who newly get that support as that part of the income is reduced.

Q164 Mr Fallon: So you do not regret it; you do not care about those people. Mr Whiting of the Low Incomes Tax Reform Group told us last week that the group hardest hit by all the changes in the PBR were those around the £40,000 level, where you are paying National Insurance at what will become the standard rate of 11.5% and you face going into the 40% income tax bracket as well, so it is that sort of level that will see the greatest loss. That is Middle Britain, is it not?  
Mr Williams: If you look at the measurements as a whole to 2011–12, I think it is clear that the group suffering the greatest loss are those on the highest incomes, not at the £40,000 mark, because of the withdrawal of the personal allowance for people over £140,000 and because of the introduction of the additional 5% rate. Also, of the additional 0.5% on National Insurance; the effect of that becomes greater the more income you have subject to National Insurance contributions.

Q165 Mr Fallon: But there are millions more at the £40,000 level than there are at the £100,000 level, are there not?  
Mr Williams: Yes.

Q166 Mr Fallon: So Mr Whiting must be right then that it is Middle Britain you are hitting hardest with these changes. There are more people suffering more from the impact on people earning £40,000 than there are on £100,000.  
Mr Williams: There are more people on £40,000, certainly. Clearly, that is an area of the income distribution where there are far more people than over £100,000 but if you look, for example, at the measures in table B5, the measure to restrict the personal allowance, which of itself scores £1.3 billion, applies only to people above £100,000. That is the top 2% of the income distribution and the 45% rate only applies above £150,000.

Q167 Mr Fallon: We will come to the people over £100,000 in a moment. I just want to be clear: why are you attacking people on around £40,000? Why is the PBR hitting Middle Britain?  
Mr Williams: The fiscal consolidation from 2010 onwards, 2010–11, applies only above £100,000. From 2011–12 the main route for the consolidation is the extra 0.5% on National Insurance contributions.

Q168 Mr Fallon: But Mr Whiting says those hardest hit will be those around £40,000.  
Mr Williams: I think that does not take into account the other changes, which mean that others will be hit more than at that level. At £40,000, for example, that is the crossover point. If you start with April 2008 and compare the position then with April 2011, that is where you see the crossover point, as we said in 5.9. People below £40,000 do not pay more if you compare the April 2008 regime—that is before the change that the Chancellor announced on 13 May—with April 2011. So I do not think, given that I have confidence in what we said in the PBR, that you can deduce from that that it is the people at the £40,000 level that are the hardest hit.

Q169 Mr Fallon: So you are conceding they are hit but you are saying the losses are greater for those over £100,000. You are conceding that those around the £40,000 level are worse off as a result of this PBR? Is that a “yes” or a “no”?  
Mr Williams: You have to be very careful what the comparison is across such a large number of changes. Very broadly, if you compare the regime in April 2008 to the regime that will exist in April 2011, very broadly, people under £40,000 tend to gain and it is at about £40,000 that people start to pay more tax and National Insurance.

Q170 Mr Fallon: Thank you. So those over £40,000 worse off. Now, over £100,000 it was explained to us last week you have five different rates: 60% up to £106,475; 40% up to £140,000; 60% again up to £146,475; 40% up to £150,000; then the new 45% rate over £150,000. Who came up with a mess of having five different income tax rates over £150,000? Whose idea was that?  
Mr Williams: They are not in fact five different income tax rates. In the Finance Bill Parliament will not be called upon to create five rates.

Q171 Mr Fallon: Effectively, they are five marginal rates, are they not?  
Mr Williams: There are some people who will face the effect of those marginal rates, yes, but we also need to bear in mind that there are individuals who currently do not get personal allowances and, of course, they are not at all affected, whether their income is above or below £100,000, by the tapering down of the personal allowance from the £100,000 point in 2010. The taper mirrors the taper that we have for pensioners. You will know that pensioners get additional personal allowances and they are tapered in exactly the same way as the personal allowance will be starting at £100,000 down to the value for a basic rate taxpayer and starting at £140,000 to remove that personal allowance.

Q172 Mr Fallon: But over £100,000 there will be five effective marginal rates—yes or no?  
Mr Williams: It is not as straightforward as that. Mr Fallon. There are some people who will face the effective rates that your witness from the IFS said last week; there are other people who start out
Mr Williams: For Housing Benefit?

Mr Williams: I am afraid that, while I have expertise in Housing Benefit, Mr Cousins, I do not have expertise in local government finance. I think we will have to come back to you on that.

Mr Ramsden: We will provide you with a note on that.¹

Q175 Jim Cousins: You do see though, Mr Williams, the important interconnection of those two things. Mr Ramsden told us earlier that for home owners with mortgages, their housing costs are likely to go down because of the cuts in interest rates but for council renters, they are facing a continued increase in their housing costs, which is going to drive more people on to Housing Benefit and will catch more people in these very high tax rates brought about by the withdrawal of benefit and tax credits. Do you not see that that is a problem, a squeeze, a continued squeeze; on the incentives to earn of the least well-off earners?

Mr Williams: I think you are right to draw a link between Housing Benefit and local authority rents. I think equally it is the case that local authority rents go up, but in general people on Housing Benefit will get additional support given the way that Housing Benefit works. I think we would need to do more research to see if the impact is as you describe it in terms of putting more people on to marginal reduction rates. It depends exactly where they are on the income distribution and exactly what rent change they would face.

Q176 Jim Cousins: Yes, but you do understand that the cultural and psychological impact of this is far greater than the sheer mechanical working through of tax and benefit changes, that large numbers of low income earners are facing a continued squeeze on their costs because their rents are going to up, and big disincentives to earn more money?

Mr Williams: I think in many cases, if you look back, for example, to Budget 1998, the number of people on very high marginal deduction rates has come down, although I accept, as Mr Fallon made the point, that if you look at the position for 2008 as compared to 2009, there has been some slight deterioration. Equally though, what that generally reflects is additional targeted support to those who needed help most, which help is then tapered out. As I think Mr Brewer said last week, there is not an easy way of avoiding the effect of the taper creating relatively high marginal deduction rates. It is a consequence of focusing the support that is available on people on lower incomes.

Q177 Jim Cousins: But, Mr Williams, at the present moment somebody on Jobseeker’s Allowance is allowed to earn £5 a week without it being taken into account in their benefits. That is roughly 45 minutes at the Minimum Wage. If they work for more than 45 minutes, they either go on the fiddle and do not declare it, or everything they earn is taken into account in their benefit at 100%. It is withdrawn penny for penny. Do you not see—Mr Ramsden said it—that in the world of Waitrose, because fuel prices are going down and homeowners’ mortgage costs are going down, we can look forward to the squeeze on costs lessening but in the world of Netto the squeeze on costs is not getting less; it is getting greater and the disincentive to earn more legitimately is actually going up, not down? Do you not see that there is a real difficulty there in the kind of world we live in?

Mr Williams: If you look at this table, as I think we made clear, this is about people working where you have a household with the person working at least 16 hours or more a week, so it is not focused on the Jobseeker’s Allowance.

Q178 Jim Cousins: What about all the people in our wonderful, flexible labour market who are not working 16 hours a week? They were done in the 10p tax thing and they have never got it back.

Mr Williams: The 10p tax issue has, I think, been addressed by the Government in the Chancellor’s statement of 13 March, and indeed again to settle the position for future years in this PBR. On the question of spending, Mr Cousins, I am sure you are right that lower income people are perhaps less inclined to go into stores like Waitrose but, on the other hand, they too buy VAT-able goods and the distributional analysis, our I think reasonable assumptions show that while lower income people spend less on goods with VAT, so the absolute amount that they save is smaller, proportionately the amount they save from the VAT cut on reasonable assumptions is greater than for, for example, working people on high incomes.

Q179 Jim Cousins: There are an awful lot of people in this country, Mr Williams—I do not like to shock you—who by their electrical goods in the pub, not in PC World, and that is VAT-free, and there is a good reason for it. Mr Ramsden, what about the people who are facing—let us not call them the five dinosaurs. What about all the people in the world of Netto who are doing 45 minutes, they either go on the fiddle and do not declare it, or everything they earn is taken into account in their benefit at 100%. It is withdrawn penny for penny. Do you not see that that is a problem, a squeeze, a continued squeeze; on the incentives to earn of the least well-off earners?

Mr Williams: I think you are right to draw a link between Housing Benefit and local authority rents. I think equally it is the case that local authority rents go up, but in general people on Housing Benefit will get additional support given the way that Housing Benefit works. I think we would need to do more research to see if the impact is as you describe it in terms of putting more people on to marginal reduction rates. It depends exactly where they are on the income distribution and exactly what rent change they would face.

¹ Ev
pension relief of 40%.” Are those sensible behavioural signals to give higher income earners? We are giving poor signals to lower income earners; is it sensible to give higher income earners those sorts of signals: bung your money offshore, switch it to capital or bung it all in your pension?

**Mr Ramsden:** I do not recognise that we have given any of those behavioural signals in the PBR.

Q180 Jim Cousins: By the introduction of this very complex tax situation for the higher income earners?

**Mr Ramsden:** I think Mr Williams has set out—

Q181 Jim Cousins: Do look at the Sunday papers! There are pages of this stuff: bung your money in a pension, bung your money offshore, switch it to capital where it is taxed at 18%. It is all over the Sunday papers. You do not have to go to Morgan Stanley.

**Mr Ramsden:** I wish I had time to read the Sunday papers.

Q182 Jim Cousins: I think, Mr Ramsden, your policy making might be improved if you did.

**Mr Ramsden:** I am sure that is true. What we have done in the costings, particularly for the higher rate measure that you talk about, is to try and make sensible, prudent, behavioural assumptions. Those were discussed at your experts’ group last week but I do not think in any sense are we sending any signals with those behavioural costings. We are trying to ensure that our costings are likely to be achieved so that our fiscal forecasts are based on policy costings which actually turn out to be the amount that the policy raises but that is not in any sense to send signals.

Q183 Jim Cousins: Mr Ramsden, are you really telling me that in the Treasury it is not acknowledged that tax changes behaviour, and that you can put tax rates up and no money comes in because people can do something else with their money so it is not taxed?

**Mr Ramsden:** All I am trying to say, Mr Cousins, is that of course we take account of behavioural factors in all the costings we do and we set out in the ready-reckoner document that we publish alongside the PBR what those behavioural assumptions imply in terms of costings, but those are with a view not to sending signals about how the tax system should be interpreted but as an underpinning, consistent with the Code of Fiscal Stability, for our fiscal forecast. So we are not making any value judgements, which is probably what is happening in other commentary.

Q184 Mr Brady: Returning to the whole question of VAT and the temporary cut in VAT, there was a comment that you made earlier, Mr Ramsden, as well about the impact of commodity prices bringing down inflationary effects. What consideration have you given to the dangers that the temporary VAT reduction actually has a deflationary effect at precisely the wrong moment?

**Mr Ramsden:** We flagged up in the document, again, trying to be transparent and trying to highlight the uncertainties, the risks around very low inflation rates but, as the Governor emphasised to you a couple of weeks ago, there is an important distinction to draw in economic terms between a very temporary reduction in price level on one measure, which is the RPI measure of inflation—and remember, VAT is contributing to that, as are the cuts in mortgage interest payments that Mr Cousins was just highlighting; they are contributing to RPI falling below zero but that is a temporary fall in RPI. Our forecasts show it picking up again consistent with the rise back in CPI towards target through 2010. In a sense, the VAT measure, by the very nature of being temporary, should give people reassurance that, whilst it will bear down on the price level in the short term, the price level will then go back up in the medium term, as highlighted in last week’s MPC statement that accompanied their interest rate cut. That is one type of temporary movement in prices. That is very different from what would normally be recognised as a risk of deflation, which is a sustained fall in prices that impacts on expectations of future prices and therefore impacts on demand. That is very different from the kind of very temporary effect that we are seeing on one measure of prices, which, as I have said, is analogous to the impact on RPI from falls in interest rates. Remember, both falls in interest rates and the decline in VAT are there for the purpose of encouraging demand rather than the reverse, which is the implication you have with real deflation.

Q185 Mr Brady: Professor Colin Talbot on our experts’ panel told us last week, “Certainly if I were buying a new car at the moment I would wait until the end of the VAT cut period and buy it then on the grounds that prices are likely to have fallen by that time.” This is something that the Governor of the Bank of England also said in response to a question from me two weeks ago when we saw him immediately after the PBR, when he said any stimulus effect of this kind of temporary VAT cut is loaded towards the back end of the period. The effect of it is to bring forward expenditure decisions at the end of next year.

**Mr Ramsden:** As I said to Mr Cousins, I was too busy to read the Sunday papers this Sunday but my previous reading of the newspapers suggests that car prices have been falling for quite a while. I was interested in Mr Talbot’s remarks because when you are thinking about a measure like VAT, there are two very important aspects to the temporary VAT cut. One is the income effect, which leads to an increase in consumers’ real purchasing power throughout the 13-month duration of the VAT cut, and you could see that type of income effect being analogous to what you would get from other types of tax cuts. Of course, because we can do VAT straight away, we get it for the whole 13 months rather than having to wait, as with some measures, until next year. The second thing, which is I think what the Governor meant, if you like, that first aspect will
mean that it is cheaper to buy goods: your purchasing power is stronger throughout the whole period of the VAT reduction, and you see that already in the shops, whichever shop you go to. Nearly all of them that I have seen are passing on the VAT reduction, and we assumed that they would pass on the majority of it over time. Secondly, VAT reduction, and we assumed that they would already in the shops, whichever shop you go to.

Mr Troup: In the last PBR we did announce an intention to move to a per plane duty and there was extensive consultation. I think we had 170 replies to that. The Government is obviously committed to the environmental objectives of reforming air passenger taxation; by 2015 we expect aviation to contribute something like 35%...
Q191 Chairman: OK, but these are considerable savings to families. As a result of that, could you give us your written response to that submission.

Mr Troup: We will do that.2

Q192 Mr Mudie: Mr Williams, can we start off by agreeing the target for halving child poverty by 2010? What figure would we have to reach?

Mr Williams: In 1998–99 it was 3.4 million so we would have to reach 1.7 million.

Q193 Mr Mudie: And we are about 1.1 million now?

Mr Williams: About that, yes.

Q194 Mr Mudie: We are not agreeing, are we? This is a bad start!

Mr Williams: I fear that we are, Mr Mudie.

Q195 Mr Mudie: How many children were taken out of poverty in the PBR report?

Mr Williams: If you mean how many are a

cut either in

treating, I think that is about the right ball park.

Q196 Mr Mudie: So it is a fair way to go in a couple of years. Is it now accepted in the Treasury that the Government will fail to meet the 2010 target?

Mr Williams: No. As we made clear in the PBR Red Book, Ministers are going to take stock of where we have got to on the 2010 and 2020 targets in the Budget.

Q197 Mr Mudie: The IFS have continued to claim it will take 2.8 million to reach the target. Is there a disagreement in the Treasury about that figure?

Mr Williams: We do not ourselves forecast that figure but, as I think we discussed at the hearing after the Budget, I think that is about the right ball park.

Q198 Mr Mudie: Going on to unemployment, Mr Ramsden, you have been quoting our expert quite a bit, and you will recognise that they have failed to find a forecast of unemployment levels in the PBR. Can you give the Committee the Treasury’s forecast, which we failed to find.

Mr Ramsden: Your experts failed to find any forecast because, consistent with usual practice, the Treasury does not publish forecasts for unemployment. What we set out very clearly—I am sorry.

Q199 Mr Mudie: Do not read anything into that sigh. You are being too defensive today. It was just a straightforward question. No tricks.

Mr Ramsden: I am not sure if the experts drew attention to this but we do set out the key assumptions in box B1. So the assumption, based on the average of independent forecasts, that we publish so that people can see what independent forecasters are saying and which we use for our fiscal projections are that unemployment will rise over the recession. Unemployment is already increasing, has increased from its very low level at the beginning of this year and is already rising.

Q200 Mr Mudie: I accept that. The experts actually, as you are aware, drew our attention to that, that you were using outside forecasts for unemployment, not your own. For example, elsewhere in the PBR you settle on estimate figures for JSA. You will also have to do some work on income tax, the lowering of income tax because of unemployment. So somewhere in the Treasury your model must work out the number of people that you anticipate will be unemployed in the coming financial year. Why will you not tell the Committee that?

Mr Ramsden: It is a longstanding convention. As part of my preparation for today’s hearing, I looked back at Budgets and Autumn Statements from the early Nineties, the last recession in the UK, and there was no mention of a Treasury forecast.

Q201 Mr Mudie: If we do not ask for a forecast because of convention but I say, “Right, what are the figures that you have based the income tax reductions on, what are the figures that you have put into JSA that reflect unemployment?” I think that is a legitimate question for the Treasury Committee to ask.

Mr Ramsden: We are completely transparent on this in the sense that the unemployment assumption that we use is audited by the NAO. They last audited it at Budget 2008 to assess whether it was a reasonable assumption. That is the basis for the fiscal work that we do and which underpins all the numbers in this document. At this PBR we have recognised the challenges that are going to be caused by the continued increases that we are going to see in unemployment through the recession, which explains why additional provision was made to DWP for the operation of Jobcentre Plus, amongst other things. That is set out again very clearly in table B5, that they are going to get additional funding.

Q202 Mr Mudie: I know that but that is not Jobseeker’s Allowance. That does not tell us the number of claimants you expect. I think, with the greatest of respect, it is a straightforward question. You have presented us with figures for Jobseeker’s Allowance and I am entitled to say how many claimants do you estimate you will have coming through the door?

Mr Ramsden: All I can say, consistent with previous convention, is that the Treasury does not publish its—

Q203 Mr Mudie: I am not asking you to publish. I am asking you to tell me. We are supposed to scrutinise expenditure. Here is a multi-million pound item—and we have been taught on this by experts that we should be very gentle with you but we should persist in asking you questions on the
figures in the Budget. This is a multi-million figure for Jobseeker’s Allowance. I just asked a straightforward question that any councillor or any Member of Parliament would ask of their treasury. You have this figure in the Budget—how many people are going to be unemployed that this represents? I think that is a straightforward question. Mr Ramsden: I have set out—and I am very happy to go back and check this—that the figuring for this Pre-Budget Report is based on the NAO assumptions.

Q204 Mr Mudie: Yes, that is right. That is what our experts told you. The only figure in this PBR that is a figure that gives an analysis or an estimate of unemployment is a figure outside the Treasury. So you are basing the numbers in your book, the amount you put as Jobseeker’s Allowance, on what outside experts say. That is very interesting. You have not done any work, you do not have a model, you do not have a figure—you are basing it on what you read in the papers, when you get time to read the papers. Mr Ramsden: No, we are basing it on an assumption that the NAO audit — and compared, as I said, with the early Nineties forecasting, which I was involved in when I used to forecast the labour market in those days, we did not publish anything about the assumptions that we use for unemployment. We now publish an audited assumption which shows unemployment rising according to the independent average to 1.41 million at the end of 2009 and to 1.55 million at the end of 2010. That is the assumption. You have to make assumptions to produce forecasts and that is what is driving the forecasts that we have made.

Q205 Mr Mudie: So your assumptions in the Treasury are the same as the outside experts. Mr Ramsden: I did not say that. I have set out very clearly the assumptions that we use for the forecasts. I am not sure what more I can tell you.

Q206 Mr Mudie: You can tell me your assumptions. Mr Ramsden: I have told you.

Q207 Mr Mudie: I have asked you to confirm it and you said “No, I did not say that.” You said that the assumptions in the Budget are based on outside forecasts. Right, so I said, “Will you confirm that these JSA figures are based on a 1.4 million figure published in the PBR which relates to outside forecasts?” Yes. Mr Ramsden: That is my understanding.

Q208 Mr Mudie: You have no different figure within the Treasury? Mr Ramsden: I have explained to you how the fiscal figuring is produced.

Q209 Mr Mudie: So you anticipate 1.4 million people being unemployed next year?

Mr Ramsden: You are asking me questions to try and get me to say—I did not say “I anticipate”. I said the assumption on which our forecasts are based, as it has been for many years, as this Committee well knows, is the independent average forecast. Mr Mudie: I just find it incredible that there may be conventions but it is hardly national security for me to say “Tell me how many people you reckon are unemployed.”


Q211 Nick Ainger: We have seen crude prices fall from a peak of $147 a barrel in July to now around $40 a barrel, if not below. We have seen pump prices on the forecourt fall accordingly but for electricity, mains gas, heating oil, and LPG for heating, consumers have not seen any falls. Teresa Perchard from Citizens’ Advice told us last week she did not think much of Ofgem’s performance. She said, “I think the ball is in the court of the regulator at the moment to act decisively and quickly to protect consumers, and I do not think we have seen decisive, quick action by the regulator.” Do you agree with her? Mr Richardson: I should say at the start clearly the falls in energy prices in the spot markets are good news for fuel poverty. The Government has asked—

Q212 Nick Ainger: Hang on. The prices have not fallen yet. She is critical of Ofgem in failing, as a regulator, to ensure that the substantial falls in wholesale prices of energy have been passed on to retail consumers, both in terms of fuel poverty but there is also the wider issue here of industry as well, because they have not seen any significant falls yet in their energy costs. Do you agree with Teresa Perchard that we have not seen decisive, quick action by the regulator? Mr Richardson: My point was about the spot prices. Can I come on to answer your question?

Q213 Nick Ainger: You have made a point but you are here to answer questions. Mr Richardson: I was just about to get on to answering your question, if I may. The Government has asked Ofgem to publish quarterly reports looking at the relationship between wholesale and retail prices. Clearly, these are not simple markets. Energy providers engage in hedging behaviour. They do not necessarily buy their inputs on the spot markets at which we have seen prices fall, so understanding those relationships is a complex matter that Ofgem are looking into. I think we need to have the facts to establish whether there is a divergence between the prices that we might expect to be seen in the markets and those that we do see before leaping to conclusions.

Q214 Nick Ainger: It is a peculiar market where a supplier of energy, in passing on very quickly the rises in wholesale energy prices, quotes those wholesale energy prices as the reason for the rise in...
the retail price, but when the wholesale price starts to fall, suddenly it becomes a very complex issue and they find it incredibly difficult to find any justification to pass on that fall to their retail consumers.

Mr Richardson: It is not for me to speak for the energy companies.

Q215 Nick Ainger: It is an abuse, quite frankly. Is not the market acting almost as a monopoly? Not one energy supplier has made a move, despite the fact that we have seen these huge falls—and remember, it is not just from the $147 a barrel in July; when they put up their prices, in one case by 36%, the price of crude was less than $120 a barrel. It is now $80 a barrel less than that, yet still not one energy supplier has made a move to cut prices.

Mr Richardson: As I said, I cannot speak on behalf of the energy companies but the Government has asked Ofgem to look at these relationships, and we need to have the facts before us before jumping to conclusions.

Q216 Nick Ainger: Let us move on then to the social tariff and prepayment meters. The Chancellor announced that negotiations were taking place with the energy suppliers about prepayment meters and a social tariff or an extension of the social tariff. Again, last week I asked Teresa Perchard if the Citizens’ Advice had seen any significant change in relation to social tariffs and prepayment meters and she said, “I do not think we have.” The informal compulsory social obligation, which is the new social tariff, is supposed to cost £225 million. Companies are supposed to spend it on social tariffs but basically Citizens’ Advice have not really seen any significant change. What is your view?

Mr Richardson: The Government has agreed social tariffs with the energy companies. As you say, the latest agreement on that added £225 million over the CSR years to the social tariffs, bringing them to a total of £375 million over the CSR period and that is obviously one of a range of factors contributing to reducing fuel poverty.

Q217 Nick Ainger: Are you monitoring this? Certainly the evidence which we had from Citizens’ Advice is that they have not actually seen any significant change yet. Who is actually monitoring the performance of the ICSO?

Mr Richardson: The Department for Energy and Climate Change are responsible for the Government’s approach on fuel poverty and, as the Committee will know, they publish an annual report looking at the position on fuel poverty.

Q218 Nick Ainger: You have told us that the PBR is now requiring Ofgem to publish quarterly reports. Is that not an indication, as Ms Perchard indicated, that in fact Ofgem have actually failed in their job to properly police the energy market?

Mr Richardson: No, I do not agree with that but it reflects the fact that there is concern around this issue and the Government wishes to ensure that the full facts are in the public domain, and we have therefore asked Ofgem to produce these quarterly reports so that the full information is available to people who are concerned about these issues.

Q219 Nick Ainger: Has work started on preparing any legislation to deal both with the operation of the energy market and social tariffs to address what are clearly major problems in terms of fuel poverty?

Mr Richardson: Social tariffs are a matter of voluntary agreement between the Government and the energy companies. They do not have a legislative underpinning. What the Government has said is that it stands ready to consult on legislation to tackle unfair pricing differentials between methods of payment for energy, should that prove necessary. Obviously, our hope is that the discussions between Ofgem and the energy companies bring that matter to a satisfactory voluntary resolution.

Q220 Nick Ainger: To address this winter’s fuel poverty the Winter Fuel Allowance has gone up by £50 for the over-60s and £100 for the over-80s but it is a one-off. The PBR does not give any indication whether this is going to be replicated in 2009. Is it likely to be replicated in 2009?

Mr Richardson: That will be a matter for future fiscal events.

Q221 Nick Ainger: It is strictly a one-off?

Mr Richardson: The policy is for it to be a one-off. Clearly, the Winter Fuel Allowance of £200 or £300 for a household with a person over 80 in it is an ongoing policy at a cost of somewhat over £2 billion a year; in light of the particular issues around the price of fuel this year, a one-off addition has been agreed for this year. As you say, the price of fuel in certain markets is considerably lower now and clearly that will have to be a consideration played into any future decisions on the rate of Winter Fuel Allowance in future years.

Q222 Nick Ainger: But in terms of the operation of the market and the reluctance of energy suppliers to bring their prices down in line with wholesale price falls, as far as you are aware, there is no preparation for any legislation to cover that?

Mr Richardson: As I said, the Government has said it is ready to consult on legislation to tackle unfair pricing differentials but I think our view is that the energy market is competitive. Clearly, when the facts come out from the Ofgem quarterly reports, we will look at that in light of the facts.

Q223 Mr Love: Mr Maxwell, turning to mortgage markets, what are the objectives of the Lending Panel that you mentioned earlier on? Is it solely to get lending back to the levels in 2007?

Mr Maxwell: The Lending Panel is intended to bring together different groups to, firstly, monitor levels of lending and then look at the policy issues and other issues that arise in relation to that. It is a forum to
bring people together, and it gives an opportunity to look at the situation and understand exactly what is happening and decide if things need to be done.

Q224 Mr Love: Let me ask you this. Northern Rock and, by implication, Bradford & Bingley, are shrinking their businesses and all the other banks and building societies are saying that that is going to have a major impact on lending to the wider market. How would the Lending Panel deal with that issue?

Mr Maxwell: The decisions about what to do with Northern Rock and Bradford & Bingley, in the case of Northern Rock, the business, following the rules set down at the European Commission around state aid, is reducing the size of its mortgage business in line with its business plan. That business plan will have to be updated over time. In the case of Bradford & Bingley, again, that business is being reduced in size. Those steps are in hand.

Q225 Mr Love: Could that not lead to criticism of the Lending Panel that where their overall objective is to ensure the supply of finance to the mortgage market, they are prepared to make exceptions for nationalised organisations; in other words, putting additional pressure on the rest of the banking and building society industry?

Mr Maxwell: I do not think it works like that. As I say, Northern Rock and Bradford & Bingley are in very particular circumstances. The people running those organisations now are doing so in the context of plans that have been agreed by the Government. The objectives in the case of both of those institutions are around promoting financial stability, around looking after taxpayers' interests as well as protecting consumers. However, it is worth saying that those lenders continue to be regulated by the FSA in their activities. They also have made commitments about how they will treat their mortgage borrowers, so those things remain in place.

Q226 Mr Love: One of the other concerns that is raised by the industry, particularly by building societies but I suppose it applies to some extent to banks, is that by reducing interest rates, which I think we all accept is necessary in the current economic circumstances, you will reduce the amount of money held by organisations like building societies available for re-lending so that there will be downstream an impact on mortgage finance availability. Is that something that the Lending Panel will look at?

Mr Maxwell: As I mentioned earlier, one of the key determinants of the ability of banks and building societies to be able to lend is having the right financing arrangements in place and that is both about having enough capital but also enough funding, and one of the sources of funding is from deposits but when you see base rates being reduced across groups of banks I think building societies and banks continue to be able to raise money through deposits to be able to support their mortgage lending. It is not affected directly by that.

Mr Ramsden: Can I just add, and it links back to earlier points about rebalancing, that at the macro level we are expecting the saving ratio to pick up back to levels of around 3%. That is typical during a downturn phase in the economy.

Q227 Mr Love: Even under the possibility that interest rates may go to zero?

Mr Ramsden: Under the assumptions on which we put this forecast together, which were consistent with market expectations of a couple of weeks ago, we have got the savings ratio picking back up. That will play into the issues you are raising but at the macro level.

Q228 Mr Love: I do understand these are difficult judgments. Can I turn to the scheme announced on 3 December, it think it might have been by you, Mr Ramsden, but you will correct me if I am wrong? First of all, why was it not announced as part of the Pre-Budget Report? Was it that you did not think that the Pre-Budget Report had done enough for home buyers? It was described by our experts last week as a political gesture. Will it have any real impact?

Mr Ramsden: I will hand over to Clive for this.

Mr Maxwell: If you are talking about the scheme to help people who suffer a temporary loss of income and stay at home—

Q229 Mr Love: That is right.

Mr Maxwell: — I think that has the potential to offer a real benefit to those particular groups of people that it is targeted at.

Q230 Mr Love: But how many people do you estimate that it will help because there have been reports in the press that range from several thousand right through to a very large number? What sort of numbers are you expecting to benefit?

Mr Maxwell: I do not know how many numbers are going to benefit from that.

Mr Ramsden: Can I make a general point related to that? If you think about what this scheme, along with a lot of the other policies that the authorities are introducing, whether it is the Bank of England or the Government, it is with the aim of boosting confidence about prospects for the economy once we get through this recession and minimising the extent of the recession. If you think of this scheme, there are nearly 12 million mortgage holders in the UK economy and the peak of repossessions in the last recession was about 75,000, so it is a very small proportion of that total. With a scheme like this there will be a debate about how many people will actually take it up but also it should be seen as a more general confidence-inducing measure so that people who fear they might get into difficulties are aware that there is an additional safety net for them.
through the scheme that was announced on 3 December. Again, I do not know if it is relevant, but in a macro context that is how I saw the scheme.

Q234 Mr Love: And will that impact be mostly at the end just before it is taken away or during the whole of the period?

Mr Ramsden: The way we saw this one operating I do not think the relative price effects on a house are as strong as they are on a consumer durable, for example. We costed it as having pretty much the same amount of impact in 2008–09 as in 2009–10.

Q235 Mr Todd: The Government, as part of the PBR, put in some additional funding for debt advice. The CAB have told us the volume increases they are already experiencing in business. Is the sum allocated to them, welcome though it is and Teresa Perchard did welcome it, going to be sufficient to meet the sort of demand that is predicted in these times?

Mr Williams: There are two areas there. There is the money that has been given to Citizens Advice Bureaux, which is £10 million to March 2010. There is also additional money, £5.85 million to March 2011, which has gone to National Debt Line to increase telephone debt advice. They are quite significant extra amounts. If I look first at the Citizens Advice Bureaux money, that is estimated to enable local face-to-face advice capacity to be expanded.

Q236 Mr Todd: Has there been some research which shows which are the preferred routes for consumers with these problems?

Mr Williams: I think some consumers prefer one route; others prefer another. Not everyone, for example, would go—

Q237 Mr Todd: I appreciate that. I am just saying, has there been some research? Anecdotally I would agree with what you said but it seems that the Government is spraying in a variety of directions without necessarily working out which is the most effective way to assist people with these problems.

Mr Williams: I think it is more that we are recognising that people access the advice through different routes and you have therefore got to give them different ways of accessing it. For example, and hopefully not to digress, there is also going to be more information provided on line at Directgov.uk about debt advice.

Q238 Mr Todd: That is presumably just going to be signposting though, is it not, which is, “If you live within this postcode here are your CABs”, and, “If you want to ring up this number they can provide some help”?

Mr Williams: It is also going to provide some free advice online, which is obviously more basic than you could get by, for example, going to a citizens advice bureau, but maybe some people will choose to access the advice through that route.

Q239 Mr Todd: Experience tells us all that at times like these people do not necessarily think to take advice. They instead look towards those who are
offering them apparently easy ways out of their debt problem. To what extent has the Government anticipated that in terms of regulating more tightly the IVA marketplace and particularly the lender marketplace to prevent consumers making their problems still worse?

**Mr Williams:** The Government has, as you say, already looked at that and will, of course, keep under review whether more needs to be done with regard to that.

**Q240 Mr Todd:** I am sure you have seen some of the stories. I do not know whether your reading patterns are the same as Mr Ramsden’s but you will have seen some of the problems over mis-selling of IVAs and other attempts to persuade people that there are solutions to debt problems without properly facing up to them.

**Mr Williams:** I suspect my reading patterns are not the same as Mr Ramsden’s so I am certainly not going to confess to them being the same. Although you are right that some people will not access advice, equally, by providing advice through a number of different channels, we are doing all we possibly can to give them access to that advice.

**Q241 Mr Todd:** What I am highlighting finally is that we need to provide the advice but we need some assistance at the other end to stop the supply of wholly inappropriate solutions to some people’s problems because that has to be the other part of that package. I am not sure I have heard from you or from anywhere else that we are doing that second part.

**Mr Williams:** On that, you are absolutely right: there is a danger that people will turn to loan sharks, and since September 2004 the Government has committed £11 million to tackling the problem of loan sharks and the Department for Business is going to continue to fund teams to tackle illegal money lending in every region of the country.

**Mr Todd:** I think we are all consensual about the sharks. I am more pointing to the barracuda that are also out there who are people operating legally but inappropriately and mis-selling the services they offer, and the IVA suppliers are ones that are criticised strongly in this area. Anyway, I leave it at that, Chairman.

**Chairman:** Mr Ramsden, thank you very much. I am sorry for the overrun but your answers were very expansive and helpful to us in preparing for the Chancellor’s visit tomorrow, so we look forward to your company tomorrow.
Wednesday 10 December 2008

Members present

John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Mr Colin Breed
Jim Cousins
Mr Stephen Crabb
Mr Michael Fallon

Ms Sally Keeble
Mr Andrew Love
Mr George Mudie
John Thurso
Mr Mark Todd
Sir Peter Viggers

Witnesses: Rt Hon Alistair Darling MP, Chancellor of the Exchequer, Mr Dave Ramsden, Managing Director, Macroeconomics and Fiscal Policy, and Mr Mark Bowman, Director, Tax Strategy and Delivery, HM Treasury gave evidence.

Q242 Chairman: Chancellor, good afternoon to you and your colleagues in the Pre-Budget Report Inquiry. Can you introduce them for the shorthand writer, please?

Mr Darling: Yes, I am here with Dave Ramsden, who you saw yesterday, who is the Chief Economic Adviser to the Treasury, and Mark Bowman, who is the Director of Budget and Tax.

Q243 Chairman: Bank lending: the critical need to get banks to lend. The Governor of the Bank was before us a couple of weeks ago. What progress has been made on that? Is it still at an exhortation level?

Mr Darling: No, I bear in mind your stricture to be brief, Chairman, but it is quite a complex subject. The Governor is right, and I said on a number of occasions at the Pre-Budget Report and since then that, with interest rates being the lowest they have been since the early 1950s and with the fiscal stimulus that I announced a couple of weeks ago, the important factor now is to encourage banks to continue to lend into the wider economy. In October we took steps to recapitalise the banks, because that was absolutely essential. The banking system across the world was on the verge of collapse in many cases and it was necessary. That process has taken place. It has ensured that no bank has failed and we have also been able to secure the position of individual depositors in this country. In relation to those banks in which we have taken a stake, a shareholding, of which the RBS is the only one that so far actually has been completed—we now own 57% of RBS, but we will, assuming the merger between HBOS and Lloyds TSB goes ahead, own something like 40% plus there—there will be a specific agreement, which is that they have to maintain lending at the same levels that they were making available at 2007. It does not mean that everyone who wants to get a loan, whether it is for business or for buying a house, will get a loan on exactly the terms that they want, but it does mean that the quantity has to be made available, and, of course, in the last few days you have seen announcements from RBS, from Lloyds TSB, that they will pass on rate reductions and treat their business customers fairly. You have also seen an announcement from HSBC, which of course raised additional capital itself—it did not come to the Government—over the weekend that they would increase lending to both businesses and to home owners. As I said on 25 November in a written statement to the House, I have been looking at the way in which the Credit Guarantee Scheme has been operating, as well as other measures that will help increase lending, and I will be discussing some of those matters when I meet the chief executives of banks tomorrow. I can say in relation to the Credit Guarantee Scheme that we made £250 billion available; £100 billion has already been subscribed by banks; so they are actively taking up the scheme. Obviously, we will not disclose who is taking it up, for reasons, I think, the committee will appreciate. There is perhaps just one thing I could add for the sake of completeness, Mr McFall. Today, as you know, I attach considerable importance to financial stability, and the Banking Bill going through Parliament at the moment strengthens the Bank of England’s role there, and following the decision of Sir John Gieve to stand down as Deputy Governor, and I would like to place on record my appreciation for what he did. I am sad not wish to serve a second term. I would like to put on record my appreciation for what he did at the Bank and for many years in the Treasury, we advertised, following the new procedures, for a replacement and I can tell you that this morning the Queen has approved the appointment of Paul Tucker as the new Deputy Governor responsible for financial stability. He will take up office on 1 March, but there will be plenty of time for you to carry out your pre-appointment confirmation hearings. Finally, again for the sake of completeness, Professor David Blanchflower, who is a member of the MPC, has informed me that he does not wish to serve a second term. I would like to put on record my appreciation for what he did. I am sad that he has reached that decision, but I think his commitments in the United States are making it difficult for him to fulfil his duties. Again, we will advertise to prepare for his replacement, and the committee will be involved in that in the normal way. I am sorry that is a long answer, but it is quite a complex area.

Q244 Chairman: It is very welcome, getting that information in advance. We have not always had that, so it is very good to get that, and we will be able to plan on that issue. We are sorry that Professor
Blanchflower has not taken up a second term, because he gave us information in this committee that was what we would describe as unique. It was very helpful to us.

Mr Darling: I am sure he will appreciate your remarks.

Q245 Chairman: Thank you. On the issue of interest rates coming down, Chancellor, a number of people have contacted us regarding the balance between borrowing and saving. Is there anything that can be done for savers? Do you have any comments or initiatives in that area?

Mr Darling: There is clearly a tension between the interests of somebody who is borrowing money from a bank and somebody who wants to put money into a bank and get the best return that they can, and that is why I said on Friday, following the reduction in interest rates that the Bank announced last week, that it was not surprising that some institutions were having to weigh in the balance their desire to pass on those reductions and the fact that they do need to attract deposits. That is particularly the case in relation to building societies which rely to a very large extent on getting money in through the door so they can then lend it out. The MPC fixes its interest rates in accordance with the duty it has to target our economic objectives. So that is what they are targeting, and in doing so they reached the decision that interest rates were to fall yet again, but, obviously, from the point of view of savers, banks do have to ensure that they can offer a sufficiently attractive rate to get savings in. The other thing is that there is potentially also a tension between our desire to ensure financial stability to build up the capital position of the banks and our desire to ensure that banks lend out into the wider business community and to individuals. I think in that case that is a tension that can be reconciled. I think the recapitalisation has gone a long way to help our banks build up their capital position and, as you were suggesting earlier, I think, in relation to your very first question, the key now is to ensure that we can also encourage those banks to be healthy and also to lend to businesses and to lend to people.

Q246 Chairman: Should interest rates fall to zero? Do you think the concept of quantitative easing will come on the agenda?

Mr Darling: Interest rates have not fallen to zero yet; they are still at 2% and they still have some way to go, but I think, in relation to what we might do over the coming months and even beyond that, the situation is full of uncertainties. Just look at the information we are getting in now from across the world—Europe, Japan, the United States. There are an awful lot of uncertainties out there and I think we will always be in a position where we will react to the circumstances as we need to, but interest rates are still at 2%, we have not got to a situation where they are down at zero per cent yet.

Q247 Chairman: Given that uncertainty, through the 232 pages of Pre-Budget Report there is no mention whatsoever of deflation. Is that not on the agenda? Are you not thinking of that?

Mr Darling: We are. The Bank of England is forecasting very low rates of inflation on the CPI measure. I think where deflation becomes a problem is if people believe that prices are going to continue to fall for a long time and, therefore, they defer spending on the basis of that. If we look ahead, although now, for example, with oil at about $40 a barrel, it seems a long time ago, but in the summer they were way up approaching $150 but, as the economy starts to grow and the world comes through this, some of the inflationary pressures that we saw in the summer, I am afraid, have not gone away in relation to commodity prices. So whilst you do need to be mindful of the problems that deflation could cause, at the moment I think that the greater risk to our economy and the greater risk to the world economies is the need to maintain growth and the need to maintain bank lending. That is why it is so important that other countries around the world are prepared to take action, and I very much welcome what President Elect Obama was saying at the weekend, where he has indicated that his new administration has at the very front of its mind the need to put further stimulus into the United States’ economy, because that will be very, very important to all of us.

Q248 Mr Brady: There was speculation in The FT this morning that you might be looking at a wider guarantee for bank lending. Was any such wider guarantee considered at the time of the recapitalisation package?

Mr Darling: The speculation comes from a very good source. It is what I said at lunch-time in the House of Commons yesterday. You remember that when we announced the recapitalisation scheme at the beginning of October at that time we were the first in the world to do this, and I said that we would keep under review the way in which it had worked. As I said, £100 billion has been subscribed so far, but I think it is right, and I said further in my written statement of 25 November that I would look at what else we needed to do, but, I will make very clear, I am prepared to look at a number of things that will make it more likely that banks will lend. However, from the banks’ point of view, they have to understand that with billions of pounds worth of tax payers’ money either invested in shares or being made available as a guarantee, the general public, businesses, people, are entitled to something in return. So, yes, if we do something, that I think will be welcomed by people, but we have also got to make sure that it gets passed through. There are encouraging signs—the HSBC announcement at the weekend is very welcome. RBS’s statement in relation to how it will treat its business customers, the same with Lloyds TSB announcing they will pass through the reductions—but I think we do need to go a bit further.
Mr Brady: Did you consider doing so at the time you announced the recapitalisation package?

Mr Darling: Remember, when we drew up that scheme, at that time we were in uncharted waters and we could not be sure anybody else would do it; we were on our own for a few days. What we tried to do is to make sure that the essential elements were there, building up the capital position, giving banks the choice as to whether they did it through the Government or elsewhere. On the Credit Guarantee Scheme, we wanted to ensure the money was there to help the inter-bank lending, but we had to price it in such a way—. I remember there were a lot of questions in the House of Commons at the time with people saying, “Well, the tax-payer was doing this but are you getting a return for it?” The actual amount we charge, there is no magic number to that, the important thing is to get it right, although interestingly, as I say, £100 billion has already been subscribed, which does tend to suggest there is a demand for it at the price that we are offering but, as I say, it is one of a range of things we are looking at.

Mr Darling: It would affect us in different ways. Firstly, one of the biggest effects would be what would the impact be on the wider economy in terms of employment? As I said to Mr McFall—and I am going to look at the up-side actually—one of the reasons that I am more confident that we will get through this sooner rather than later is that, with lower commodity prices, with lower inflation, lower interest rates, the effect of the lower exchange rate, there are many things that will actually help us. So low inflation, lower prices and lower commodity prices will actually help the economy. Where deflation becomes a problem is if people come to believe that prices will be low and low for a long time or will be falling for a long time—then that would cause a problem—but I do not think we are in that position.

Mr Darling: I think the temporary VAT cut puts £12.5 billion into the economy. So it is putting money into the economy at the moment, but in order to achieve its economic effect it has to be something that is temporary and focused and, obviously, VAT will go up at the beginning of 2010.

Mr Darling: I think the temporary VAT cut puts £12.5 billion into the economy. So it is putting money into the economy at the moment, but in order to achieve its economic effect it has to be something that is temporary and focused and, obviously, VAT will go up at the beginning of 2010.

Mr Darling: I think, if I look across the piece, if I look at everything we are doing, if I look at what is happening and is likely to happen in relation to prices generally, whilst it is undoubtedly the case that commodity prices, for example, will fall, fuel prices will fall, energy prices will fall. I think that where it will become a problem for the economy is if people thought those prices were going to fall for some considerable time: then people’s behaviour responds. I do not think we are in that position at the moment. It may be that Mr Ramsden wants to add to that, if he is allowed to.

Mr Ramsden: All I would add is that the subsequent return of VAT to 17.5% will obviously bring the price level back up very quickly; so this is a temporary period when only on the RPI measure do we see prices falling and very specific prices which are included in RPI and are not included in CPI, so it is mortgage interest payments and house prices.

Mr Darling: I understand that problem, and obviously for sometime we have been concerned about the road transport industry generally. However, they are benefiting from the fact that fuel prices are falling now, and you can see that at the pump, especially in petrol, slightly more slowly in diesel, which I understand is partly due to refining capacity, and prices are further apart than one would like but that is where we are. What I wanted to do with the VAT reduction was to benefit as many people as I could, but I do have to get some revenue in at some stage.

Mr Darling: As a matter of long-term policy, do you accept that the British haulage industry is operating in a very competitive European market and it is not sustainable to put a higher burden on British hauliers than continental ones?

Mr Darling: As you know, this has been a long-running problem going right back to 2000. We have looked at a number of factors that influence the costs that hauliers have to face. I think there is a number of things we have done to help in relation to the duty that hauliers pay, but the biggest help that they will get at the moment is the price of fuel is coming down and, as long as crude oil remains at around $40, we would expect to see that go well into the coming year.

Mr Darling: What I said in the statement was that I expected the economy to start to grow in the second half of next year, which is slightly different to the form of words that you use and different again to the ones you used yesterday. I think, based upon the information that we have, based on the low interest rates, the advantages that will come from lower inflation, the fiscal stimulus that I put into the economy in the Pre-Budget Report, and also there are other factors—our economy is pretty flexible—I believe that the economy will start to grow in the second part of next year. It is broadly in line with
what the Bank of England, quite independently of us, has also been saying. But there is a lot of uncertainty out there. There is not a day that goes by when there is not news from one part of the world that people, obviously, sit up and take note of. A few months ago people assumed, for example, that the Asian economies—China and India—would carry on with precious little effect; whereas it is obvious now that there is not a part of the world that is not being affected by this; this truly is a global problem.

Q256 Mr Fallon: The UK news this minute is the National Institute says output will fall more sharply than expected, and Andrew Sentance from the Monetary Policy Committee has said this session is likely to be comparable in length and depth with the previous three major post-war downturns.

Mr Darling: Yes, I saw what he said. As I say, the Bank of England and a member of the MPC are not necessarily responsible for everything the Bank does, and he is entitled to his own view. Its forecasts are broadly in line with ours and its forecast, of course, was drawn up before the Pre-Budget Report, so it would not have taken into account the announcements that I made at that time. Also, in relation to the National Institute Report today, we do expect the fourth quarter, if you like, to show that the economy is slowing and has slowed. I have been saying now for a few weeks that we are, like every other major economy in the world, moving into recession, and that remains the case.

Q257 Mr Fallon: Does your recovery forecast depend on bank lending returning to the levels of 2007?

Mr Darling: It clearly will be influenced by bank lending, and, indeed, the Pre-Budget Book makes that clear, that we hope that bank lending will begin to recover throughout the course of next year. The 2007 levels pertain to the banks that we are taking shareholdings in, but I think that is set out in the Budget Book.

Q258 Mr Fallon: If the economy does start growing again next summer as you hope, would unemployment continue to rise?

Mr Darling: Inevitably, there is a lag usually between the time that it takes for the economy to rise and for that to be reflected in jobs. We saw that both in the 1980s and 1990s.

Q259 Mr Fallon: The OECD has forecast that unemployment could reach nearly 8% by the end of next year. That is 2.5 million. What is your estimate?

Mr Darling: We know that unemployment has increased, and as the economy slows down it is inevitable that more people will be at risk of losing their jobs. The reason that we put more money in is because the evidence that I think is widely accepted now is that, although it may be expensive in terms of employees in the Department for Work and Pensions and Jobcentre Plus, if you can get to people when they are still in work, even after redundancies have been announced, you have got a better chance of placing them elsewhere. There is not a correlation, if you like, between DWP employees and the number of people out of work is concerned, indeed there is always a negotiation, as you might imagine, between me and the Secretary of State there, but Jobcentre Plus’ experience over the last eight or nine years has been quite positive and we do need to increase the staffing in anticipation of what could well happen.

Q260 Mr Fallon: You have said that you need to spend £400 billion more on job centre services next year and the year after, so you must have made your own statement of the increase in unemployment.

Mr Darling: We know that unemployment has increased, and as the economy slows down it is inevitable that more people will be at risk of losing their jobs. The reason that we put more money in is because the evidence that I think is widely accepted now is that, although it may be expensive in terms of employees in the Department for Work and Pensions and Jobcentre Plus, if you can get to people when they are still in work, even after redundancies have been announced, you have got a better chance of placing them elsewhere. There is not a correlation, if you like, between DWP employees and the number of people out of work is concerned, indeed there is always a negotiation, as you might imagine, between me and the Secretary of State there, but Jobcentre Plus’ experience over the last eight or nine years has been quite positive and we do need to increase the staffing in anticipation of what could well happen.

Q261 Mr Fallon: But you still have not given us your estimate of what will happen.

Mr Darling: No, because we do not publish estimates of what we think unemployment will be.

Q262 Mr Fallon: Do you make an estimate of what unemployment will be?

Mr Darling: What we do is we look at the consensus of forecasters, and that is what drives the assumptions that underpin our overall fiscal position.

Q263 Mr Fallon: Is the OECD likely to be right that unemployment scales will jump by 700,000?

Mr Darling: Lots of people will make predictions, and I am not proposing to do so. What I do know is that next year is going to be tough, is going to be difficult, for reasons that are perfectly obvious, not just here, but if you look at what is happening in the Euro area it is in recession, America has now been in recession for a year, the problems have now spread to the Far East to the Asian economies, they are beginning to affect South America. There is not a corner of the world now which is not being affected by this, which is why I keep coming back to the point: it is all the more important that countries across the world take the appropriate action to try and ensure that the recession, when it comes, is less painful and less damaging than it would otherwise be.

Q264 Mr Fallon: But despite what happened in the past, would it not be more honest and open if you told people how much unemployment they were now facing? If you have your own estimate that it is going to go up by 700,000, you are planning for it, why not publish it?

Mr Darling: As I say, no government has in this country. I cannot speak for other countries. In making our calculations in relation to the fiscal position we have got to make some assumptions,
and what we have done is we look at what forecasters are saying and we work off that consensus. That seems to me to be far better, rather than to make predictions: “It’s official. The number is X.” I do not think that would be particularly helpful to anybody, frankly.

Q265 Mr Fallon: It seems odd to work off other people’s assumptions when you must have got your own internal estimate, which you are now covering up, that unemployment is going to jump by 700,000?

Mr Darling: In order to work out what the impact of unemployment is on the overall fiscal position we have to make an assumption and, at the risk of repeating myself, the assumption we make is driven off the consensus, if you like, of the forecast. That is what we do. The NAO looks at these things and I think I am right in saying that at the time of either the last Pre-Budget or the last Budget they said that was a sensible way of proceeding, and that is what I propose to do.

Q266 Mr Fallon: So the current assumption you are working on is that unemployment will rise by how much by the end of 2009?

Mr Darling: What we are doing is saying, if you look at the book—in fact can you get me the relevant page—that we think that unemployment will rise. It is all set out there on page 188 in the green box, B1.

Q267 Mr Fallon: Yes, I am looking at that. That only gives you the claimant count. So the actual total will be what: 2.5 million?

Mr Darling: That is the assumption that we are working off, and those are the figures that we have published.

Q268 Mr Fallon: So you are not going to give us the real figure?

Mr Darling: I am going to give you the figure. I am giving and have given you the figures that are in this box.

Q269 Mr Fallon: So it is around 2.5 million?

Mr Darling: What that has there—. If you look at it, the claimant unemployment, you will see the figures set out there.

Q270 Mr Fallon: That is the claimant count, not the headline figures?

Mr Darling: That is the assumption which the numbers in the Pre-Budget Report are drawn on.

Q271 Mr Breed: Can we turn to the value of sterling, Chancellor? Is there a point at which, should sterling fall any further, it would turn from being potentially advantageous for our economy to becoming more of a hindrance to any growth?

Mr Darling: Look, for perfectly good reasons, finance ministers do not do running commentaries on exchange rates. Exchange rates right across the world have been pretty volatile, very volatile in fact. The point that I was making earlier is that because of the depreciation, that clearly does help our exporters, but currencies generally have been pretty volatile over the course of the last few months.

Q272 Mr Breed: Yes, we explored this yesterday. You must have come to the conclusion that there comes a point in time where the advantages of the lower sterling value to our economy cease and begin to affect potential growth. We are trying to find out where that might be. Not to forecast what sterling is going to be, but just where that point might be.

Mr Darling: I do not have a figure in mind, but what is important, I think, if you look at the longer-term health of our economy, is that people can be confident that we are taking the right measures to support our economy just now but also that over a period of time that people will be confident that the international context is providing a backdrop of supply and demand that is allowing us to support our economy in the long term.

Q273 Mr Breed: That would mean, therefore, that if we reached whatever that particular point would be that you would then be prepared to support sterling if necessary.

Mr Darling: No, the Bank of England’s policy is to target inflation, not to target the currency.

Q274 Mr Breed: So you would not support it.

Mr Darling: I said to you that I thought that the situation clearly has been volatile over the last period, but what I think is more important is that you make sure that the underlying fundamentals of the economy are right, and that is what I was doing in the Pre-Budget Report.

Q275 Mr Breed: So we do not know what the point might be and we do not know whether you would support it or not?

Mr Darling: What you can be sure of is that I will do everything that I can to support our economy, whatever that is.

Q276 Mr Breed: In the PBR you announced that port occupiers, amongst others, will have eight years to repay their back-dated business rate liabilities. You must be aware that there has been a huge angry response by a lot of port occupiers, who have pointed out repeatedly to us both as constituency MPs and to the select committee that this may leave their businesses technically insolvent at a very difficult time and, potentially, unable to legally continue in business. Have you not left those directors with a very difficult decision? Either they are forced to decide between closing down their business, or perhaps risking personal ruin through wrongful trading if they accept this eight-year period which they just cannot cope with.

Mr Darling: Firstly, the decision in relation to whether or not a company continues to trade has to be legally a matter for its directors. What I was trying to do was to help a lot of people, particularly people who occupy comparatively small premises and ports who have been affected by a decision by...
the Valuation Committee which has caused a lot of difficulty for people. I was trying to strike a balance between giving people sufficient time to adjust and time to pay with the fact that, as with all things, it can be difficult, but we do need to get some revenue in.

**Q277 Mr Breed:** These are real liabilities that businesses simply cannot afford to pay at this present time.

**Mr Darling:** Businesses have many liabilities and business rates are one of them, but with a thing like this, if people have got representations to make, the whole point of a PBR is that you can come back to these things in the Budget if you need to. I do not want to give people false hope and I do not want to raise expectations that may not be fulfilled, but what I was trying to do here was to deal with a particularly difficult problem for quite a lot of businesses in port areas that have arisen simply because it seemed to me to be quite a fundamental change in approach by the Valuation Committee, which appeared to benefit people who were going to be made redundant, an amount of about £30,000 for many years now. To help some of those people who some might have thought had less broad shoulders as far as their ability to pay.

**Q278 Mr Breed:** One last question, Chancellor. The Governor has brought forward a number of measures for businesses and for those that have, unfortunately, maybe become unemployed in the foreseeable future. One of the areas that you have not tackled, in fact, is the threshold to the non-taxable part of redundancy payments. It has been about £30,000 for many years now. To help some people who were going to be made redundant, an increase in that non-taxable element would help considerably for those that are going to find it difficult to find a new job quickly. Has the Government given any thought to raising that threshold which, quite frankly, has been at the same level for very many years?

**Mr Darling:** I think we have actually looked at it on a number of occasions, and I remember it being looked at before I was Chancellor. Yes, I looked at it in the Budget and I looked at it in the Pre-Budget Report, as I did with a whole range of other things that I had to take into account, and I will continue to keep it under review. I know it has not been changed for some time, and there are many things that I might like to do, but I have to operate under some constraints.

**Q279 Mr Breed:** At the present time you have concluded that £30,000 is the right approach.

**Mr Darling:** Obviously, I did not change it in Pre-Budget Report, but it is something that I will very much keep in mind.

**Q280 Mr Crabb:** Chancellor, have you been involved in any discussions, either internally within the Treasury or with your colleague, the business secretary, about a list of strategic business sectors to protect and save as the downturn worsens?

**Mr Darling:** We have been discussing the impact of the downturn not just in the financial sector but in the wider sector, and I dare say we will be called upon to react to a number of things over the coming year, but, for understandable reasons, unless the person who approaches us chooses to make it public, we do not intend to make public people’s approach if they think they might need assistance in difficult conditions, because it could be quite unhelpful, but what I am saying is we would look at all these things on the merits.

**Q281 Mr Crabb:** The statements from the business secretary at the Treasury suggested a rather more proactive approach than that, not just responding to requests for assistance but actually proactively drawing up a list. Are you aware of any such list being drafted?

**Mr Darling:** What we do need to look at is, in the event of some large institution getting into difficulty, what would be the wider repercussions on the economy. Let me give an example. You may think it is a perverse example, because it is one we decided not to act in, but when Rover collapsed in 2005 one of the considerations that we took into account was what effect it would have on the wider economy in the West Midlands. We also, though, had to take into account was there a future for Rover, as it was then, and we came to the view that because the economy at that time was growing quite strongly, because the Rover business model was clearly in difficulties, it would be better to try and get people relocated. At the present time, when you are dealing with a substantial downturn, we would look at these cases on their merits, ask ourselves what are the implications here, perhaps for the chain of supply for companies—there is a whole range of things—but I would not want you to think that we just wait there until someone pitches up at 1 Victoria Street. Of course we give these things a lot of thought, but sometimes these thoughts are ones that for obvious reasons we keep internal to government.

**Q282 Mr Crabb:** Assuming either that there is a list or assuming that someone does pitch up and makes a request that you listen to sympathetically at Downing Street, what might be the levers available to you to assist in protecting them?

**Mr Darling:** It would really depend on what the problem was and what was being looked at. As you know, at the moment the Department of Business and Enterprise directly, or through the RDAs quite often, can help businesses. For example, if you take the automotive industry, when I was Secretary of State for Trade and Industry we were able to help Vauxhall get the new generation of Astras built in Ellesmere Port. That would not have happened if it had not been for our intervention. So there is one mechanism. I announced a range of other measures, like, for example, the time to pay in relation to VAT, national insurance, and so on. That can help businesses. There is a whole range of things that you can do, but it is terribly difficult to speculate in relation to the hypothetical or even the nearly hypothetical.
Q283 Mr Crabb: Is it hypothetical if you recently wipe clean the tax debts of a number of profligate football clubs who have wracked up tens of million of pounds of tax debt? I am sure I could think of a few more potentially more deserving business sectors that would be pleading for a similarly understanding relationship with your department!

Mr Darling: You recall that I did announce that HMRC is now stepping up its Time to Pay campaign. Obviously, we will never disclose who approaches the HMRC, and I do not know who approaches them for perfectly good reasons, but if people need help to defer payment of tax in the current circumstances, that service is available to them.

Q284 Mr Crabb: Moving on, if I may, and picking up the point about exporters, you mentioned it and it came up in yesterday's discussion with your colleagues over at the Home Office trying to do and the evidence that there is now about the sensitivity between the price of alcohol and young people’s alcohol consumption? Do you not think that the tax breaks for alco-pops is a bit reckless?

Mr Darling: Firstly, you recall in the Budget I announced a 6% increase in alcohol duties, and I did so, and I was very explicit about this, to raise money to pay for increased provision for children and pensioners, and I did not link it with the arguments about health, but you will bear in mind that in relation to the duties it is not possible to discriminate. You can with spirits, wines and beers, but it is not possible to start breaking down categories of alcohol. I think Mark knows more about the technical side of it than I can recall, but there is a limit to what you can do. I know, for example, in the last Budget there was talk at that time—I think your party was on about taxing alco-pops. My advice is that it is not possible within the current European rules to separate them out. What I tried to do in the Pre-Budget Report though was to leave alcohol more or less where it was. In other words, I cut VAT but I increased the duty so the tax paid, the price that people pay, would stay approximately where it was; and actually the end result of it was that, I think broadly speaking, if you buy alcohol on-sales, in pubs, and so on, it is slightly cheaper, if you buy it from the supermarkets it is slightly more expensive.

Q285 Mr Crabb: But it has been a persistent concern of the likes of the CBI over the last four years that UK exporters have not done better.

Mr Darling: Well, we always want them to do better.

Q286 Mr Crabb: Yes, but given how well other countries are doing, I have one more question to conclude, Chancellor, if I may. Do you not think it was deeply irresponsible to give what effectively amounts to a tax break to alco-pops, given all the concern that there is around teenage drinking and all the work that your colleagues over at the Home Office are trying to do and the evidence that there is now about the sensitivity between the price of alcohol and young people’s alcohol consumption?

Mr Darling: I say that as Chairman of the All Party Whisky Group here!

Mr Darling: I think Germany has taken something similar. Despite some of the things we have been saying lately, I think Germany has taken action and will no doubt continue to do more.

Q287 Chairman: You did not change your mind on Scotch whisky, Chancellor, did you, because you left the profit?

Mr Darling: I will tell you why I did it.

Q288 Chairman: Your officials did not know the strength by volume.

Mr Darling: Perhaps we should have handed a few bottles of scotch around the place. It would have concentrated the mind at least for a short time!

Q289 Chairman: I say that as Chairman of the All Party Whisky Group here!

Mr Darling: What we wanted to do was to try and keep the thing broadly flat across the whole piece. Obviously, because duty is applied by alcohol content, it would have put whisky up too much, so the duty increase on whisky was 4%, not 8%, and the result of that is that—I was looking at the price of spirits just now—if you buy it in a pub, very approximately, you are paying 70 pence less duty. So, who knows, it might lift the ban on me going to any pub in this country!

Q290 Mr Mudie: It was absolutely nothing to do with you being Scottish, was it?
Mr Darling: You are Scottish too.

Q291 Mr Mudie: You were totally impartial!
Mr Darling: If we had applied it across the board, it did have a perverse impact on whisky, and that was not my intention. My intention was that we more or less kept a level playing field.

Q292 Mr Mudie: You have persuaded me.
Mr Darling: Maybe you will buy me a drink at the end of this to celebrate.

Q293 Mr Mudie: I would be happy to, Chancellor, because I do not think I will get through all the questions and we can finish off! What percentage of UK lending in terms of businesses and households are covered by the banks you have recapitalised or the ones that are in the agreement?
Mr Darling: On small—

Q294 Mr Mudie: On business lending and households.
Mr Darling: My recollection is—. If you want exact figures I had better write to you on this. I am just going to give you an idea for it. RBS, which is actually one of the biggest banks in the world, which we own 57% of, and Lloyds TSB, between them, I think, are responsible for about 60% of lending to small and medium-sized businesses. If you look at mortgages, HBOS is probably the biggest mortgage lender, but other banks do a lot of mortgage lending as well. Northern Rock was the fifth biggest mortgage lender.

Q295 Mr Mudie: So they are a fair bit of the market?
Mr Darling: RBS and Lloyd’s, HBOS certainly. If that merger goes ahead, it will be quite a large—

Q296 Mr Mudie: I am interested because coming from Question Time and reading the papers and speaking to constituents and colleagues, there is a consensus that the Government acted very well in rescuing these banks. Not moralising, just getting stuck in, realising the danger of the crisis in the financial markets right across to the real economy, recapitalised and the bankers have thrown your good works back in your face. I think that is a general consensus as we sit, but you appear to be encouraged, and I would like a definitive statement where you feel you are with the banks. Are they behaving badly in terms of lending and reasonable rates, or do you think we have turned the corner and we are all slightly behind the curve in the argument?
Mr Darling: No, I agree with you on the first point you make. I think most people accept that we had to recapitalise the banks otherwise we would have been facing complete calamity. In relation to lending, as I said, to Mr McFall at the start, there are two separate forces at play here. One is that we need to build up the strength of the individual banks. If you take, for example, HSBC, which is one of the biggest banks in the world, a lot of its business is outside Britain: because of its basic strength it was able to announce at the weekend the five billion dollars lending for small businesses, it also announced a big extension of lending into the UK domestic market, which it has not been previously able to. That is where you would like to be in the case of a lot of banks. In relation to the other banks, I think the position is mixed. If you look at what has happened, for example, in the last two interest rates cuts, in many cases it was all passed on, but in some cases it was not. HBOS, for example, broke the floor they have on their tracker mortgages and actually reduced those interest rates, but they did not do it for the standard variable rate. If your question is: do you need to do more? Most certainly, yes. I am prepared to do more to help free up lending, but one of the reasons that we established the Lending Panel, which has its meeting tomorrow where I and Lord Mandelson will meet the chief executives of the biggest banks as well as Nationwide tomorrow, is because we believe there is more that banks can do, particularly in the small and medium-sized enterprises where, frankly, the well-being of our economy depends on the ability of people to get credit. The price, obviously, in terms of interest rates, is important but actually the availability of money is very important as well.

Q297 Mr Mudie: You said there “particularly the small business field”. Does that mean you are content with the way things are going in the household field, the mortgage field?
Mr Darling: No.

Q298 Mr Mudie: They are the two areas.
Mr Darling: I am sorry; I thought you were asking me about small businesses.

Q299 Mr Mudie: No, I am asking on both fronts.
Mr Darling: I think right across the piece, I think I said this when I answered Mr McFall’s first question. Both in relation to people wanting mortgages—and obviously the problem in mortgages is slightly less acute today, simply because the activity in the housing market is pretty low, although I am very conscious of the fact that when the housing market picks up people will be wanting mortgages and we have got to make sure there is the availability there—but also in relation to businesses. Yes, in answer to your question, unequivocally much more needs to be done, and that is what we want to do.

Q300 Mr Mudie: Chancellor, I do not want to go into another colleague’s field in terms of housing, but one of the reasons the mortgage market is down is the banks have put the amount you borrow up too low, so you have to put a huge deposit in, and that is scaring kids and everybody else from the market. In other words, we are in a war of headlines here and I think the banks are winning, because the banks play ducks and drakes, they want to increase, and then you play hell with them, it fades away and the next one comes and it is a smaller one and they meet you and you say it is wonderful.
Mr Darling: I do not think anyone says it is wonderful at all.
Q301 Mr Mudie: People out there are saying it is pretty bad in terms of getting a mortgage, and people out there in small businesses are saying it is pretty bad either carrying on your existing agreement or getting a new agreement. You sit there and smile. You seem to be encouraged. I am just trying to find out: are we all out of tune or are we not seeing what you are seeing?

Mr Darling: I think I am largely agreeing with you, that a lot more needs to be done both in relation to—. Let me finish.

Q302 Mr Mudie: Good. Let me just ask you a small question in terms of what needs to be done. Is there an element there that the banks in question are not sticking to the remit you made when you put the £37 billion in, or you put a lot more than that in? Are they not sticking to it?

Mr Darling: No, what I was trying to explain to you is that banks are obviously trying to build up their capital position, and that is another long-term interest that that happens. We also want to make sure that they maintain their lending. In relation to RBS, where the deal has now been done, if you like, because we now have those shares, they have an undertaking in terms of the availability of lending; and they have announced, for example, about two or three weeks ago, that they would ensure that they treated their business customers in a better way than in the past. If you ask me, "Is there more to be done?", my answer is that there is much more to be done. That is one of the reasons that I am meeting all the banks again tomorrow, to ensure that we identify problems, we sort those problems out. In relation to mortgages, the point that I was making is that as of now, the beginning of December, where the housing market tends to be flat anyway but in the particular circumstances of the day it is pretty flat, the problem is not quite so acute, but it will be next year. That is why I want to make sure that more mortgage lending is available.

Q303 Mr Mudie: You say you agree with me. This is a matter of misunderstanding, because my view is you have behaved very well as a government towards these bullheads who have got us in this mess in the first place, you have done very well, and they are not playing their part. Do you fall out with that statement?

Mr Darling: As I said to you, I think there is a lot more we need to do.

Q304 Mr Mudie: No, I have just made a statement. I have just asked you: do you fall out with it? You said you agreed with what I said. Well this is what I say.

Mr Darling: I would put it differently. I would just say that we have recapitalised the banks. The banks have to understand that we have put very substantial sums of public money in to support them. They, in turn, have to play their part. There are a number of areas—

Q305 Mr Mudie: But are they?

Mr Darling: There are a number of areas where I believe they need to go much further.

Q306 Mr Mudie: For example?

Mr Darling: In terms of making available lending both to businesses and to individuals.

Q307 Mr Mudie: Can I ask you about your rates? We berate the banks for not lowering their rates when the base rate goes down. You have put 12% on an aspect of the rescue plan. The Bank of England has got a very expensive haircut on money they lent. In the last months have you as a government reduced any of the rates that you are charging the people we are berating? Have we changed any of the rates?

Mr Darling: I was going to answer. As soon as you stop, I will start.

Q308 Mr Mudie: I will stop.

Mr Darling: Good; I will start. What drives the banks’ cost of lending is how much it costs the banks to borrow, which is substantially driven off the LIBOR rate, which is down on a couple of months ago. The 12% that you are referring to, which the Leader of the Opposition referred to at Prime Minister’s Questions today, is not the cost of funding, it is the cost of the equity: it is a preference share premium. You must have misunderstood the position, but that is the remuneration, if you like, the premium that they pay us for the preference shares that we now hold, and the reason we did that was that we wanted to stop us putting money into a bank simply to see it go out the other side straight to the shareholders without actually doing what we are wanting. Those prices have not been changed, but as part of my general review of how the Credit Guarantee Scheme is working and how the recapitalisation scheme is working, that is one of a number of matters we are currently looking at, as I announced on 25 November.

Q309 Mr Mudie: Okay. My good friend Mr Brake has pointed out that the US charge is 5% compared to your 12%, but there you are. Can I go to child poverty? Yesterday we finished it in two seconds, because Mr Williams confirmed that we had a target of 3.4. The 2010 target was 1.7, that is half children, half poverty, and at the moment we are 1.1 million. So, in 11 years we have on average taken 100,000 kids out of poverty, which is laudable, but we have 600,000 to do if we are to meet our 2010 target. In other words: two years, 600,000 children. I know Mr Ramsden gave me the answer yesterday in terms of the PBR says you are going to take stock at the Budget time. Can we convert that into you would still feel confident you will meet the 210 target?

Mr Darling: The position is that if that is what Dave Ramsden said, he is right. I am sure he is always right.

Q310 Mr Mudie: He was in a bad mood yesterday, I should tell you.
**Mr Darling:** I read the transcript, Mr Mudie. I could almost see why he was. Look, as you rightly acknowledge, this is an extremely important target to us. I will have to reach a decision, just as I did in the last Budget, as to what we can do in the Budget next year. I cannot make that decision today, obviously. At the Pre-Budget Report what I did was to bring forward some of my decisions that I announced in March, particularly in relation to the Child Tax Credits. We will, of course, hopefully, if the department agrees, by the end of the session, have a statutory obligation on government to ensure that we do eradicate child poverty over that 20-year period, but I will have to make a decision in the spring as to what I do.

**Q311 Sir Peter Viggers:** Chancellor, you led your Budget by a proud statement that the United Kingdom is in the best position to withstand recession than most other countries. Since when, of course, sterling has fallen steeply against the dollar and the euro. Has the market got it wrong or were you right?

**Mr Darling:** The market is pretty volatile at the moment. As I said to Mr Breed a while ago, if you look at the volatility in currencies even over the last few months, it is perhaps not surprising, given where we are and the figures coming out of various countries from time to time. The point I was making—two points really—firstly, if you compare where we are now to where we were at the 1990s or the 1980s when we had interest rates of 15% or 17%, we had much higher rates of inflation, much higher rates of unemployment. We have got 29 million people in work at the moment. We are better placed than we were then, and we have just come out of a period when we had over 10 years’ uninterrupted growth that this country has not seen, certainly not in modern times, and although debt is now rising, we did reduce it quite substantially over 10 years and at the same time trebled public investment. So I think we are in a better position than we were on previous occasions in the 1980s and 1990s, and that is why I said what I said.

**Q312 Sir Peter Viggers:** Looking at public-sector-led debt, your Pre-Budget Report forecasts this will increase over the coming period.

**Mr Darling:** Yes.

**Q313 Sir Peter Viggers:** Beginning to stabilise for over 57% of GDP in 2013–14. Your previous estimates have proved to be optimistic. What is the upper limit of national debt that you think would be sustainable?

**Mr Darling:** We obviously want to keep debt as low as possible, and, again, it is rather like Mr Breed’s question. I do not think there is a particular number beyond which you cannot go. Even if you look at the gross debt figures—it is net debt we use, but if you look at the gross debt—our debt is still below that of France, Italy, Japan and the United States and, looking at net debt, even at that number it is still lower than the United States, Japan and Italy. Obviously, you want to keep debt as low as possible, and it is higher than we would like it to be, but I had to reach a judgment at a time when we are being hit by the credit crunch by, earlier in the year, these very high inflationary prices. What did I do to support the economy? Firstly, and I think there is all-party agreement to this, you let the automatic stabilisers play their role. That is quite expensive actually in terms of rising benefits, but we have to do that. It does affect your borrowing. I also have to take account that our revenues, particularly from the financial services industry are going down quite dramatically; because we are such a big financial services centre we are being affected by it. We are being affected by the downturn in the housing market—that means that borrowing does rise. I had to allow that to rise, because if I had started to take money out of the economy now, or earlier than I am proposing to, I think it would make a difficult situation a lot worse. In addition to that, of course, we also have been maintaining investment, spending on transport and housing and capital projects, and so on, which at the moment is as high as it has been for 30 years. Again, that supports jobs. So, you know, on any view, any Chancellor would want to keep borrowing and debt as low as they possibly can.

In the current circumstances my judgment is that it is right to take the approach I have done to support the economy at the moment, but, of course, as we come out of this and we start to grow, then we need to be able to get that borrowing back down. That is the strategy I set out.

**Q314 Sir Peter Viggers:** What impact will the size of the national debt have on your ability to afford any further significant fiscal stimulus?

**Mr Darling:** Again, a judgment has to be reached, whether a Budget or Pre-Budget Report, as to what the various risks are, what the options are, and it does help us slightly that, of course, interest rates are a lot lower than they were because the cost of servicing that debt is less than it might otherwise be. This a judgment that I have to reach, but what I am pretty clear about is that to stand back and do nothing and simply let the recession take its toll, I think, would be irresponsible.

**Q315 Sir Peter Viggers:** The fiscal rules, the Golden Rule and the Sustainable Investment Rule, were built up into a totem and, of course, they have gone. How seriously should we take the Temporary Operating Rule? Is it something that we should be focusing on and judging them by?

**Mr Darling:** Yes. The fiscal rules were important and fiscal rules remain important and will always be important, and we actually met them over the cycle which ended in 2006, and they were designed to ensure that some of the home-grown problems that successive governments had run into over the previous 30 years were dealt with. That is why we put them in place. The code for fiscal stability, which has statutory effect, really, really helped to get us where we are. The situation where because of extraordinary circumstances you have to depart from these rules, and it says there you have to have a temporary operating rule, and the Temporary Operating Rule,
which again is set out in the paper here in my Pre-Budget Report speech, is that as we come through this we bring the current Budget back into balance so that we are borrowing simply to invest and also that we reduce debt as a share of GDP. The important thing is not just the rule but the way in which we would implement it, and, again, it is set out here, and that is that as we come through this from 2011 there is a tightening of 0.5% until 2015–16. So I think the rules are important but also seeing evidence that you are prepared to take the necessary steps to stick to those rules are important as well. I have seen representations, for example, that you should appoint a committee to advise you. Well, that is all very well. The question will be: if they are advising you, do you take their advice and are you prepared to do what is necessary to get the budget back into a position where we are living within our means? What I have done is to set out a temporary operating rule, but also, importantly, the way in which I intend to deliver on that.

Q316 Sir Peter Viggers: In due course do you see us reverting to previous rules, or do you see a new set of rules emerging?

Mr Darling: I said in the Mais Lecture, which I gave at the end of October, that I thought that ensuring that you borrowed only to invest is actually quite a good discipline and that getting debt down to a sustainable level is also important. I also went on to say that if you had applied those rules now as they stood, that would have had a perverse effect on the economy and buy UK currency and so on? Mr Darling: Yes, of course. If you look at the long term gilt yields in this country and where they are today I think people do have confidence in us, but confidence comes from two things. One is that people want to know what rules you are operating under and also whether you are prepared to do what is necessary in order to ensure that you do stick to the objectives you set out.

Q317 Sir Peter Viggers: Do you anticipate that you will be consulting on a new fiscal framework in due course.

Mr Darling: I will leave that option open. I do not have any immediate plans to do so. Obviously I leave that option open.

Q318 Mr Todd: You suggested that the fiscal rules were a little bit like chastity belts and hair shirts in being an aid to self-discipline rather than necessarily for external consumption as reassurance as to a Government’s purpose. Do you think that is actually what they are?

Mr Darling: I think they are a pretty good discipline. It has helped us since 1997 to have rules that governed how much you could borrow and which were a discipline on us to reduce debt. As you know, debt came down quite substantially during that 10-year period.

Q319 Mr Todd: But do you not think there is an external consumption of these rules as well in terms of a reassurance of what the Government’s intent might be if you are seeking to invest in the UK economy and buy UK currency and so on?

Mr Darling: When do you think that, as you put it, global shocks will have worked their way through the economy in full?

Mr Darling: If I can refer you to what I said in the Pre-Budget Report, we expect the economy to begin to recover in the second half of next year and we expect to see growth return in the following years. However, as I said earlier today and I have said on previous occasions, there is a lot of uncertainty out there. A lot will depend on how quickly other countries are prepared to take action. The American economy is of immense importance not just to us but to the whole world because of its sheer size and also because of confidence generally, but also it is important that other countries play their part, which is why we attach so much importance to the G20 which we will hold the presidency of for the next 12 months and, as you know, finance ministers are due to meet here in March and the leaders of those largest economies in the world in April.

Q320 Mr Todd: Forecasting of public finances, as others have said, has not been our strongest suit, in recent years anyway, but it is even more uncertain now. I must admit I was reassured by the evidence of the leak of the possible 18.5% VAT rate that other contingency plans might be being considered to deal with a slow recovery of public finances. Can we assume that that does indicate that there is a reasonably robust approach to looking at other options to correct public finances over time?

Mr Darling: I said in the House of Commons a couple of weeks ago in relation to that, as you would expect in relation to any Budget exercise, that you examine a wide range of options. I decided that because I needed to raise money it would be fairer to do it through raising by half a per cent national insurance.

Q321 Mr Todd: But the temporary operating rule is a pretty vague statement of intent. I take your point on gilt yields which are perhaps driven mainly by the desperation of people to find reasonably safe places to put their money at the moment rather than necessarily specific confidence in an individual country’s policies.

Mr Darling: I think that having rules is important but showing that you are prepared to stick to the rules is equally important so that people understand that you have a plan and that you have the determination to meet it.

Q322 Mr Todd: Do you think that, as you put it, global shocks will have worked their way through the economy in full?

Mr Darling: If I can refer you to what I said in the Pre-Budget Report, we expect the economy to begin to recover in the second half of next year and we expect to see growth return in the following years. However, as I said earlier today and I have said on previous occasions, there is a lot of uncertainty out there. A lot will depend on how quickly other countries are prepared to take action. The American economy is of immense importance not just to us but to the whole world because of its sheer size and also because of confidence generally, but also it is important that other countries play their part, which is why we attach so much importance to the G20 which we will hold the presidency of for the next 12 months and, as you know, finance ministers are due to meet here in March and the leaders of those largest economies in the world in April.

Q323 Mr Todd: I think that was an entirely prudent and reasonable response.
Mr Darling: If you are asking me, for the avoidance of doubt, what I decided to do instead it was to put up national insurance. In relation to your other point, it is important that we are spending money now. The fiscal stimulus is only one part of it. Again, listening to the Leader of the Opposition yesterday, the automatic stabilisers which he supports and I support are also going to have to be paid for, as is also the fact that—

Q324 Mr Todd: But they are much larger than the fiscal stimulus that we have—

Mr Darling: On any view it is going to take some time. If you take the financial services industry, it will take some considerable time before we see revenues coming back to anything like the level we have seen in the last few years.

Q325 Mr Todd: There is a view that the public finances concealed a structural deficit in the last few years. We should have been producing a surplus over a period of growth but were not doing so years. We should have been producing a surplus. The reason I wanted to draw attention to table 2.2 in the Budget book. I think you saw Treasury officials yesterday who indicated that we had assumed a 4% reduction as a result of what has happened. In looking back, I think the forecasts that we made were perfectly reasonable. Many people will then go back and say, “You should have done this, you should have done that”, but I come back to the point—

Q326 Mr Todd: We need more just forecasting accurately tax revenues over a period of time and there were fairly consistent errors that were appearing, which suggests, as I said, that the fiscal regime itself may be becoming outdated.

Mr Darling: Forecasting by its very nature has to have a degree of uncertainty, and I think by and large the people who have looked at that, the IFS, have said that what we have done is set out here is a reasonable approach, given all the circumstances.

Mr Ramsden: The reason I wanted to draw attention to some numbers is that the cyclically adjusted surplus on current Budget in 2006–07 is that there is a deficit of 0.3% of GDP, so when the economy was on trend there was a very small deficit. If you look at the end-year fiscal report that we published alongside this PBR, as we do every year as a contribution to transparency, that showed that our year ahead forecasting record for the Budget in 2006 and the Budget in 2007, the errors were relatively small, so I think we have been making progress over time until we were hit by these very significant shocks.

Q327 Mr Todd: But I think you are gently conceding my point to some extent, that there was indeed a structural deficit which we had certainly not fully addressed over that period.

Mr Ramsden: 0.3% of GDP would be well within the bounds of error of the kind of estimate—

Q328 Mr Todd: But in terms of public finances it is quite a large amount of money.

Mr Ramsden: It is actually a pretty small sum of money in terms of the kind of public finance billions that we have been talking about today.

Q329 Mr Todd: My last point is that your chart B1 on page 208 tracks a recovery in the tax to GDP ratio which, if one looks at the graph, suggests a recovery more in line with the shock of the early part of this decade than the recession of the early 1990s.

Mr Darling: Yes, that is what we are projecting. That is our best estimate of what we think is likely to happen.

Q330 Mr Todd: So we are going to come off a lot better than in 1991/1992/1993?

Mr Darling: If you look at what we are proposing and what the figure was in 1989 you will see that our position is different. All you can do is set out your best estimate, your best forecast of what will happen, for the reasons that we have stated here.

Q331 Mr Love: Chancellor, was a fiscal stimulus, as in the Pre-Budget Report, necessary or inevitable in the current economic circumstances?

Mr Darling: I think it was absolutely necessary. You have a choice. You can sit back and say, “Let the recession take its course”, yes, of course, benefits will go up and so on but you do not do anything else. I think the consensus of opinion here and across the world is that that would be quite wrong. It was tried in the 1930s and it did not work and it was a very painful process for many people across the world. Again, in the 1980s and 1990s I believe that the then Government could have done a lot more to help people and to help businesses. I think it is absolutely essential that we do this.

Q332 Mr Love: How do you respond to suggestions voiced by one of your sternest critics in a major speech yesterday, that “extra discretionary borrowing now over and above the effect of the automatic stabilisers will not help with the recession”?

Mr Darling: My answer to that, as the Chairman of the CBI said a few weeks ago, is that if we do not do anything there is a greater risk that the cost of not doing anything will outweigh the cost of doing something. If you allow a recession to become deeper and longer than it might otherwise be there is a cost to it. Indeed, as we were discussing earlier, if you look at the automatic stabilisers, which are in crude terms the costs that you have got, increased benefits and unemployment benefit and so on, if you allow a recession to become longer and deeper than otherwise it might be, there is a bigger cost there and that cost will result in increased borrowing, all other things being equal, and you have to repay that. There are times when the Government spending money now can help and it might be a better thing to do not just in cost terms but, importantly too, in
economic terms as well as social terms. That is the choice that I have made. I know that, assuming you are quoting from David Cameron’s speech yesterday, he has made a rather different choice. All I would say to him is that he constantly elides the fiscal stimulus and the automatic stabilisers, which I think he is still in favour of. The automatic stabilisers do have a cost which has to be met.

Q333 Mr Love: He not only does that; he also berates you for not being tough enough—“We need to restrain public expenditure”. Do you agree?

Mr Darling: I think you should always make sure that you are very careful with public expenditure. What I have set out in the Pre-Budget Report is that public expenditure will grow on average about 1.2% for the next CSR period. That, of course, is on a much higher base than it was 10 years ago but it will be a tight settlement. What I think Mr Cameron was saying yesterday was that he wanted to cut borrowing and cut it now. I look forward to finding out exactly what he is proposing to cut if he said that he wants to start now. Where would he start? I think taking money out of the economy now would be grossly irresponsible. We have identified about £5 billion of efficiency savings in the year 2010. He says he wants to go further. That is fine. He has to tell us where that is going to be. I think the difference of opinion is that he says basically, “Let the automatic stabilisers work but that is it”. I say you have to go much further. That is why I have cut VAT, I have reduced income tax being paid by basic rate taxpayers, I have announced a whole range of measures to help businesses, because I think to sit back and do nothing would be grossly irresponsible. I am just not prepared to do that. We must approach these things with the idea of what can you do rather than what can you not do.

Q334 Mr Love: I was going to save this till the end but I will ask it now since it is directly relevant to what you said. A close reading of the text suggests that he looks for savings in spend in foreign trips or office redecorations at the taxpayer’s expense, no secret books to store those salary perks and unnecessary training. Do you think that will produce the savings that you are looking for?

Mr Darling: I dare say that putting off decorating the office for a year or two—as someone would say, every little helps, but I do not think it is going to solve the problems that—

Q335 Mr Love: Could I come on to the more serious point because you did indicate that there was £5 billion over and above the £30 billion that was already written into the Budget? Our experts last week cast what I would consider to be some doubt on it. They were particularly concerned that there was no detail given, in particular a breakdown at departmental level. Why did that not happen and when can we expect those figures to be available?

Mr Darling: We had not allocated the £5 billion across departments at the time of the PBR. That is something that we will do over the next few weeks and at that stage I am sure the Select Committee will want to look at it. What I would say is this, that if you consider that we spend over £400 billion in public spending on departmental expenditure I defy anybody to tell me it is not possible to find £5 billion worth of efficiency savings. Every public body can. In fact, there is not any organisation in the world that cannot be more efficient if it puts its mind to it. I think in terms of our back office operations we do not really exploit our position as a bulk buyer of goods and services. I think we could do a lot more. We appointed four people from outside to look at various areas. I am not sure if the Select Committee has ever looked at that or not but if it has not I am quite happy to make available to you their thoughts. Indeed, you might want to talk to them at some stage, whether it is in formal or informal session; I do not know.

Q336 Mr Love: I think we will because the question that is immediately triggered from your answer is how much fat is there out there? You are saying that the £5 billion should be easily realisable from the overall expenditure but it raises the question if we can save £10 billion should we not save it?

Mr Darling: Jack Straw in the Ministry of Justice is responsible for the Prison Service. His department has shown that it is possible to be more efficient and to reduce the cost of housing prisoners. There is terrific variation, as you probably know, across the prison estate. If we take the price that we pay for electricity as a government, there is an amazing variance, something like 50%, between what one part of the public sector pays and what another part pays. If you take the Department for Work and Pensions, which I know quite well, when we set up Jobcentre Plus in about 2000 we decided at that time, especially when unemployment was falling, that the number of people employed could be reduced and I think about 30,000 posts went. Obviously, just now, as you have got pressure, you need to accommodate that but I think there is not an organisation, certainly no part of government, where you cannot be more efficient. It is not because people are lying around being grossly irresponsible, or spending money on things that they do not need or even decorating the office a year before it perhaps is due; I do not think that is the problem. I think it is a question of just being a little bit more efficient and also, in relation to assets you do not need, deciding that you can sell them.

Mr Love: There is still that expensive training.

Chairman: Chancellor, we are going to be looking at the £5 billion saving in the new year with the Sub-Committee.

Q337 Nick Ainger: Chancellor, when you appeared before us I asked you if you would place in the library a copy of the agreement between the banks that you proposed to assist, and I have got a copy here of the agreement between Lloyds TSB, HBOS and the Treasury. Schedule 6 details the conditions attached to the support and it refers to lending for mortgages and for SMEs and I just want to talk to you about SMEs. It actually talks about, and you referred to this earlier, “a commitment to
immediately restore and maintain the availability and effective marketing of competitively priced lending to SMEs at a level at least equivalent to that of 2007”. It then goes on to say, “... publish an annual report on overall lending to SMEs, overdraft facilities in loans to SMEs, volumes, values and rates, foreclosures of debt finance to SMEs, appropriate lending of Small Firms Loan Guarantee Scheme, and application and use of the EIB global loan facility”. How are you going to monitor this? They are going to produce an annual report but businesses are facing the problem immediately. We cannot wait until December 2009 for the banks to produce an annual report. How are you going to ensure that that deal is being honoured?

**Mr Darling:** You are right and that annual report helps but that is not nearly enough. There are two things. One is that, in relation to RBS and Lloyds HBOS, if the merger goes ahead what we intend to do there is this. You have got that agreement. Shareholdings are managed by an arm’s length organisation which we have set up, United Kingdom Financial Investments. It will hold those banks to account and it will do that on a constant basis. I was talking yesterday to John Kingman, who is the new Chief Executive, about the need to do this on a very constant basis, having very regular meetings with these banks to make sure they deliver on that. The second thing, as I said in the Pre-Budget Report, is that we are setting up a lending panel where I will meet the chief executives of banks along with Lord Mandelson on a monthly basis; there is a meeting tomorrow. In addition to that there are three groups at a working level, one looking at the small business side of things, and that has been meeting for a couple of weeks now, one looking at mortgage finance which George Mudie was asking about, and another one looking particularly at the credit card problems which are George Mudie was putting so much money into the banking system, we are ensuring and will ensure that we look at all these problems as they arise, and as problems are identified try to get to the bottom of them and sort them out. We are looking at things like the pro-cyclicality problems of Basel II, we are looking at the pricings of government support. We are also looking at lending conditions and so on.

This is something that needs to be done on a very regular basis. I know it is something the banks are not used to because over the past few years they have very much worked on their own, but it is a *quid pro quo* as far as I am concerned. We have put a lot of money into the system. We need to make sure that we get to the bottom of some of these problems, especially when you get people around the country—and I am sure all of us have had it as MPs—write to you and say, “I had a facility and it has been withdrawn”, or “I went to my bank and I could not get any help”. We need to have a system where we can get to the bottom of what is happening. Sometimes these things can be quite complex but it is not something you can leave to an examination of a report once a year. That would be totally inadequate.

**Q338 Nick Ainger:** Our experts told us that there is actually a contradiction in the current position in that for individual banks it is in their own interests to try and build up their reserves, their balance sheets, therefore not lend, whereas at the same time we are expecting them to maintain levels of lending at 2007 rates. Our experts went on to say that collectively it is in their interests as well as the wider economy that they do lend, and Roger Bootle went so far as to say that the Government should seriously consider the regime which existed post-war where the Government was directing banks on their lending policy. If this monitoring arrangement which you have set up does not work, does not deliver the lending and the credit flow into the small business sector, or for that matter mortgages, will you consider looking at what happened post-war and whether you can start directing banks, short of nationalisation?

**Mr Darling:** It seems odd that the planning and direction that certainly the post-1945 Government set so much store by is now being discussed even by economists who would not normally put a foot in that camp. You really need to look at this in stages and you raise a number of points there. One is that we can make this work. You are absolutely right, and I have said it a number of times this afternoon: there is potentially a tension here in our saying on the one hand to banks, “We want you to be as strong as possible”, and on the other hand I gave you the example of HSBC which, because of its strength, because of its deposit staking in one part of the world, wants to lend into the UK market more, which is good, and RBS, for example, which has recapitalised substantially because of the Government and has been able to do things for the small and medium sized enterprises that ought to be encouraged. Although there is potentially a tension there I think it is one that is reconcilable. We have recapitalised the banks, or the banks have been able to do that under their own steam, so to speak, but at the same time they too recognise that it is not in their interests to find that their customers are suffering so that they are not there to be customers in the future. I think the two things are reconcilable and the whole point of having this lending panel and being able to sit down with the banks and just work our way through these problems is that I think it can work and I want to make sure that I do everything to make sure that it does work. We are looking at ways that will further strengthen the banks’ capital position here and there are some things like Basel II which are international, of course, as well as looking at things that we have got a greater control of. You were asking about specific things. In the Pre-Budget Report I mentioned Crosby and the support in the housing market, for example, which is addressing a particular problem, so I think there are some specific things that we can do. Where I think it will be more difficult is for any government, frankly, to be standing in the place of bank managers up and down the country and saying to you, Mr Ainger, when you come in. “Yes, I will lend you so much at such-and-such a rate and these are my terms and conditions”. You could do it with a few large customers, I
suspect, or you could do it in sectors but for the state to get into millions and millions of individual decisions would be difficult. I would rather use the banking system, which, as I say, we have put so much money into, to make sure that it delivers for us.

Q339 Nick Ainger: On that, the banks are going to be the vehicle for the European Investment Bank funds, the £4 billion which is available there. There is another billion that you are putting into the small business finance scheme and with the export credit scheme as well about £7 billion is going to be available. If lending does not return to some sort of normality by 2010 do you envisage increasing that £7 billion to substitute for the lack of lending from the high street banks?

Mr Darling: I have indicated on a number of occasions that this is something I will keep under constant review. We will have a Budget in the spring, we will have a Pre-Budget next autumn, and in between times, certainly in relation to banks, this is something that, because of the urgency and importance of it, we will be looking at all the time.

Q340 Nick Ainger: Can we move on to fuel poverty? We have discussed this and why crude oil prices went through the roof and so on and I still maintain I am right and it was not fundamentals; it was a commodity hike, a speculative peak. Irrespective of that, we have now seen crude oil prices fall from $147 a barrel in July to around $40 as they are now. What have we not seen is the electricity, mains gas, LPG and heating oil prices fall at all in that period. I have got a copy of the Secretary of State for Energy and Climate Change’s speech yesterday, where he says, “There is no excuse for unfair treatment of the most vulnerable”. This is in relation to energy supplies. If someone happens to live off the gas maybe there is no excuse to overcharge them. If someone lives in an area where a company used to have a monopoly that is no excuse for overcharging. There can be no excuse for these prices and unless all energy companies accept their responsibilities should we not now really be taking action against the energy supply companies?

Mr Darling: I agree with what Ed Miliband said in his speech last night and I also said in the PBR that if this did not happen then we will legislate to make sure it happens.¹

Q341 Nick Ainger: We keep being told about this lag. There did not seem to be any lag when prices were going up. There only seems to be a lag when prices are going down.

Mr Darling: I agree with the proposition that Ed Miliband was making and that you are making, that we want to see these price reductions passed on as quickly as is possible. One of the things that I think will help that process is that that process has been rather opaque in the past and that is why I think Ofgem needs to do more so that people can see the link and you can see as wholesale prices change the feed through into what they pay at the meter.

Q342 Nick Ainger: You announced quite a few weeks ago that you were in discussions with the energy supply companies over the social tariff, prepayment meters. We had the Citizens Advice Bureaux people before us and I asked them if they had seen any effect, any significant change, in relation to social tariffs and reductions in the costs of prepayment metres. They have not seen anything. Again, irrespective of the price change, the fact that we are having people that are the most vulnerable, the ill, the poorest people, paying the highest rates for energy, surely we could have tackled that?

Mr Darling: It might be better if I were to let the Committee have a note on this. These discussions are being led by the Department of Energy and Climate Change and I think it would be better if you had an up-to-date picture, but I did say in the Pre-Budget Report that if this did not happen then we will legislate to make sure it happens.

Q343 Jim Cousins: Just to follow that one up, does what you have told us mean that if by the time of the Budget there have not been significant energy price cuts then a windfall tax on the energy suppliers will be back on the agenda?

Mr Darling: I do not think I said that at all.

Q344 Jim Cousins: Are you ruling it out?

Mr Darling: I think I said earlier in the summer that I thought the way we had approached it was a better way of approaching it. Windfall taxes inevitably have difficulties in terms of creating uncertainty at a time when I want to encourage investment in lower carbon and new generating plants, but all Chancellors keep every option under review. I do not think anything I said to Nick Ainger could lead you to reach that conclusion.

Q345 Jim Cousins: But is it definitely off the agenda?

Mr Darling: Look: I see no reason to flesh out any decisions I make at this stage. Windfall taxes could be very damaging in relation to long term investment which is something that I think is pretty essential for this country. I think it is better to deal with the matter in the way that we have dealt with it.

Q346 Jim Cousins: You have indicated this afternoon that with regard to the banks you are willing to consider stronger measures of support and guidance. Would it not be better to buy existing assets and guarantee new assets in line with the report that you have just had on mortgage lending but perhaps going further? Would it not be wiser to do that now than allow a queue of industries like cars or construction to develop wanting specific schemes of support?

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Mr Darling: Are you talking about Crosby?

Q347 Jim Cousins: Yes, but you talked about Crosby-plus.

Mr Darling: Yes. As I have indicated to the Committee, we are looking at a range of measures to build on what we announced in October but if we are going to do that there has to be a quid pro quo as far as the banks are concerned.

Q348 Jim Cousins: But would it not be better to get the new regime, if there is to be one, in place now than allow a system to develop in which, industry by industry, people come forward—house builders, car constructors, wanting their own means of support?

Mr Darling: It would be much better if we could get the banking system working effectively. Of course, in relation to large companies, it is not just banks; they raise their money in other areas as well, but yes, of course it would be much better to get the banking system working more effectively. Indeed, the whole point of taking the action we have taken in relation to the banks is that the whole economy and particularly industry depends on it being able to operate effectively.

Q349 Jim Cousins: If the recession continues to develop, when we get to Budget time are you willing to consider a bigger boost to the economy than the one set out in the Pre-Budget Report?

Mr Darling: At the Budget, as you would expect, I will look at what is happening in the economy and then whatever decisions are appropriate. We live in a time when an extraordinary chain of events will look at what is happening in the economy and that was a deliberate choice I made.

Q350 Jim Cousins: You will obviously appreciate that we have millions of low income workers whose jobs are not very secure, whose incomes are quite low, their savings and assets, if they have got any, are worth significantly less now than they were a few months ago, their earnings very often vary from week to week. The measures of assistance specifically for them here in this report are not great. Are you willing to consider more assistance for them if their position gets worse?

Mr Darling: On that point, we have reduced the amount of income tax basic rate taxpayers pay and increased the amount available. The reduction in VAT helps everyone but it will help people on pay in addition to that. The fact that oil prices fall will reduce the price that people pay at the pump for petrol and diesel, which certainly helps people on low incomes. I want to see that through the energy price as well, so I do not agree with you that what we announced a couple of weeks ago somehow will not help. It will help, but of course I will keep all options open to me, as you would expect at a Budget or a Pre-Budget.

Q351 Jim Cousins: But those measures you have set out are not specific for these millions of low income earners.

Mr Darling: They are.

Q352 Jim Cousins: They are not specific for them; they are for everyone. They are just brought in on collateral effects and yet your own report says two million of these people face some of the highest tax rates that anyone is facing.

Mr Darling: The increase in the personal allowance helps all basic rate taxpayers. For people who are retired the pension will go up by £4.50 in April. We have increased the amount of money they get over and above the Christmas bonus from January. People with children will benefit from the increased child benefit rate that will come in in January. In addition to that the child tax credit increase has been brought forward so they will benefit there as well, so I do not agree with your assertion that it is not helping people on low incomes.

Q353 Jim Cousins: I did not say it was not helping them. I said the help it was giving was not specific for them. The low income earners whose jobs are not secure, whose earnings vary from week to week and whose very small savings and asset pots have declined in value, are saying to themselves, “What are they doing for us?” because prosperity is going to feed back in the economy as it trickles up from those people.

Mr Darling: What I am slightly disagreeing with you on is that if you look at the range of measures that I announced two weeks ago I think they do help people. In fact, they disproportionately benefit people on lower incomes and that was a deliberate choice I made.

Q354 Jim Cousins: What about the people in your report, the two million earners who are facing marginal tax and benefit cut rates of 60-70%?

Mr Darling: Which group had you in mind?

Q355 Jim Cousins: Low income earners, the people on tax credits, and incidentally, the tax rates are so high that that is one reason a lot of people do not even claim them because they do not want to be caught in the trap.

Mr Darling: I will ask Mark to say something in a moment but if you increase people’s income through tax credits, through housing benefit or whatever, because these are benefits that get tapered out, when somebody comes off them there can be a problem with marginal deduction rates. Frankly, I think it is better though to provide that extra help for people on those low incomes. I know that people do look at marginal deduction rates; it is a perfectly legitimate thing to do. They also, I think, need to look at the undoubted benefit that comes to people who are getting tax credits or who are getting housing benefit.

Mr Bowman: The specific point about the increase in marginal deduction rates in 2009 comes about because of a measure that was introduced in the Budget, the child benefit disregard in housing benefit and council tax benefit, which is giving increased support to low income families but it does have the
effect that there are more people who are on the housing benefit taper and who as a result face these marginal deduction rates.

**Q356 Jim Cousins:** But do you not see the difficulty that the people whose jobs and earnings are most at risk in the economic situation we are facing and on whose economic future we are most going to depend to pull us out of the recession are the very people who are caught in those difficulties?

**Mr Darling:** One way of getting rid of marginal deduction rates would be not to increase housing benefit or not to have child tax credits. I think that would be the wrong approach. The child tax credit has probably done more to help us reduce child poverty than anything else and in terms of the housing benefit, and I remember the exchange with Sally Keeble at the time of the Budget, what we are trying to do there is help people. If you do help people on low incomes and you taper out help then you have a problem with marginal deduction rates. The other thing I would say to you is that you were talking about specific help and we were not exactly seeing eye to eye there either, but I think in terms of the general stimulus we are putting into the economy that helps many of the people that both you and I are concerned about, people on low incomes, people who all too easily may find they come in and out of work. The more we can do to keep the economy going the better the chance that people will remain in employment.

**Q357 Ms Keeble:** I have a quick question for Mark first. The changes you talked about just now are coming in only in October 2009, are they not, so they are a way off yet?

**Mr Bowman:** Yes, and this is the increase in the marginal deduction rates in 2009.

**Q358 Ms Keeble:** Chancellor, the outline that you set out in the Pre-Budget Report was a very challenging one in terms of substantial fiscal stimulus, interest rates heading down towards zero, not there yet, unemployment going up, consumer spending going down, optimistic growth assumptions. There are obviously a lot of uncertainties there. First, which do you see as the main risks to that quite careful balance of measures, and, second, what happens if it does not work? What is your second line of measures to try to get the economy moving again?

**Mr Darling:** In some ways the biggest unknown is what is going to happen in the global economy generally because we do not fully yet know what other countries are going to do in response to this, and I mentioned America several times.

**Q359 Ms Keeble:** I was going to ask you about Germany.

**Mr Darling:** Germany did put in place a fiscal stimulus a few weeks ago. Obviously, it is for the German government to decide what is appropriate there, but they are very conscious of the fact that they are in recession; their manufacturing sector, which is much bigger than ours, is in difficulties. I would be surprised if you did not see them taking more action. France, for example, has announced something pretty similar to ourselves just in the last week or so.

**Q360 Ms Keeble:** But in terms of the risk factors it could destabilise that, the profile that has been set out. Which do you see as being the main one?

**Mr Darling:** What I said. If you look at the two things that I have in the front of my mind at the moment, one is what is happening in the global economy generally and the other is something we have been discussing all afternoon, and that, quite rightly, is the importance of getting bank lending going again.

**Q361 Ms Keeble:** What are your fallback measures? You mentioned in response to Jim Cousins that you will keep things under review come the Budget next spring and you will look again at measures then. What measures are you considering then?

**Mr Darling:** I have just announced the Pre-Budget Report and I think I will keep my Budget until next year.

**Q362 Ms Keeble:** But what kinds of measures are you looking at? Are you looking at VAT or tax credits or what?

**Mr Darling:** At the Pre-Budget Report stage and at the Budget I look at a whole range of measures and then I reach my decisions. The decisions I reached in November I announced on that day and I think we will leave that until next year when I come to the Budget.

**Q363 Ms Keeble:** You referred to the £2.6 billion fiscal stimulus through the change in the threshold of personal tax. I think the perception of some of us was that that was done largely in response to a political problem which was about the 10p tax difficulties. Would you have done that anyway or would you rather have had room for manoeuvre to tackle the economic pressures?

**Mr Darling:** With the Pre-Budget you start from where you are. When I looked at the various things I could do, and if we take the things that affect people most directly, people have asked, “Why did you do that? Why did you do income tax?”. The advantage of that is that you can do it quickly. The change was implemented six days after I announced it. You cannot change income tax before the next financial year; it just is not possible to do it. I have said before this Committee on a number of occasions that I am very conscious of the fact that there are people on modest incomes whom I think we could do more to help and I wanted to do something and I would probably have raised their personal tax allowances anyway. As it is, I was able to make permanent what I announced earlier this year and I was also able to increase it.

**Q364 Mr Love:** Looking at the tax credit measures, you have obviously made the commitments about increasing take-up, particularly for people without dependent children.
Mr Darling: On the tax credits?

Q365 Ms Keeble: Yes, but what assumptions have you made about increased take-up, bearing in mind it is not just people who are unemployed but also people who have reduced working hours? What assumptions have you made about expenditure and what assumptions have you made about the tax take as a result of VAT, bearing in mind reduced consumption and such like? You will have seen the discussions we have had with some of the previous witnesses.

Mr Ramsden: Could you just repeat the question?

Q366 Ms Keeble: There are two things. There are the assumptions about increased spend on tax credits given that people will have reduced working hours and you have got commitments about improving take-up, and, secondly, what are your assumptions about income, about revenue from consumption-based taxes, ie, in particular the impact of the VAT changes? You will have seen the discussions we had then with some of our previous expert witnesses.

Mr Ramsden: I could deal with the second of those. We are assuming that consumption will fall next year and also, therefore, with the addition of the reduction in VAT, we are forecasting a very significant reduction in VAT next year, going down from £82.6 billion this year to £72.6 billion next year.

Q367 Ms Keeble: That includes the very substantial discounting that is going on, the falls in commodity prices as well as reductions in consumption?

Mr Ramsden: We have obviously taken account of what we think will be the overall consumption profile, what will be the VAT-able share of consumption and taken account of the different VAT rates for things like domestic fuel and power. We have factored all that in. As we have explained in the book, we have assumed that the majority of the VAT reduction is passed through. We have not assumed it is all passed through straightaway. I think we have made realistic assumptions there, but we will obviously keep all that under review. On the tax credits part, I think that would be for Mark.

Q368 Ms Keeble: While he is looking at it can I ask one other quick question? Stephen Crabb asked about alcopops. One of the things that has been repeatedly raised with me on the alcohol front is the duty on white cider, given that it does not bear any relation to trees, which I think is what some of us have talked about with the cider industry.

Mr Darling: I think I need to write to you on that one. ²

Mr Bowman: Just on tax credits, I do not have the absolute detail of the assumptions we have made on take-up but table B16 on page 210 sets out our estimates and projections for expenditure on tax credits.

Q369 Ms Keeble: Could we have the basis of the assumptions because I think that would be helpful in terms of take-up and the projections of income profiles with people having reduced incomes?

Mr Darling: That is not a problem.

Q370 John Thurso: Chancellor, you have answered questions about the banking system and the availability of credit for a number of colleagues and I have listened carefully to the answers you have given. Can I put one particular point to you? From the discussions I have had with a number of businesses in the far north, availability of credit— and I am particularly focusing on small businesses, not the mortgage market—is not the problem; it is changes to the arrangements, on average between 1.75% and 2.75% increase in basis points plus doubling of fees, sometimes accompanied by a reduction in facility but it is much more about the cost. These are all pretty sound businesses that are going to trade through and will survive. They will make less money but they will survive. Their concern is the cost of that capital, basically. You have a problem, which on the one side is that the banks have to repair their balance sheets. You have given them some quite expensive capital to do that with. You have made available money in the money markets, but there is an expectation on one side of the price not going up and there is a reality on the other side that the price is going up. Can you not produce a reasonably simple, straightforward concordat, memorandum of understanding, agreement, call it what you will, just setting out the high points of the principle of what you are expecting the banks to do, the banks can agree to it at your meeting tomorrow and we will at least all have a template to work to?

Mr Darling: Yes, we can. That is something that I want to achieve because I think people do need to know where they stand. I thought you were going to ask me a slightly different question which I was going to agree with as well.

Q371 John Thurso: Why do you not ask it and I will agree with you? I love the idea of self-questioning Chancellors.

Mr Darling: It can be good for the soul sometimes. With regard to the point you make about companies believing they have an agreement with a bank and then discovering either on renewal or when they say, “I would like to take you up on the credit line that you said was available”, they then say, “Well, actually, it is not now”, or, “We are going to renegotiate our terms and conditions. Here is a big fee. It is going to cost you more or there is less money”, that is one of the reasons that led me to believe that we needed to put the banking code on a statutory basis. You may have seen that on Monday Lord Mandelson met the banks in relation to small businesses with a view to getting a far stricter code which we would incorporate within the code. If you have not got details of that I would be very happy to let you have the details,

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but it is on the point that George Mudie was raising. There is a range of problems. There is price, there is availability, there is certainly. They all need to be dealt with and that is the purpose of establishing this lending panel so that we can deal with these problems. You mentioned the price that we charge. The Government has made facilities available. Banks, of course, can go elsewhere if they want but some of them have found it is more expensive than coming to us.

Q372 John Thurso: I am grateful for that answer because I do think it is important that the high points are out there so that the expectation on either side or any divergence between the expectations is clearly available and the sooner we can have that the better.

Mr Darling: I agree with you.

Q373 John Thurso: There was one question regarding pensioners. We have had evidence from a number of people, one in particular who described what was done for the pensioners as “somewhat skinflint” because, aside from the £60 bonus and PBR measures for older people, the measures basically reflect the statutory minimums which could be offered. Is that a conscious choice in the sense that did you look in any way at the possibility of grey purchasing power and whether it offered any ability to stimulate the economy?

Mr Darling: I think you have to look not just at the Pre-Budget Report but also at the Budget itself when I increased the amount of money being paid to the winter fuel payment which, of course, is now being paid during November/December. Simply because of the mechanics of it we cannot increase the winter fuel payment before next year but what I could do was put extra money into the hands of pensioners from January, which is why we are paying £60 for pensioners on top of the £10 Christmas bonus because the same systems can pay out that money so they will get £70 from January. In relation to the increase in the pension, it is not statutory. It is open to a government to reach whatever decision it wants. I think several years ago we said that we as a government policy we would make sure that the pension went up by a basic amount. The increase this year was higher than it normally is because of the RPI; that is why it is going up by just over £4.50, but, of course, the pension credit we also introduced and that helps about half of pensioner households. There are a number of measures that I think will increase pension income. The other thing is that people on fixed incomes benefit from low inflation because prices do not go up so much, which increases their spending power. I am aware of the general points you make. Not everybody but a lot of older people do go out and spend money and that is an important part of what we are trying to achieve.

Q374 John Thurso: The other side of the banking, where we are at the moment, is, of course, that there an awful lot of older people who have got savings and they are seeing a rapidly diminishing additional income. One feels a great deal of sympathy for them, having had their whole working life and now the people who are running businesses are clamouring for lower interest rates but they are losing. There is the grey panther and all of that grey purchasing power. There is an area of stimulus there and I just wonder if there is anything you can do.

Mr Darling: There are a lot of people who have saved for their retirement. They have got money in the banks and building societies and stocks and shares and when interest rates come down there are two sides to that. It depends whether you are a borrower or a saver. It was one of the Chairman’s early questions. I recognise that, which is why a number of the building societies and some of the banks were saying, “Interest rates came down last time but we have also got to remember we have got to attract savers”, and that is particularly true in the building society sector.

Q375 Chairman: Chancellor, just this afternoon one of the national newspapers came out with a story on the web about the Bank of England printing more money to tackle deflation and there is a Treasury spokesman—

Mr Darling: This would be The Guardian?

Q376 Chairman: Yes, exactly. A Treasury spokesman was quoted, but should the Bank of England have to combat deflation and undertake quantitative easing? Would that require Treasury approval, for example, for more money to be printed?

Mr Darling: Anything like that certainly would.

Q377 Chairman: Would that require parliamentary approval?

Mr Darling: I do not know. I am aware of this report but, as I said earlier, interest rates are still at 2%.

Q378 Chairman: Would the Committee be informed of things like that over the Christmas period?

Mr Darling: As with any major step, if the Government’s policy changed or developed significantly then Parliament would be informed. I cannot necessarily say it would be the Committee because I think it is the sort of the thing the whole House needs to know. This is a newspaper report. It is no more than that.

Q379 Chairman: Yes, I know, but it says “Treasury spokesman” and there are direct quotes from the Treasury spokesman in the paper.

Mr Darling: I know there was such a report. It is no more than a report. It is just something that we are not looking at at the moment.

Q380 Chairman: I understand, okay. One of the points is that it says that a spokesman said that the announcement would come from the Bank of
England so the Chancellor would not necessarily have to make a Commons statement on the matter, meaning an announcement could be made after Parliament has risen for the Christmas recess. That is why it has been brought to our attention.

Mr Darling: It is purely a bit of speculation in the newspaper; it is no more than that. Interest rates are still at 2%. They have a long way to come down yet.

Q381 Chairman: I understand that, Chancellor.

Mr Darling: I think we should not get too excited about a newspaper report.

Q382 Chairman: It does say “a Treasury spokesman”. It seems to add some significance to it.

Mr Darling: I do not know what was asked of anyone in the Treasury press office. I was asked about this yesterday by, I think, somebody who works for The Guardian and I gave the same answer. I made the point that interest rates are at 2%, they have some way to fall, it is a matter for the MPC. This is pure speculation. It is another newspaper report. It is not something, frankly, that people should get too excited about.

Q383 Chairman: But I think it is worth asking.

Mr Darling: I do not mind you asking anything you want.

Chairman: So if we come back after Christmas and we see it, it will not be speculation; is that right? Chancellor, can we thank you very much, and, Mr Ramsden, I am sure Mr Mudie will want to thank you very much for your good behaviour today. It is excellent to see you. Thank you.
Written evidence

Memorandum from the Child Poverty Action Group (CPAG)

We are pleased for the opportunity to write to you ahead of your evidence sessions on the Pre-Budget Report (PBR). This letter is necessarily brief but seeks to highlight key issues from the PBR and outlines some implications of the November statement for children in poverty.

CPAG wrote to the Chancellor (copied to you) ahead of the Pre Budget Statement outlining the need to make more progress on child poverty (available at www.cpag.org.uk). In brief, this letter proposed five steps:

— Greater investment in Jobcentre Plus given the increasing strain upon it (we welcome the resources found for this in the statement).

— Greater investment in skills for those distant from the labour market, we are concerned these groups may get “squeezed out” of provision given the downturn (the PBR announced investment in Train to Gain, and though that is welcome and important it is focused on those nearest the labour market).

— Revision of welfare reform plans around greater conditions and sanctions. These reform proposals are based on now erroneous assumptions about rising labour demand and economic stability.

— That more work should be done with employers to overcome discrimination and open up better job opportunities for those distanced from the labour market.

— Government should make the necessary investment to meet its own 2010 target to halve child poverty.

CPAG also argued that investing in poorer families now would provide a cost-effective fiscal stimulus (poor families being more likely to need to spend and so boost local businesses) and that if resources were required there were a variety of ways in which Government could shift the balance of taxation to ensure those with the broadest shoulders bear more of the load (such as increasing income tax and reducing tax privileges for the very wealthy).

Although some useful investments have been made, the 2008 pre-budget statement was a disappointment because it did not move use further forward in tackling child poverty. The 2010 target to halve child poverty can still be met but much now rests on the next budget. The pre-budget report argues progress will be reassessed ahead of the budget:

Low-income families and children will also benefit from the wider measures on personal taxation and VAT, as well as the uprating of benefits and tax credits above earnings this year and the real terms gains from projected inflation next year. In the light of the wide range of changes coming into effect in the coming months, the Government will take stock of progress towards its 2010 and 2020 child poverty target in the Budget.1

It is clear (not least from Committee reports) that despite progress in the 2008 budget we are significantly off track in reaching the 2010 target.2 While improvement of services and opening up of employment chances is vital to reach the 2020 target, meeting 2010 provides the foundation to reach further to eradicate child poverty. Reducing child poverty by half by 2010 will mean additional expenditure of around £3 billion invested in family incomes—small indeed in the context of wider economic packages.

While CPAG welcomes the commitment to enshrine the 2020 target in legislation and are keen to see robust law able to mobilise all parts of society towards that central aim of a fair deal for all children, legislating will be meaningless without more concrete steps to achieve the 2010 target—and time is running out.

In April, whilst welcoming measures taking in the 2008 budget on child poverty, your Committee noted:

We remain concerned that the Government has yet to provide a clear explanation of the linkage between its target to halve child poverty by 2010–11 and the proposed deployment of resources to meet that target. It is of crucial importance that the Government makes it clear that the necessary resources to meet the 2010–11 target are available and that the Government is committed to deploying those resources directly to support low-income families.3

Following a further rise in the number of children in poverty, you amplified this message in June when the Chancellor recommitted the government to its targets noting “it is a very important target and I attach considerable importance to it”.4 There is a good deal of consensus around the importance of tackling child poverty and it is regrettable that the pre-budget report was a missed opportunity to getting Britain closer to this historic aim. We urge the Committee to push Government to spell out in some detail how it intends to fulfil its crucial targets on child poverty.

1 HM Treasury, Pre Budget Report, November 2008, para 5.13
2 Latest data on the government’s preferred central measure of child poverty suggests this stands at around 2.9 million; the target is 1.7 million. Recent spending (before the pre budget statement) in place by 2010–11 will narrow this (the pre-budget report suggests by 500,000) leaving an unfilled gap of about 700,000 children who need to be lifted out of poverty to reach the 2010 target.
3 Treasury Committee, The 2008 budget, April 2008
4 Treasury Committee, Budget measures and low income households, June 2008
ON THE SPECIFIC MEASURES IN THE REPORT

CPAG would have preferred to see fiscal stimulus (at least in part) to be delivered directly by increasing the incomes of poorer families, those suffering most from rapidly rising cost of living. Such a measure would be money well spent in delivering improved fairness and well spent in stimulating the economy. Government has chosen to focus resources on consumption taxation. VAT is a regressive tax (poor people spend more of their incomes so pay a higher proportion in tax) and cutting it is progressive in proportional terms (and should reduce cost of living slightly) but in cash terms the greatest gainers are those who spend more—richer households. The VAT measure costs £12 billion over two years, though this is short term expenditure only it is higher than the annual amount CPAG and others have recommended be invested in family incomes which would have provided both a stimulus effect and directly reduced the hardship experienced by those with the least in society.

The income tax changes are broadly welcome. CPAG supports the continued protection of those who lost out through the 10p tax changes, however much of the cash gain of this move falls on more affluent basic rate taxpayers (somewhat offset in the future by increased National Insurance contributions) and there is a strong case for doing more for those on the lowest incomes which can be most effectively achieved through benefit and tax credit transfers, not just tax. We support the proposed increase in tax for those with incomes over £150,000 and the reduction in personal allowance for those with incomes over £100,000 and we would like the Government to go further.5 It is right that those who have gained colossal sums in recent years pay a fairer share of tax to support the investment society as a whole needs.

The spending measures on poor families are limited. While bringing forward increases on child benefit (to January) and child tax credit (£25 additional on top of proposed increased, initially planned for April 2010) to April 2009 will improve families’ positions, these will not affect the child poverty target (original plans would have had this spending in place by the target year). The one off payment through the Christmas bonus (£900 million to pensioners and other groups—including those receiving disability benefits) will help some hard pressed families. However, these measures are small and do not match the scale of the challenge. To meet the 2010 target—and fulfil the Government’s commitment to a fairer society—much more significant investment in family incomes is needed.

The PBR proposes to further increase the capital limit for paying mortgage interest relief to £200,000; we support this move along with the previously announced shortening of the waiting period. However, the broader package of measures around interest relief, of which this is one element, (initially announced in September) also includes an unwelcome proposal to time limit to two years. Time limiting benefits is something the Government has rightly resisted and we are concerned about a proposal which will result in support being determined by how long you have claimed, not your need for support. Though we welcome the increased in the upper limit, the proposal to time limit (which saves little money but disadvantages a small group of vulnerable people) is a source of considerable concern, and we urge you to call on the Chancellor to reconsider this move.

The Government has recognised rising pressure on Jobcentre Plus and has responded by increasing funding by £400 million in each of the next financial years and setting aside more in the reserve in case it is needed. With rising unemployment it is important the services and support are available to help people back into work as fast as is possible. We note the desire to achieve a further £5 billion efficiency savings in 2010/11. While we recognise the need to get good value for money from public services we urge the Committee to identify where these efficiencies will come from and to argue these should not weaken frontline services.

The Government is rightly concerned that the economic downturn should not result in those furthest from the labour market being denied access to service support. However, within a rapidly changing labour market, we are concerned that support may be redirected to those most recently unemployed. We urge the Committee to inquire what measures will be taken to protect against this occurring. While the investments being made in skills through Train to Gain are welcome and important, these are being focused on those nearest the labour market (those facing redundancy).

CPAG agrees with the Government that the provision of better support and more personalised services are essential to help people move into work. However, the imposition of increased conditions and threats about benefit sanctions will have a negative impact on people’s perceptions of the support on offer, and displays a misdiagnosis of about why people are not in work. The government argues that the vast majority of people who currently targeted would like to work, and accepts that some groups face considerable barriers to employment (including ongoing discrimination among employers and inflexible jobs). There is no evidence base to suggest increased conditions and sanctions can overcome these barriers to employment, whilst they do impact hardest on the poorest families and they are administratively burdensome on Jobcentre Plus. A more constructive, positive agenda to improve chances of moving into employment, particularly when the labour market recovers, is one that builds upon better service support, engages more effectively with employers to open up opportunity, and ensures that incomes for those out of work are higher and do not undermine the chances of parents moving back into employment.

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5 CPAG has argued for a 50p rate for those with incomes over £100,000.
In summary though CPAG recognises some investments have been made, in terms of child poverty these are relatively minor and unless robust action is taken to get back on track to the 2010 target it is very unlikely that welcome proposals such as that to put the 2020 ambition into law will have sufficient credibility.

We understand that the Government faces many budgetary demands, but it is essential during this time of economic difficulty to invest in those facing most hardship—not to retrench on commitments.

November 2008

Memorandum from ACCA

SUMMARY

— In difficult times such as these, clear leadership and symbolic gestures are needed.
— The retail sector gives some idea of the extent of what is needed—for example Marks and Spencers have opened stores with hours extended until 11pm, and reductions on all lines of 20%.
— The current VAT reduction, even if it is carried through to point of purchase, is a 2.1% reduction in price. The VAT cut may need to be extended to boost spending, and the VAT revert deadline should be moved from a traditional high-street sale period.
— A symbolic and useful gesture for home buyers would be the withdrawal of Stamp Duty Land Tax for 12 months with immediate effect.
— There should be incentives for consumption in the right sectors, ie in capital expenditure and in manufacturing, increases in capital and enhanced capital allowances, particularly in the renewables sector—recognising, of course, that these are longer-term measures.
— Small and Medium Enterprises (SMEs) might be adversely affected by the additional administration for the temporary VAT cut.
— We welcome measures taken to help SMEs, but hope that any interest charged will be restricted to the equivalent of the Bank of England base rate.
— The rise of National Insurance by 0.5p is a tax rise dressed up as something more palatable. This sends out the wrong message to all who make National Insurance Contributions.
— The effective top rate of tax of 46.5% in 2011 is high by global standards and might deter foreign business. The reduction on high-level personal allowances adds to this.

INTRODUCTION

1.1 ACCA is the largest and fastest-growing international professional accountancy body with over 122,000 members and 325,000 students worldwide, whom we support through a network of 80 staffed offices and centres around the world. ACCA has its headquarters in London and 54,000 of our members and over 60,000 of our students are based in the UK.

1.2 The expertise of our senior members and in-house technical experts allows ACCA to provide informed opinion on a range of financial, regulatory, public sector and business areas, including: taxation (business and personal); small business; pensions; education; and corporate governance and corporate social responsibility.

EVIDENCE

2.0 VAT

2.1 Slicing the top rate of VAT from 17.5 to 15% until the end of next year means that certain products and goods charged at the top rate will be cheaper. The aim is to kick-start high street spending, but business needs to pass on the savings from Monday 1 December when this cut comes into effect. The question is whether this is enough of a stimulus. Big and effective measures are needed. Will a year be enough? If not, this temporary reduction may need to be extended.

2.2 The retail sector gives some idea of the extent of what is needed—for example Marks and Spencers have opened stores with hours extended until 11pm, and reductions on all lines of 20%. The current VAT reduction, even if it is carried through to point of purchase, is only a 2.1% reduction in price.

2.3 The reduction may be too little to have a serious impact, but the final deadline where the 15% reverts back to 17.5% appears to be arbitrary and the impact on the commercial sector does not seem to have been thought through. The date when the 17.5% is restored is 1 January 2010, which is when many stores will be holding their sales. We believe that the date should be put back for greater impact, for example to the 31 January 2010.
2.4 There is serious concern that forcing businesses to change their VAT accounting, sales and purchase systems for just over a year is likely to cause significant and unwelcome additional costs, especially to SMEs.

2.5 In addition, the cut may also cause SMEs to be caught up in a spiral of administration where recent purchases are cancelled by customers and then re-issued in order to take advantage of the new lower VAT rates.

3.0 National Insurance Contributions (NICs)

3.1 The uncapped National Insurance increase of 0.5% extends the uncapped 1% NICs payment which already exists. The impact of this is both wide-ranging and undesirable. It means that all who pay National Insurance will pay at this extra rate, including the individual, the business which is an employer and the self-employed. Overall this could be perceived as sending the wrong message, i.e. that NICs is not an insurance contribution to pay for the bad times when the Government is in need of a hand-up and a hand-out, but rather is purely another branch of Income Tax.

4.0 Income tax

4.1 The proposed new 45% rate, together with the uncapped NICs rate of 1.5%, makes the UK’s top rate of tax 46.5%. This is high by the standards of our global competitors and supports the findings of ACCA’s recent paper: Perspectives on Fair Tax, an international study of finance professionals, which found that the UK’s tax system is viewed as less fair and less transparent than other tax regimes around the world. A copy of the report can be found here: http://www.accaglobal.com/documents/tech-tp-ft.pdf

4.2 The restriction of the Personal Allowance to 20% for anyone earning £100,000, and the subsequent withdrawal of this Personal Allowance by the time someone is earning around £140,000 confounds the problem.

4.3 It may be that taxing those on earnings above £100,000 at 46.5% draws little sympathy, but it is possible and even likely that the band will drop. There is no reason to leave it at £100,000—it could feasibly drop to £50,000. The amount likely to be raised is also less than a billion pounds, making it of little significance in plugging any Budget deficit running at over £100 billion.

5.0 SMEs

5.1 We welcome the £50,000 carry-back of tax losses for three years. This will be a real relief and will aid much needed cash flow for SMEs. We also welcome the fact that SMEs will be able to defer tax payments indefinitely. However we hope that any interest charged will be restricted to the equivalent of the Bank of England base rate.

16 December 2008

Memorandum from the Association of Friendly Societies

The Association of Friendly Societies wishes to make the following points:

1. Most friendly societies are small businesses, so it is disappointing that the PBR, which suggests it is working on behalf of small businesses is likely in reality to lead to the demise of a number of friendly societies.

2. As Friendly Societies only recover a small amount of VAT suffered, the changes should lead to slightly lower operating costs in 2009. On the other hand, system changes will be required for any Taxable Outputs made by Societies to ensure that the correct VAT rate of 15% is applied for the period 1 December 2008 to 31 December 2009. At the same time, employment costs will increase due to the raising of NI rates. The net effect likely therefore is an overall increase in costs.

3. The announcement that the Saving Gateway will match savings at the rate of 50p for every £1 invested means that this will be a very attractive vehicle for short-term savings for low income households. In effect, this equates to an average interest rate of 100% over two years. We support this as an excellent way of starting the saving habit.

4. However the consequence will be that this market is less likely to save in alternative vehicles such as the Tax Exempt Savings Plan or ISA, or by topping up their Child Trust Fund. In his speech the Chancellor indicated that the providers of the Saving Gateway will be “banks, building societies and credit unions. Friendly societies, lobbied to be included in the providers of the Saving Gateway because of the concern that it would otherwise undermine their markets. So we are particularly concerned that Treasury has overlooked our proposals, and instead put proposals in place that will directly lead to a reduction in new business, and closure or consolidation in the sector.
5. The insurance bond market, which was savaged in the last Budget, will also be further undermined for people with income in excess of £100,000.

December 2008

Memorandum from Professor David Heald,6 specialist adviser to the Committee

PRE-BUDGET REPORT 2008: THE RETURN OF HARD TIMES

INTRODUCTION

1. This Pre-Budget Report (Treasury 2008b) is more important than most Budgets and therefore requires close Parliamentary attention. Extensive comments could be made on the PBR itself and associated documents, but this memorandum will concentrate on a restricted range of topics:

— the sudden deterioration of the fiscal position;
— fiscal rules in the last cycle and in the current one;
— public expenditure changes in PBR 2008;
— the implications for public expenditure of the move to International Financial Reporting Standards (IFRS); and
— issues for Parliament to take up.

THE SUDDEN DETERIORATION OF THE FISCAL POSITION

2. For convenience, Table B4 (Treasury 2008b, p 192) is reproduced below. The deterioration from March 2008 to November 2008 is startling. Taking Net borrowing, for example, 2008–09 increases by 82.6%, followed by 210.5% (2009–10), 228.1% (2010–11), 222.2% (2011–12) and 204.3% (2012–13). Checking back to the comparable table in Budget 2008 (Treasury 2008a, Table C2, p 179), which compares PBR 2007 with Budget 2008, there was then only a small deterioration in the projection years. This raises questions as to:

(a) whether the Budget 2008 projections were excessively optimistic on the basis of information available at the time; and

(b) whether the PBR 2008 projections involve taking “a big bath” (so that future shocks are avoided) or there is the likelihood of further deterioration in Budget 2009.

One way of highlighting the dramatic deterioration is that the United Kingdom is projected to breach the 60% Maastricht Treaty limit in every year from 2009–10 to 2013–14 (Treasury 2008b, Table B3 on p 190).

3. Examination of Table B17 (Treasury 2008b, p 211) shows that net increases to TME since Budget 2008 are positive but small in the projection years 2009–10 (1.1%) and 2010–11 (0.3%). In contrast, the deterioration of current receipts (Table B13 on p 203) is dramatic: down by £29.8 billion in 2008–09 (5.2%) and £72.7 billion in 2009–10 (12.0%). The issue is not yet one of expenditure control in the sense of overspending against plan.7 However, the sudden and dramatic scale of the worsening of UK public finances does reinforce the frequently made point that the UK Government was running a deficit that was too high given the general health of the economy. However, this is a criticism of expenditure policy, not of the control system.

4. Of the £74 billion deterioration in the Surplus on current budget in 2009–10 (Table B4) between Budget 2008 and PBR 2008, 17.6% is attributable to discretionary changes and 82.4% attributable to revisions and forecasting changes. Table 1.2 (Treasury 2008b, p 10) shows total policy decisions since Budget 2008 to be costing £16.330 billion in 2009–10.

6 Declaration of interest: the author is a member of the Financial Reporting Advisory Board, nominated as an independent economist by the Head of the Government Economic Service. The views expressed are entirely his own.

7 This view is supported by the End of Year Fiscal Report (Treasury 2008d), which covers 2006–07 and 2007–08.
### Table B4

**FISCAL BALANCES COMPARED WITH BUDGET 2008**

<table>
<thead>
<tr>
<th></th>
<th>Outturn&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Estimate&lt;sup&gt;2&lt;/sup&gt;</th>
<th>Projections</th>
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<td>Budget 2008</td>
<td>36.4</td>
<td>42.5</td>
<td>38</td>
<td>32</td>
<td>27</td>
<td>23</td>
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<td>Changes to current budget</td>
<td>−1.2</td>
<td>31.6</td>
<td>74</td>
<td>77</td>
<td>65</td>
<td>56</td>
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<tr>
<td>Changes to net investment</td>
<td>1.4</td>
<td>3.5</td>
<td>5½</td>
<td>−4</td>
<td>−5½</td>
<td>−8</td>
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<tr>
<td>2008 Pre-Budget Report</td>
<td>36.6</td>
<td>77.6</td>
<td>118</td>
<td>105</td>
<td>87</td>
<td>70</td>
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<td><strong>Surplus on current budget (£ billion)</strong></td>
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<td>Budget 2008</td>
<td>−7.9</td>
<td>−9.6</td>
<td>−4</td>
<td>4</td>
<td>11</td>
<td>18</td>
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<tr>
<td>Effect of revisions and forecasting changes</td>
<td>1.2</td>
<td>−23.3</td>
<td>−61</td>
<td>−78</td>
<td>−75</td>
<td>−72</td>
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<tr>
<td>Effect of discretionary changes&lt;sup&gt;3&lt;/sup&gt;</td>
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<td>−8.3</td>
<td>−13</td>
<td>1</td>
<td>10</td>
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<td>2008 Pre-Budget Report</td>
<td>−6.7</td>
<td>−41.2</td>
<td>−78</td>
<td>−73</td>
<td>−54</td>
<td>−37</td>
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<td><strong>Net investment (£ billion)</strong></td>
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<td>Budget 2008</td>
<td>28.5</td>
<td>32.9</td>
<td>35</td>
<td>37</td>
<td>38</td>
<td>41</td>
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<tr>
<td>Effect of revisions and forecasting changes</td>
<td>1.4</td>
<td>2.5</td>
<td>2½</td>
<td>−½</td>
<td>−2</td>
<td>−1½</td>
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<tr>
<td>Effect of discretionary changes&lt;sup&gt;3&lt;/sup&gt;</td>
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<td>1.0</td>
<td>3½</td>
<td>−3½</td>
<td>−4</td>
<td>−6½</td>
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<tr>
<td>2008 Pre-Budget report</td>
<td>29.9</td>
<td>36.5</td>
<td>40</td>
<td>33</td>
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<td><strong>Cyclically-adjusted surplus on current budget (per cent of GDP)</strong></td>
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<td>Budget 2008</td>
<td>−0.7</td>
<td>−0.5</td>
<td>0.1</td>
<td>0.5</td>
<td>0.8</td>
<td>1.0</td>
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<td>2008 Pre-Budget Report</td>
<td>−0.8</td>
<td>−2.8</td>
<td>−4.4</td>
<td>−3.4</td>
<td>−2.3</td>
<td>−1.6</td>
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<tr>
<td><strong>Cyclically-adjusted net borrowing (per cent of GDP)</strong></td>
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<td>Budget 2008</td>
<td>2.7</td>
<td>2.7</td>
<td>2.2</td>
<td>1.8</td>
<td>1.5</td>
<td>1.2</td>
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<td>2008 Pre-Budget Report</td>
<td>2.9</td>
<td>5.3</td>
<td>7.2</td>
<td>5.6</td>
<td>4.3</td>
<td>3.5</td>
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<tr>
<td><strong>Net debt (per cent of GDP)&lt;sup&gt;4&lt;/sup&gt;</strong></td>
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<tr>
<td>Budget 2008</td>
<td>37.1</td>
<td>38.5</td>
<td>39.4</td>
<td>39.8</td>
<td>39.7</td>
<td>39.3</td>
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<tr>
<td>2008 Pre-Budget Report</td>
<td>36.3</td>
<td>41.2</td>
<td>48.2</td>
<td>52.9</td>
<td>55.6</td>
<td>57.1</td>
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</tr>
</tbody>
</table>

Note—Totals may not sum due to rounding.
1 The 2007–08 figures were estimates in Budget 2008.
2 The 2008–09 figures were projections in Budget 2008.
4 Debt at end March; GDP centred on end March; excluding financial sector interventions.


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**FISCAL RULES OVER THE LAST AND CURRENT CYCLES**

5. In The Government’s Fiscal Framework (Treasury 2008c), the fiscal framework is given a clean bill of health for the last cycle. Table B2 (Treasury 2008b, p 189) presents data in a tabular form and Chart 2A (Treasury 2008c, p 27) focuses on the golden rule. The Treasury (2008e, p 3) has now dated the last economic cycle, as having started in the first half of 1997 and ended during the second half of 2006.
### Table B2

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<tr>
<td><strong>Golden rule</strong></td>
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<tr>
<td>Surplus on current budget</td>
<td>-0.1</td>
<td>1.2</td>
<td>2.2</td>
<td>2.4</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
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<tr>
<td>Average surplus since 1997–98</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
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<tr>
<td>Cyclically-adjusted surplus on current budget</td>
<td>-0.1</td>
<td>0.5</td>
<td>1.1</td>
<td>1.4</td>
<td>1.4</td>
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<td><strong>Sustainable investment rule</strong></td>
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<tr>
<td>Public sector net debt</td>
<td>42.5</td>
<td>39.2</td>
<td>37.4</td>
<td>35.6</td>
<td>35.1</td>
<td>31.0</td>
<td>31.0</td>
<td>31.0</td>
<td>31.0</td>
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<tr>
<td>Core debt</td>
<td>41.1</td>
<td>39.2</td>
<td>37.4</td>
<td>35.6</td>
<td>35.1</td>
<td>31.0</td>
<td>31.0</td>
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<tr>
<td>1. As debt is a stock measure, performance against the sustainable investment rule is measured against the end point of the previous cycle.</td>
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<td>2. Debt at end March; GDP centred on end March.</td>
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</table>

**Source:** reproduced from Treasury (2008b, p. 189).
This is not the place to recount the saga of the dating of the last cycle, or how the Treasury has alienated many commentators and bred an air of cynicism about the fiscal rules. Although showing that the golden rule was met in the last economic cycle Table B2 also records that there was a deficit on the current budget in every year from 2002–03. For the same period, there was in each year a cyclically-adjusted deficit on current budget.

6. In Chart 2A, the bars plot cumulative achievement, showing that the surplus attributable to the first half of the economic cycle was almost eliminated in the second half. The solid line emphasises the same point by plotting each year’s cyclically adjusted surplus on current budget. Table B2 shows that the sustainable investment rule, about which there has been ambiguity as to whether it applied to each and every year or over the cycle, was met in every year except the first two (1996–97 and 1997–98) years of the last cycle.

7. A key decision in PBR 2008 has been to suspend these fiscal rules for the present cycle. This is permissible under the Code for Fiscal Stability (Treasury 1998, para 11):

11. The Government may depart from its fiscal objectives and operating rules temporarily, provided that it specifies:
   a. the reasons for departing from the previous fiscal policy objectives and operating rules;
   b. the approach and period of time that the Government intends to take to return to the previous fiscal policy objectives and operating rules; and
   c. the fiscal policy objectives and operating rules that shall apply over this period.

Given the exceptional circumstances, there will be a temporary operating rule for the current cycle:

3.11 Consistent with the Code for Fiscal Stability, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

3.12 The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015–16 when the global shocks have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5% of GDP a year from 2010–11 (Treasury 2008c, p 47, emphasis added).

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"The Government’s specification of the level below which public sector net debt should be held over the economic cycle developed over time. In the 1998 Economic and Fiscal Strategy Report (EFSR), the Government stated "other things equal, it is desirable that net public debt be reduced to below 40% of GDP over the economic cycle". At the 2001 Budget, the Government stated “other things equal, net debt will be maintained below 40% of GDP over the economic cycle”. At the 2003 Budget, the Government stated that to “meet the sustainable investment rule with confidence, net debt will be maintained below 40% of GDP in each and every year of the current economic cycle" (Treasury 2008c, para 1.42)."
This quotation, with certain words put in bold for emphasis, indicates the highly conditional nature of this policy commitment. Also, it places a huge weight on the technical process of cyclical adjustment.

8. The Treasury made two important innovations in PBR 2002, namely the annual publication of the End of Year Fiscal Report and the Long-Term Public Finance Report. Because of the early timing of PBR 2007 (which was combined with the Comprehensive Spending Review), the Long-Term Public Finance Report that would have been published then was published alongside Budget 2008. Notwithstanding the reversion to normal PBR timing, there is no Long-Term Public Finance Report in the set of associated PBR 2008 documents. PBR 2008 (Treasury 2008b, para 2.116 on p 41) states that “The next Long-term public finance report will be published in 2009”. This presumably refers to Budget 2009. The long-term fiscal projections sit on top of the five-year medium-term forecast, which has dramatically deteriorated since Budget 2008. The size of the fiscal adjustments required to restore fiscal sustainability (as defined in successive issues of the Long-Term Public Finance Report) is a topic to which the Committee may wish to give priority at the time of Budget 2009.

9. Box 2.4 (Treasury 2008b, p 31) contains an important statement: As any extra liabilities that may become classified to the public sector through these [financial sector] interventions will be temporary and backed by significant financial assets, they do not reflect future calls on the taxpayer. The long-term impact on the public finances, and any burden on future generations, would be determined by any eventual economic profit or loss incurred on the interventions. As a result, consistent with the treatment of Northern Rock announced in Budget 2008, while the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on public sector net debt both including and excluding the impact of these interventions.

The Government will base its fiscal policy, and measurement of its fiscal rules, on aggregates that exclude that impact. Any economic profit or loss on interventions will be included in both measures (and so within the fiscal rules) when that profit or loss crystallises for central government. Annex B sets out in full how the support has been accounted for in the public finances (emphasis in original).

This statement strikes an optimistic note as to whether these massive interventions will have a net Exchequer cost. Given their exceptional nature, the proposal to report both “including” and “excluding” is reasonable, provided that this is done clearly. Annex B is disappointing in this regard, containing not much more than the explanatory listing in Box 3 (p 220) and the composition of the public sector net cash requirement. Moreover, there is a question of what “crystallizes for central government” is taken to mean: for example, in the context of bank shares acquired at above current market prices.

PUBLIC EXPENDITURE CHANGES IN PBR 2008

10. The significance of the public expenditure changes exceeds their numerical value. The present author cannot remember any occasion since the Spending Review system was established in 1998 when the multi-year settlement has been re-opened in such a way. One of the features claimed for this system has been that it enables departments to plan ahead. The euphemism of “Public spending: additional value for money savings” in Table B5 (Treasury 2008b, p 194) marks a reduction of £5 billion in planned spending in 2010–11 (the third and final year of CSR 2007) and in 2011–12 (the first year of the next Spending Review). These have not yet been allocated to departments.9 There has been a re-profiling of capital spending, with £3 billion brought forward from 2010–11 to 2008–09 and 2009–10.

11. Looking beyond the current CSR period, there has been a reduction in forecast real spending growth. Total Managed Expenditure (TME) is assumed to grow at 1.1% on average in real terms over the period 2011–12 to 2013–14 (Treasury 2008b, para 2.51). In contrast, Budget 2008 (Treasury 2008a, para 2.67) had forecast real-terms TME growth of 1.9% on average over the period 2011–12 to 2012–13. Giles (2008) calculated that reductions in public expenditure plans are forecast to contribute £35 billion of the £104 billion fiscal adjustment required to restore balance by 2015–16.10 Given the complexity of problems confronting major functional areas of spending and the pressures arising from recession, the public expenditure climate on the ground is going to be very tough after many years of strong growth. For the first time since the Departmental Expenditure Limit/Annually Managed Expenditure distinction was introduced in 1998, it seems inevitable that, within a fixed TME, DEL will come under pressure from AME as a result of rising debt interest and recession-induced social security costs.

12. There is a clear indication from para 6.26 and Box 6.4 (Treasury 2008b, p 117 and p 119) that the Government will seek to dispose of public sector businesses and assets. Leaving aside the issue of whether or not the named businesses belong in the public or private sectors, hurried sales into depressed markets have a record of producing bad outcomes. In any case, asset disposals represent a portfolio adjustment (ie exchange assets for cash) and do not address the issue of properly measured deficits and debt.

9 “The Barnett formula will be applied as usual to the devolved administrations’ budgets when reductions to departments’ budgets are announced” (Treasury 2008b, para 6.32).
10 The other contributions come from tax increases (£19.5 billion), fiscal drag (£29.8 billion) and the effects of economic growth (£19.7 billion) (Giles 2008).
13. In my memorandum to the Committee on Budget 2008 (Heald 2008), I drew attention to the implications of the adoption of International Financial Reporting Standards (IFRS), from 2009–10 in central government and 2010–11 in local authorities. It is widely expected that most Private Finance Initiative (PFI) assets currently off the public sector client’s balance sheet will go on balance sheet under IFRS. However, this is a change relating to financial reporting (eg resource accounts) and not to the national accounts on which the fiscal aggregates are based. In terms of a spectrum as to the difficulty of keeping PFI assets off the public sector client’s balance sheet, IFRS is stricter than FRS 5A (ASB 1998), which is stricter than Treasury Technical Note 1 (Revised) (Treasury Taskforce 1999). However, the Eurostat (2006) guidelines are even more permissive of off-balance sheet treatment than Treasury Technical Note 1 (Revised). Thus far, the Office for National Statistics has been following the financial reporting treatment, as it does not have the resources to make judgements on individual schemes: the implication is that more PFI is currently on balance sheet in the UK national accounts than is required by Eurostat guidance. There are very important questions as to how PFI assets and liabilities will be reported in fiscal documents after the implementation of IFRS brings most PFI assets on balance sheet in resource accounts.

14. Governments display a general disdain for Parliament in budgetary matters, treating it as a rubber stamp or irrelevant. Each Budget or PBR is heavily trailed in the media beforehand, softening up public opinion and granting favours to chosen media outlets. Some of the leaks about PBR 2008 seem to have been genuine leaks discomforting the Government, rather than plants. Commendably, MPs secured an Emergency debate on PBR 2008, in recognition of that being a landmark financial statement. Deeply embedded characteristics of UK politics militate against constructive engagement by Parliament in budgetary matters. Nevertheless opportunities arise when governments are weakened. There follow three suggestions as to actions that Parliament in general, and the Treasury Committee in particular, might take up.

15. First, in The Government’s Fiscal Framework (Treasury 2008c), the document showing that the fiscal rules were met in the last economic cycle, there are eight substantive references to the role of the National Audit Office (NAO) in auditing the assumptions behind the Treasury’s macroeconomic forecasts. Heald and McLeod (2002, para 505) warned against this role for the NAO:

The NAO does not audit the forecasts, its role being to ensure that these forecasts of the public finances are based on assumptions that are transparent and widely regarded as reasonable. However, the NAO can only audit the assumptions that the Treasury puts to it, though since the March 2000 Budget there has been a rolling review of previously audited assumptions. Thus far, the assumptions embodied in earlier macro forecasts have not been seriously tested by events. In such an eventuality, the NAO could be seen to be implicated in forecasts that later came under challenge, thus deflecting blame from the Treasury and potentially creating difficulties in its relationship to Parliament and its committees. Although the NAO only audits certain forecasting assumptions, and not forecasting systems or methodology, this distinction might be lost in practice.

There are two central problems in this role, the latest instalment being reported on in National Audit Office (2008).11 First, the NAO does not have, nor could it have, the technical macroeconomic expertise to match that of the Treasury. Second, this arrangement (“look only at what we ask you to look at”) breaches the fundamental postulate of auditing that there must be independence to investigate as well as independence to report. Parliament should ask the NAO how it proposes to gain release from this inappropriate task and then devise genuinely independent and competent monitoring arrangements.

16. Second, tax policy-making in the United Kingdom has become shambolic. Examples of this are easy to find: the saga of the abolition of the 10p rate; the taxation of Non Domiciles; the effective closing down of future VAT options after the posting of the wrong document on the web. Whether this situation is the fault of ministers or of officials is difficult to judge from outside. Given the forthcoming fiscal consolidation, there is an obvious danger that, one by one, viable options will be ruled out by those facing immediate political pressure. There is a clear role for the Treasury Committee in examining taxation options, establishing an information base and perhaps building some form of consensus. The forthcoming Mirrlees Report, commissioned by the Institute for Fiscal Studies, might provide a convenient peg on which to hang such an inquiry.12

17. Third, the smell of pork barrel emanating from the passage of the US Troubled Assets Relief Program is offensive. However, Congress counts in budgetary matters in the way that the UK Parliament does not. Whereas the Treasury owns public expenditure aggregates and changes them at will, Parliament does own

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11 This included dating the end of the most recently completed economic cycle.
12 Information about the Mirrlees Review, and draft versions of chapters that will appear in the supporting second volume, can be found at http://www.ifs.org.uk/mirrleesreview/publications.php.
the Estimates system.\textsuperscript{13} The Treasury (2008f) is currently consulting Parliament and other stakeholders on the Alignment project, intended to simplify budgetary documents and—as far as possible—align Budgets with Estimates and Resource Accounts. Much of what the Treasury wants seems reasonable, though care is needed about the detail: for example, on the timing of information and on there being systematic overviews of departmental information. Implemented well, there are gains for Parliament as well as for the Government, but Parliament should exploit the leverage its ownership of Estimates potentially confers over the broader question of how financial information is reported to Parliament.

30 November 2008

REFERENCES


\textsuperscript{13} “Under established usage … important changes in the customary form of the Estimates should not be made without the previous approval of the Committee of Public Accounts … and, since 1921, of originally the Estimates Committee, subsequently the Expenditure Committee and now the Treasury Committee, acting on behalf of the House of Commons” (Limon and McKay (eds) 1997, p 744).
Memorandum from Professor Colin Talbot, Herbert Simon Institute, Manchester Business School

INTRODUCTION

This note will concentrate mainly on public finance issues, but a few remarks will be made first about the economic outlook.

THE ECONOMIC ASSUMPTIONS—LIVE CAT BOUNCE?

The major assumptions underpinning the PBR08 are:

- That the global economy will slow down but not slip into recession.
- That the G7 countries will go into recession, but only for 2009 and only by $-0.75\%$ of GDP and will return to growth in 2010.
- That the UK economy will go into recession, for the same period as, but slightly more than, the G7.
- It will return to growth in 2010, again at a higher rate than the G7—a case of “live cat bounce”?

If any of these assumptions are incorrect—and in the current climate the degree of uncertainty must be much larger than at any time in many years—then of course the PBR’s forecasts and plans in other areas—especially public finances—may be thrown substantially off course.

The assumptions about the UK’s economy seem especially questionable—the UK will apparently experience both a sharper decline and a sharper recovery than the G7 average—is this really credible and if so why?

During the recession the UK inflation situation is predicted to come very close to, or even move into, deflation. CPI is expected to decline to 0.5% in 2009 whilst RPI is expected to go negative at $-2.25\%$ at the same time.

It should be noted that whilst this may be the worst financial crisis since the Great Depression it is not—on these assumptions—remotely near as big an economic crisis. For example, USA GDP shrank by about 45% between 1929 and 1933.
Conventional economic wisdom is that once an economy moves into deflation there is a serious danger of a self-reinforcing spiral—consumers put off unnecessary spending today in the hopes of lower prices tomorrow, which are then forced by decreasing demand, and so on.

**This at least raises the possibility that the 2.5% reduction in VAT could have the opposite effect to that intended if it is perceived by consumers as merely part of a general deflationary trend.**

**Public Finances**

As in previous economic downturns, in the 1970s, 80s and early 90s, public spending is expected to rise above the average levels—as a share of national wealth (GDP).

In fact public spending will rise above the long-term average for the first time since New Labour were elected in 1997.

**Figure 2**

**LONG-TERM TRENDS IN PUBLIC SPENDING AS PERCENTAGE OF GDP**

![Graph showing long-term trends in public spending as percentage of GDP](image)

Source: adapted from PBR 08

As has been widely pointed out, the effects of recession on government income and spending will exacerbate an underlying structural deficit and cause a substantial rise in net public debt, annually and cumulatively.

The size of the annual deficits—ranging from £41 billion in 08/09 through £78 billion in 09/10, £73 billion in 10/11 and so on—can only be moderately affected by the £20 billion (over 15 months) additional fiscal stimulus package announced in PBR 08.

PBR 08 plans public spending for 2011–14 to rise by only 1.1% in real terms, which already includes a £37 billion reduction in plans announced in Budget 08.

Even if spending were reduced to zero real-terms growth over the next spending round period (2011–14) the cumulative additional savings would only be around £46.7 billion, which would make a very limited contribution to the long-term reduction of net public debt.

**To reverse the cumulative additional net borrowing during this three year period (2011/14)—£242 billion—would require a cut in real terms in public spending by about 5% per annum, reducing public spending by something of the order of £249 billion over the period.**

This would mean cutting roughly the equivalent of:
- more than all public sector net capital investment;
- the combined allocations to Scotland and Wales; and
- the entire education, children and families; etc.

(See PBR 08 Table B18, p 214)

It seems unlikely any government would carry out such a draconian cut-back in spending, so the only real alternatives in the medium term are a combination of some reductions—possibly in real-terms—on public spending overall combined with tax rises. There certainly appears to be no realistic prospect of medium term tax reductions.
The impact of an overall freeze (0% real-terms growth) in public spending would in result in a real terms cut (ie minus real-terms) in spending on public services, because of the non-discretionary areas of spending which cannot be cut. Likewise a real-terms cut in total spending would mean an even greater cut in public services spending.

Finally, it should be noted that if priority were given within public services spending to areas like health, education and international development, then of course other areas of spending on services would have to suffer proportionately greater cuts.

**INVESTMENT**

PBR 09 claims that public sector net investment will continue at “historically high levels” (p 122). As the next chart shows (based on the PBR’s own figures in Table B22, p 223) it is difficult to reconcile this claim with the historic data.

Public sector annual net investment has been below the 40-year average for most of the current Government, and at the end of the next spending cycle will be exactly on the 40-year average.

It may well be that net investment in public services (schools, hospitals, etc) are at historically high levels—figures from the period before 1979 include many public corporations which were subsequently privatised. But this is not the same as public sector net investment.

**Figure 3**

PUBLIC SECTOR NET INVESTMENT TRENDS

**EFFICIENCY**

In this medium term perspective for the public finances, the pressure for continuing to deliver services and save money will undoubtedly lead to an even greater emphasis on efficiency savings.

The government already planned in CSR07 for £30 billion a year in efficiency savings and this has now been raised in the final (third) year of that spending cycle (2010–11) to £35 billion, to compensate for spending brought forward to year’s 2008–09 and 09-10.

It should be noted that the “2004 Spending Review: final report on the efficiency programme”, published alongside PBR 08, was as thin on detail (at only 9 pages) as the credibility of the final reported savings.

In cumulative cash terms over three years—£95 billion—this is almost double the Gershon cash targets of 2005–08 which totalled only £49.5 billion. In fact it is more than double, because Gershon reported cash savings were gross amounts whilst the new savings are supposed to be net of costs.

Although the government claims to have exceeded it’s own target and achieved £26.5 billion annual savings against its target of £21 billion (cash and non-cashable), this remains subject to a great deal of doubt. Most notably Health claims to have saved £7 billion in efficiencies (PBR 09, p115) at the same time that the ONS has estimated health service productivity was declining by between 2 and 2.5%. NAO reports have also cast substantial doubt on Gershon reporting mechanisms.
Even if the Governments new efficiency targets were achievable—and verifiable—both of which seem doubtful, there is clearly little scope for any addition to these targets. “Efficiency” is thus unlikely to provide a way of further plugging the holes in the public finances.

December 2008

Memorandum from John Whiting, PricewaterhouseCoopers LLP, the Chartered Institute of Taxation and the Low Incomes Tax Reform Group

This paper is a commentary on some of the taxation measures contained in the Chancellor’s 24 November Pre-Budget Report speech, associated press releases and other papers. It does not attempt full analysis and cannot be exhaustive.

Given the number of significant tax changes announced, this was more of a full Budget than a Pre-Budget Report (PBR). That in itself is not necessarily a bad thing—provided that proper consultation has already taken place, or ensues. Of the announcements, some are welcome; some less so, particularly when simplification of the tax system is borne in mind.

VAT

The VAT change was the most dramatic item in the PBR. Whether it will have the desired effect on the economy is for others to say. VAT reductions not passed on may help businesses and jobs.

From a tax technical point of view, the main issue is the administrative effort that it requires. HMRC’s own estimate of a cost for business of £300 million is not insubstantial in straitened times. It is, after all, the first general VAT rate reduction the UK has experienced; four working days notice is not ideal. For retailers, who nowadays mostly price to “price points”, there is a lot of repricing to consider; after all, they have been required to quote prices as “VAT inclusive” for some time. For the service sector, who in some sectors at least quote prices with VAT to be added, things are easier.

LARGE BUSINESS

The long-awaited announcement on how the foreign profits consultations are to be taken forward is very welcome: it brings to an end a period of considerable uncertainty for business and is a reward for a great deal of work by all sides. The move to a territorial basis of taxation is sensible and appropriate, though we await more substance. The announcements do give rise to some concerns:

— Why is the exemption only available to large and medium sized groups? Small companies/groups warrant similar treatment and if HMRC is to introduce a targeted anti-avoidance rule (TAAR) there should be sufficient protection for them.

— The interest cap proposal is not unexpected and the dropping of some mooted additional restrictions is welcome; but it has raised concerns that it will, overall, result in a net revenue gain to the Treasury when compared with the modest cost of the dividend exemption. It may also produce the odd result that companies may move more profits away from the UK to minimise the impact of the cap.

— The CFC changes, whilst announced as a “balanced package of reforms” may not justify this summary. The removal of the holding company exemption in particular seems contrary to the territorial approach if it precludes intra-territory financing.

The replacement of the outdated Treasury Consents with Quarterly Reporting is sensible. The proviso is that reportable transactions are only those where HMRC/HMT have a real interest from a risk point of view, rather than the system imposing reporting to no real point.

SMALLER BUSINESS

SMEs looked to this PBR for some assistance in tough times and some assistance was delivered. The deferment of the 1% small companies’ tax rate increase is appropriate; the general deferment of the income shifting legislation is very welcome and sensible in view of the difficulties HMT/HMRC have had in defining the precise target they wish to tackle.

The additional loss relief sounded good on the surface but is really very modest—why only £50,000 and why for only one year? If this is all that could be afforded, it would have been better to introduce administrative changes to permit a business to establish a loss more quickly and allow a notional offset against a pending tax payment, rather than requiring the payment/tax return/loss claim/repayment sequence which can take too long.

The extra resources for agreeing rescheduling of payments due to HMRC is a good initiative.
PERSONAL TAX

The increases in the main personal allowances, to conclude finally the 10% tax rate saga, are welcome. Once these are place in 2009–10, then virtually all taxpayers will have been compensated for the loss of the 10% rate band. (See the table at the end of this note for more details.)

An assault on the personal allowance for those on high incomes has always been on the cards. The route chosen seems to add unnecessary complexity to the tax system. PAYE will not cope with the restriction for many of those affected as tax codes will be based on prior year income or estimates, and so tax deducted will require adjustment after the year end. That said, those impacted will almost all be in the self assessment system already.

Freezing the pensions cap for five years seems odd given previous commitments. Presumably it is tied to the restrictions to personal allowances and the proposed 45% tax rate, to ensure that these “stick” as much as possible and taxpayers are not able to put any more of their income into pension funds. One side effect is to cap the amounts that can be commuted under the “trivial pensions” system (as the limit is set at 1% of the overall cap); it is to be hoped that if the main cap is to be frozen then this limit can be uprated to keep its value.

The new higher rate of 45% (with a marginal rate of 60% at some levels) does start to make the UK’s top rate of tax look high. Whilst other countries may have higher headline rates, the effective rates can be lower, taking into account NICs and allowing for the lack of reliefs the UK taxpayer faces for things such as mortgage interest. It also raises uncertainty about further future changes, in contrast to the progress on certainty and UK competitiveness achieved on the large business front.

MANAGEMENT OF THE TAX SYSTEM

The announcement that the HMRC/Taxpayers’ Charter is to be taken forward with a foundation in statute is excellent news. A Charter is a very necessary balance to the extensive modernisation and extension of HMRC’s powers; a legislative vires is crucial to give the Charter proper authority and to give the taxpayer a proper basis for using it.

The further consultations on HMRC’s Powers (Penalties for late returns; Interest; Payment & Repayment; and Compliance Checks) all seem to show good progress reflecting the extensive input given in response to the first stage of consultations.

AIR PASSENGER DUTY (APD) & TAXES ON THE ENVIRONMENT GENERALLY

The decision not to change from the existing APD to a “per plane” basis, despite the apparent support within the Commons was a surprise. The bandings do give some odd results, for example Egypt costing more than Turkey and the whole of the USA and Canada being in a single band. There is concern about competition with long haul flights not starting in the UK.

We still lack an overall policy strategy for taxes on the environment. The change on APD also shows that there is no overall policy/direction of travel on business tax.

CONSULTATIONS—PROOF OF THE VALUE

One welcome note that this PBR strikes is to show the value of good consultation. Income shifting has been deferred in line with many representations showing how complex the proposals were; changes to Travel & Subsistence rules which aroused fears of a much wider impact on many innocent taxpayers rather than hitting just those who artificially exploit the rules are to be rethought; studies on payrolling benefits are to continue with more input from employers and advisers; and the HMRC Powers proposals show good evidence of proper listening to submissions.

1 December 2008
APPENDIX

THE 10% TAX BAND *(FIGURES SUPPLIED BY THE LOW INCOMES TAX REFORM GROUP)*

This table looks at those on low incomes who, even after the £600 increase in personal allowances announced in May, lost out through the abolition of the 10% income tax band. Looking at their position in 2009–10 with personal allowance increased to £6,475 (the figures for income tax payable assume the same level of income throughout):

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<tr>
<td>7,000.00</td>
<td>177.50</td>
<td>193.00 (−15.50)</td>
<td>105.00 (57.00)</td>
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<tr>
<td>8,000.00</td>
<td>342.90</td>
<td>393.00 (−50.10)</td>
<td>305.00 (−12.20)</td>
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<tr>
<td>9,000.00</td>
<td>562.90</td>
<td>593.00 (−30.10)</td>
<td>505.00 (27.80)</td>
</tr>
<tr>
<td>10,000.00</td>
<td>782.90</td>
<td>793.00 (−10.10)</td>
<td>705.00 (67.80)</td>
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<tr>
<td>11,000.00</td>
<td>1,002.90</td>
<td>993.00 (9.90)</td>
<td>905.00 (107.80)</td>
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When comparing income tax payable in 2009–10 with income tax payable in 2007–08, the net winners/losers figures also takes into account the loss/gain found for 2008–09. It will be observed that the £8,000 income level is still an overall loser, although their 2009–10 tax bill has reduced compared with 2007–08.

NICs will provide additional compensation for earners, thanks to the increase in the employee’s earnings threshold.

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**Memorandum from the New Policy Institute**

**SOCIAL ISSUES WITHIN THE PRE-BUDGET REPORT**

**Summary**

1. This memorandum responds to the Committee’s request for written evidence on the social issues raised by the Pre-Budget Report (PBR). Our response here has two parts, one building upon our earlier evidence to the Committee (in May) on the taxation of low income, working families, and the other highlighting the hugely important issue thrown up by the recession, namely unemployment. In particular:

   — The announcements in the PBR to do with the raising of the income tax personal allowance are to be welcomed. The level of tax paid by low-income households is one element of the large and growing problem of “in-work” poverty. The Government is correct to use cuts in taxes, as well as increases in tax credits, to try to address this.

   — Having decided to administer a fiscal stimulus, the Government should have used the extra money that was available to commence more radical reform of the tax or tax credit systems, for example, by beginning on the task of reducing the very high (70%) “marginal effective tax rates” faced by low-income working families in receipt of tax credits. Not to have done so was to miss what may be a unique opportunity.

   — Turning to the recession, if the OECD’s forecast is correct, all the progress made on unemployment over nearly a dozen years is about to be undone in as many months. The implications of this, both for unemployed people themselves and for the “Welfare to Work” strategy, should have been at the heart of the PBR. Yet the only quantified estimate of the likely scale of future unemployment is buried in a table on page 188. Rather than saying next to nothing, the Government should be candid about the scale of the future unemployment problem, seizing upon the insurance elements within the social security system to provide a just and popular remedy to it.

**Reducing taxes on low income, working households**

2. In our previous submission to the Committee, we tried to explain why an increase in the personal allowance was the right way to compensate those who lost out through the abolition of the 10p starting rate. When we appeared before the Committee, we indicated our support for the temporary measures announced by the Chancellor in May. Naturally, therefore, we welcome the related announcements in the PBR to make the change permanent, to increase the limit further in the two years from April 2009, and to align the National Insurance primary threshold with the income tax personal allowance from April 2011.
3. At the risk of some repetition, it is worth noting why it is correct to try to reduce the tax paid by low-income households.

   — First, despite the obvious sense in the idea that work is the best route out of poverty, the number of children in working families in poverty has continued to rise, reaching a high in 2006–07 of 2.1 million.\(^{14}\) Up to now, it has been this rise in in-work poverty which has stymied progress on child poverty overall.

   — Second, this problem of “low income in work” is by no means confined to families with children. For example, over the last 10 years, the number of adults in in-work poverty has risen by 0.8 million, three quarters of the rise being among those without dependent children.\(^{15}\)

   — Third, as we showed in our earlier submission, whether or not they are entitled to tax credits, many working families in poverty are paying income tax, national insurance and council tax. In some cases, indeed, such households are actually being taxed into poverty.

4. The first of these three points underlines the central importance of “in-work” poverty, the second shows that it cannot just be addressed via child tax credits alone while the third shows that the tax paid by low-income households is, to some extent, part of the problem. Taken together, they make the case for general reductions in taxation on low-income households. Raising the income tax threshold is one way of doing that.

5. What is so disappointing with the PBR, however, is that the measures to reduce taxation on low-income households do not go further. Having decided that a fiscal stimulus was appropriate, extra resources were available that could have been devoted to this end. Since those on low incomes tend to spend a larger proportion of any extra money they receive than those on higher incomes (thereby increasing the chances that the tax cut is effective in delivering an economic stimulus), it is very surprising that Government declined to take advantage of this—presumably not to be repeated—opportunity.

6. As to what it might have done, it is important to remember that the tax problem for low-income households has two linked but separate parts to it. One, already discussed, is the amount of tax that they pay. The other is the marginal rate of tax that they face. The key point here is that a worker belonging to a family receiving tax credits (above the family element) faces a marginal effective tax rate of 70% on their earnings (that is, the combination of the 39% tax credit taper with the normal rates of income tax and national insurance). It is, quite simply, ridiculous for workers in the lowest income families in the land to be facing by far the highest marginal rates of tax. For so long as we retain tax credits, the differential cannot be eliminated; but it certainly could be reduced, through a combination of reductions in both the income tax rate and the tax credit taper.

7. Although we are not in a position to make any specific recommendation here, we would urge the Government (assuming it has not done so already), to launch a comprehensive review of what could be done to move towards this goal. Given the complexity of what is involved, this cannot be left to the last minute—which is perhaps why no such change could have been attempted in the PBR, even if Government had wished to do so.

Recession and the problem of unemployment

8. We turn now to the matter of the economic recession. In our view, the discussion that has followed the publication of the PBR is missing an essential point, namely, that for many people, a recession may even be a time of increased material comfort. Unlike inflationary episodes, or periods of normal economic growth, a recession’s impact on society is inherently very uneven. While many people are likely to be more apprehensive about their economic prospects in 2009, those who keep their jobs may even be a little better off in material terms next year than this. This is especially likely to be so for anyone enjoying lower mortgage payments as a result of the cuts in interest rates. More generally, the deep price discounting, from the bottom end of the high street all the way to the car dealerships, promises bargains for any household whose income holds up. For these people, the material impact of a recession in 2009 may really not be too bad at all.

9. By contrast, those who lose their jobs, if they cannot find another one almost straightaway may experience severe difficulties. If losing their job leads on to losing their home too, all that they have worked for may be at stake. For some of them, it will not be going too far to say that the material impact for of a recession in 2009 will be ruin.\(^ {16}\)

10. So what does the PBR say about the prospects for unemployment? Since maintaining employment is one of the two principal reasons for contemplating a fiscal stimulus (the other being to sustain investment), we would have expected the PBR to have addressed this question. There is no doubt that the Treasury has such forecasts. They are, after all, an input into the financial projections while they are also part and parcel of a GDP forecast. Yet as far as we can see, the only reference in the PBR to the likely scale of unemployment

\(^{14}\) In so doing, it now clearly exceeds—for the first time—the number of children in poverty in workless families (1.7 million). Source: Households Below Average Income, via http://www.poverty.org.uk/16/index.shtml. Both here and elsewhere, poverty statistics are quoted on the “after housing costs” basis.

\(^{15}\) Source, Households Below Average Income, via http://www.poverty.org.uk/39/index.shtml

\(^{16}\) Self-employed people and proprietors of very small businesses are in a very similar position to these erstwhile employees: if the demand for their services collapses, their prospects may be grim.
is to be found in a list of assumptions audited by the NAO on the likely scale of the increase in the claimant count. As a footnote makes clear, “this is a cautious assumption based on the average of external forecasts and is not the Treasury’s economic forecast”.17

11. One day after the PBR, the OECD published a forecast which foresees UK unemployment approaching 8% by the end of 2009, with an average for 2010 of a little above 8%. This rate is equivalent to some 2.5 million unemployed people, an increase compared with now of some 700,000.18

12. The absence of any official forecast within the PBR of either the claimant count or unemployment is extraordinary; but more to the point, it also seems to us to be quite the wrong approach. Far from denying it, we believe that the Government should now openly acknowledge the problem of unemployment and seek to protect and promote the interests of unemployed people by raising the value of contribution-based Job Seeker’s Allowance. Why?

13. While all can probably agree that those who lose their jobs deserve sympathy, that in itself is no basis for policy. Our argument, though, is different: by providing greater material security to those who lose their jobs, the Government can at the same time (if it is open and explicit about it) provide greater psychological security to many others who have not lost their jobs but who fear that they might. What that this boils down to, of course, is the straightforward idea that the beneficiaries of an insurance policy include those who gain peace of mind as well as those who actually end up making a claim.

14. This combination of greater material security for some and greater psychological security for others has two big advantages. The first is that it makes it easier to sell the idea that National Insurance contributions will have to rise to pay for the higher level of benefit. How much higher is obviously a matter of judgement. It should be noted, however, that since contribution-based JSA (JSA-C) is paid out of National Insurance which is levied as a percentage on earnings, it could be argued that JSA-C should rise with earnings. In fact, however, JSA-C is little different in real terms now from what it was 30 years ago, whereas real earnings over that period have risen by at least 75%. On that basis, an immediate rise in JSA-C to above £100 a week is indicated.

15. Is the rise in National Insurance contributions that would be required to pay for this likely to be feasible? According to the Government Actuary, payments for JSA-C are projected to represent less than 1% of all payments from the National Insurance Fund in 2008–09. While this projection pre-dates the recession, such a tiny proportion means that even a substantial (eg 10-fold) increase would be quite easy to absorb.19 Moreover, since the workings of the fund are simple, being run on a cash basis, it would be quite easy to explain to the public exactly why contributions have to go up, and who will gain as a result.

16. An enhanced role for JSA-C would require Government to start emphasising once more that not all social security benefits are means-tested “handouts”. Anecdotal evidence suggests that some people made unemployed are surprised to discover that there is a benefit to which they are entitled by virtue of the contributions that they have previously made. Given the popular support for the contribution-based State Retirement Pension, there is no reason why the public should not support contribution-based unemployment benefit too. The original architect of the system certainly had no doubt about our attitude towards the general principle: “benefit in return for contributions”, affirmed Sir William, “rather than free allowances from the State, is what the people of Britain desire”.20

17. The second advantage of the greater psychological security that an enhanced JSA-C might bring at a time like this is economic. In keeping with the current fashion, we would like to quote Keynes, drawing attention to the importance he attached to what he called “fundamental psychological factors” in his General Theory.21 Certainly one of these, namely the propensity to consume (that is, the inclination to spend rather than save or pay off debts) might well be expected to be affected by the “peace of mind” that a well-understood and valued system of unemployment insurance would confer. If this is so, an argument that began as “mere” compassion for the unemployed could end up delivering a benefit to the economy as a whole.

18. The adverse effects of the recession are not limited to those people without work who have lost their jobs since the recession began. If the OECD forecast is correct, the appearance in Job Centres of up to 700,000 people who have recently been employed is bound to harm the prospects of those who were already without a job, both those officially counted as unemployed and those seeking to return to work after a period of economic inactivity due, say, to disability.

19. We recognise that our call for an increase in contribution-based unemployment benefit raises the question as to whether other benefits for working-age adults, both contribution based and means-tested, should be raised too. We are not ready to answer that question yet; and in response to the PBR it would be

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17 Pre-Budget Report, November 2008, p188 footnote g.
21 In chapter 18 of The General Theory of Employment, Interest and Money. Besides the propensity to consume, the other two psychological factors listed by Keynes were the attitude towards liquidity and the expectation of future yields from capital assets.
going too far. There is, however, a deeper change that we do believe the Government is now obliged to make, namely, to recognise that since it is inevitable that some people will be unemployed, or economically inactive and in receipt of state benefits, they should not be stigmatised for being in that situation.

20. For a long time (since before the present Government came to office), this has not been the case. During that period, the whole thrust of policy in this area has been focussed on trying to get unemployed people into work. In itself, the preference for employment rather than unemployment is correct; but for so long as it is not possible for everyone who wants a job to have one—and there are over 3 million people in the UK who are either unemployed or economically inactive but wanting work— it is a one-sided and incomplete policy.

21. While unemployment continued to fall, it was somehow possible to overlook this one-sidedness. With the recession now upon us, it is not. If the OECD is right and unemployment rises to around 8% by the end of next year, it will take it back to a level last seen in 1996. The whole gain here won over a dozen years risks being lost in as many months. In these circumstances, the proper sentiment embodied in “Welfare to Work” must be tempered by a sober recognition of the macro-economic realities. If the threat of sanctions is used to force those least well equipped to compete in this labour market, the outcome is likely to be neither welfare nor work.

1 December 2008

Memorandum from the Institute of Chartered Accountants in England and Wales

1. OVERVIEW

1.1 The ICAEW has concerns regarding the effectiveness and impact of both the headline VAT rate change and the Government’s access to finance package, principally for small businesses, announced in the 2008 Pre-Budget Report (PBR).

1.2 The 2.5% reduction in the VAT rate is unlikely to have a major impact on consumer purchasing behaviour and, for many businesses, the administrative burdens and costs of pricing transition will outweigh any likely benefits.

1.3 Personal allowance changes, coupled with proposed increases in national insurance rates, will result in distortions and anomalies in effective marginal tax rates—producing a marginal tax rate of 60% for specific income bands.

1.4 The ICAEW awaits full details about how the majority of the measures outlined in the Government’s access to finance package will work in practice. However, we are concerned that the relatively limited scale of intervention and the significant amount of time that it will take to set up and market new finance facilities will reduce any potentially positive impact on business confidence.

1.5 A number PBR announcements are largely welcomed by the ICAEW including: the proposal for a Taxpayers’ Charter to have statutory backing; deferrals of proposed income shifting rules and the proposed increase in the small companies rate from 21% to 22%; the announcement to introduce flexible payment arrangements for taxpayers; and the proposal to extend loss relief carryback from one year to three years.

2. ECONOMIC ASSUMPTIONS

2.1 Taken together, the Pre-Budget Report (PBR) measures provide a fiscal stimulus package estimated to put £25 billion into the economy. We do not know whether this spending will have the desired effect of staving off a major recession, but we are concerned with the assumptions which underpin this decision.

2.2 The PBR assumes that GDP will fall for the first six months of 2009 before GDP growth begins to recover (paragraph 2.17 of the Red Book). Many commentators are of the view that the recession will last throughout 2009 and into 2010 and that the assumptions and estimates underlying the PBR are too optimistic.

2.3 The danger is that the fiscal stimulus proposed will not lift the UK out of recession as predicted. If the UK is still in recession in 2010, the proposed fiscal tightening from that point may have the effect of prolonging the recession further.

3. Temporary Reduction in the VAT Rate from 17.5% to 15%

3.1 The ICAEW is concerned that:

— at a macroeconomic level, the temporary reduction will have only a minor impact on consumer purchasing behaviour, particularly for low income consumers;
— for many businesses the administrative burdens and costs of pricing transition will outweigh any likely benefits; and
— for those businesses that hold prices and thereby benefit from the VAT reduction, the effects of that advantage will be small compared to other cash flow difficulties—for instance as caused by falling demand or higher import prices due to the falling pound.

Impact on consumer purchasing behaviour

3.2 The Government estimates that the stimulus from the temporary reduction in the VAT rate, from 17.5% to 15%, will amount to about £12.5 billion to the economy spread over 2008–09 and 2009–10.

3.3 The overall reduction in selling prices will not be 2.5%, the VAT reduction, but only 2.13%, the all-inclusive selling price reduction, as per the example below:

Example

A computer costs £299 including VAT at 17.5%. The VAT element is £44.53 (17.5/117.5 x £299) and the price before VAT is £254.47. VAT of 15% on this price is £38.17, making the new price £292.64. Whilst the headline reduction in VAT is 2.5%, the actual saving is £6.36 and actual percentage reduction is price is only 2.13%.

3.4 While the VAT reduction will provide some help to consumers, for low to mid-range purchases this figure will be largely immaterial for many consumers. However, the reduction may provide a worthwhile stimulus to high value purchases such as new kitchens, conservatories, extensions etc.

3.5 If the reduction in the VAT rate is passed on, which may not always be the case, it will benefit all consumers. However, those consumers on lower incomes are expected to benefit relatively less, as a higher proportion of their spending will be on items unaffected by the VAT rate change, such as food and travel fares (zero-rated), or domestic fuel (5% VAT rate—unchanged).

For many businesses the administrative burdens and costs of pricing transition will outweigh any likely benefits

3.6 The ICAEW believes that the HM Treasury impact assessment for the VAT reduction policy, which estimates a total cost of £300 million on businesses’ time using the standard cost model, may have considerably underestimated the true cost to business. For small businesses and retail businesses in particular, the administrative burden and transition cost of accommodating the change in the headline VAT rate is likely to outweigh any benefits which businesses might receive from increased sales.

3.7 The figures and assumptions in the impact assessment need to be subject to rigorous analysis. For example, the impact assessment estimate for “familiarisation with the changes” is half an hour for small businesses (costing £7) and up to three hours for larger businesses (costing £100). This is wholly unrealistic given that many businesses have relatively complicated VAT affairs.

3.8 We note that HMRC have already issued some 67 pages of guidance in eight different publications explaining how to cope with the rate changes, and more is expected. Whilst we commend HMRC for trying to assist business, the amount of guidance already published further indicates the extent of the additional compliance cost placed on business.

3.9 The estimates for repricing costs are £25 for smaller businesses and £600 for larger businesses. Again, we think that this is a significant underestimate—newspaper reports have suggested that ASDA estimate that changing all the prices on the shelves will take 100 years in man hours.

3.10 Changing VAT rates in December, during the Christmas sales and ahead of the post Christmas sales, is a highly inconvenient time for retailers to take on transition cost.

3.11 The administrative cost for those smaller businesses on simplified VAT schemes, such as cash accounting and the Flat Rate scheme, will be significantly increased—introducing complexity to a business category for which the Government has sought to reduce VAT burdens. Businesses using the flat rate and cash accounting schemes will need advice on how to deal with the changes, tailored to their particular circumstances—including professional advice based on their individual circumstances, support in developing new spreadsheets and to deal with queries as they arise. All cash received after 1 December 2008 has to be traced back to the original invoice and VAT accounted for accordingly.
Case Study—The Institute of Chartered Accountants in England and Wales (ICAEW)

The ICAEW, an organisation employing around 600 people and servicing over 132,000 members and a large number of non-member commercial relationships, has already incurred considerable time-costs spread across a number of personnel in order to understand detailed issues about the rules relating to changes in the VAT rate and how they should be dealt with.

For example we need to decide what to do where members have already paid their 2009 subscriptions. Whilst the main ICAEW subscription is VAT exempt, some members have opted to receive additional services which are subject to VAT. These have been paid at 17.5%, but the VAT rate should now be 15%. The amounts involved are very small, typically just over £1 per member, but recrediting a small amount of money to members who have paid early and opted for these services will be a major administrative task. Similar businesses and organisations will be facing the same issues.

3.12 In view of the short time, one week, between the announcement of the change and its implementation, we anticipate a high error rate among businesses. We welcome HMRC’s reassurance in their explanatory material that they will operate a “light touch” arrangement in relation to errors or mistakes made in the first VAT return.

ICAEW Recommendations

— The Treasury Committee to scrutinise the HM Treasury Impact Assessment for the VAT reduction, and potentially refer the case to the Better Regulation Executive.

— HMRC to commit resources to create an advisory service for smaller businesses on simplified VAT schemes to assist in the change-over to lower VAT rate.

— HMRC “light touch” arrangements to be extended for the duration of the VAT reduction period and thereafter as businesses adjust back to a higher rate.

4. Income Tax and National Insurance Contributions (NIC)

4.1 The Pre-Budget Report proposed to increase the main NIC rates by 0.5% in 2011. The ICAEW believes that the proposal will:

— Increase business costs and potentially widen the gap between the tax treatment of incorporated businesses as compared to unincorporated businesses, which is contrary to the Government’s policy set out in the 2007 Budget.

— Provide a disincentive to recruitment at a time when it is hoped that employment will start to increase.

4.2 In addition, the ICAEW believes that the proposed changes to the personal allowance rules in 2010 and the new 45% tax rate in 2011, coupled with the proposed increases in national insurance rates, will result in further distortions in effective tax rates. The withdrawal of personal allowances at one pound for every two pounds of income creates an effective additional tax rate of 20% in addition to the 40% income tax rate—ie an effective tax rate of 60% at income levels just above £100,000 and £140,000. This effect is demonstrated by the comparison of “Case A” and “Case B” in Table 1 as follows:

<table>
<thead>
<tr>
<th></th>
<th>Case A</th>
<th>Case B</th>
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</thead>
<tbody>
<tr>
<td>Income</td>
<td>100,000</td>
<td>100,100</td>
</tr>
<tr>
<td>Less; personal allowance (say)</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Less; personal allowance (restricted by £50)</td>
<td></td>
<td>5,950</td>
</tr>
<tr>
<td>Taxable income</td>
<td>94,000</td>
<td>94,150</td>
</tr>
<tr>
<td>Income tax at 40%</td>
<td>37,600</td>
<td>37,660</td>
</tr>
</tbody>
</table>

4.3 This example demonstrates that income of £100 has resulted in a further tax charge of £60, an effective marginal tax rate of 60%.
4.4 Table 2. below sets out the effective marginal tax rates for income ranges, against source of income.

Table 2

EFFECTIVE MARGINAL TAX RATES—TOP SLICE OF INCOME

<table>
<thead>
<tr>
<th>Income range:</th>
<th>Employment to £</th>
<th>Self-Employment</th>
<th>Earned Income</th>
<th>Unearned Income</th>
<th>Dividend Income (Gross)</th>
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</thead>
<tbody>
<tr>
<td>2010–11</td>
<td>£</td>
<td></td>
<td>£</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0 to £6,095</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>£6,096 to £6,475</td>
<td>11.00</td>
<td>8.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>£6,476 to £43,875</td>
<td>31.00</td>
<td>28.00</td>
<td>20.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>£43,876 to £100,000</td>
<td>41.00</td>
<td>41.00</td>
<td>40.00</td>
<td>22.50</td>
<td>22.50</td>
</tr>
<tr>
<td>£100,001 to £106,475</td>
<td>61.00</td>
<td>61.00</td>
<td>60.00</td>
<td>43.75</td>
<td>43.75*</td>
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<tr>
<td>£106,476 to £140,000</td>
<td>41.00</td>
<td>41.00</td>
<td>40.00</td>
<td>22.50</td>
<td>22.50</td>
</tr>
<tr>
<td>£140,001 to £146,475</td>
<td>61.00</td>
<td>61.00</td>
<td>60.00</td>
<td>43.75</td>
<td></td>
</tr>
<tr>
<td>£146,476 above</td>
<td>41.00</td>
<td>41.00</td>
<td>40.00</td>
<td>22.50</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income:</th>
<th>Employment £</th>
<th>Self-Employment £</th>
<th>Earned Income</th>
<th>Unearned Income</th>
<th>Dividend Income (Gross)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011–12</td>
<td>£</td>
<td>£</td>
<td>£</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0 to £6,475</td>
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<td>61.50</td>
<td>60.00</td>
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<td>43.75*</td>
</tr>
<tr>
<td>£106,476 to £140,000</td>
<td>41.50</td>
<td>41.50</td>
<td>40.00</td>
<td>22.50</td>
<td>22.50</td>
</tr>
<tr>
<td>£140,001 to £146,475</td>
<td>61.50</td>
<td>61.50</td>
<td>60.00</td>
<td>43.75</td>
<td></td>
</tr>
<tr>
<td>£146,476 to £150,000</td>
<td>41.50</td>
<td>41.50</td>
<td>40.00</td>
<td>22.50</td>
<td></td>
</tr>
<tr>
<td>£150,001 above</td>
<td>46.50</td>
<td>46.50</td>
<td>45.00</td>
<td>27.50</td>
<td></td>
</tr>
</tbody>
</table>

* assumes personal allowance utilised by other income

Notes

1. The above ignores the 10% savings rate and age allowances.
2. It also does not consider the implications of gift aid or pension contributions.

4.5 As the above table shows, the proposals introduce considerable complexity into the income tax system and associated tax calculations and result in two effective marginal rates of tax of 61%. This increased complexity contrasts with the announcements in 2007 PBR designed to simplify the tax system, in particular the introduction of a flat-rate of Capital gains Tax (CGT).

4.6 The difference in rate between the top rate of income tax (45%) and CGT (18%) is now 27%, further increasing the incentive to ensure that returns are received by way of capital gains rather than income.

ICAEW Recommendations

— The Government should work with the professional bodies and other sources of expertise to remove distortions and anomalies introduced by the proposed changes to personal allowances. There are a number of possible changes available to policy makers23, however any changes to the proposals will produce winners and losers as compared to the current proposals and these would need to be factored in to any decision.

Possible alternatives include:

— Give all taxpayers a tax reduction set at an amount of tax equal to the basic rate on the personal allowance. For example, if the current personal allowance was £6,000, then all taxpayers would receive a tax reduction of £1,200 (£6,000 x 20%). This approach would reduce distortions and treat all taxpayers equally. However, tax charges would increase for those with earnings between the higher rate threshold and £100,000, whilst those with earnings above £146,475 would benefit.

— Withdraw the personal allowance more gradually for those earning over £100,000, say a £1 reduction for every £8 of income over £100,000. This would reduce the distortions of the proposed system and create a single effective tax rate for income over £100,000 until the personal allowance reduced to £nil. Taxpayers earning up to £100,000 would not be affected but the there would be winners and losers between £100,000 and the point where the personal allowance would be withdrawn in full.
— The ICAEW calls for clarification on the rates at which tax reliefs, such as pension contributions, will be given. We would expect that a 45% taxpayer will now be able to obtain tax relief on pension contributions at 45%, but the HM Treasury 2008 Pre-Budget Report information is not clear.

5. UK TAX EXEMPTION OF FOREIGN DIVIDENDS

5.1 Under the current UK tax rules, dividends paid up from overseas subsidiaries to UK parents are subject to UK corporation tax but with a credit for double tax relief.

5.2 The Government has been consulting for some time on a proposal to move to an exemption system for foreign dividends, a method that is used by most other EU countries. The PBR proposes:

— an exemption on foreign dividends received by large and medium sized companies (small companies are specifically excluded);
— a worldwide cap on debt interest based on net external finance costs; and
— a review of the controlled foreign companies (CFC) avoidance rules consistent with a further move towards a territorial approach.

5.3 The uncertainty as to whether the UK would proceed with an exemption system has damaged confidence in the UK and we therefore welcome in principle this announcement. Nevertheless, much of the detail of the proposed exemption still needs to be decided, together with the scope of the proposed interest cap and what the outcome of the review of the CFC rules will be.

ICAEW Recommendations

— The Government should now work with businesses and the profession to develop the detailed proposals. It will be extremely important to ensure that, taken as a whole, the rules are reasonable by comparison with our international competitors.

6. TAXPAYERS’ CHARTER

6.1 The ICAEW fully supports the proposal that a Taxpayers’ Charter, which HMRC has been consulting since the summer of 2008, will have statutory backing.

ICAEW Recommendations

6.2 We look forward to continuing our discussions with HMRC about the precise content of the Charter, which should contain the following features:

— The Charter should set out taxpayers’ fundamental rights in their dealings with government departments in respect of tax, tax credits and related matters.
— The Charter should be underpinned by an effective route for redress for taxpayers when things go wrong.
— The Charter and its operation should be subject to an annual independent review.

7. SMALL BUSINESS TAXATION

7.1 The ICAEW welcomes the announcement that the proposed income shifting rules have been deferred again and that the proposed increase in the small companies rate from 21% to 22%, due to come into force in April 2009, has been deferred for a year. Given the challenging economic environment, we think it is right that no changes are made in these areas.

7.2 The Government proposes to keep income shifting under review. We recognise the Government’s concerns in this area but do not think that income shifting rules are the right approach to addressing any underlying problems that exist in the small business sector.

7.3 We proposed in our PBR submission that there should be a fundamental review of small business taxation. There have been a number of attempts to review the taxation of small businesses. A discussion paper, “Small companies, the self-employed and the tax system”, was published in December 2004, but progress over the past three and a half years has been slow. During recent years we have seen legislation announced which is aimed at solving perceived abuses in the small business arena. Our concern is that these measures have addressed some of the symptoms but not the underlying cause of the problem. Re-energising this review will help to provide a sound platform for policy development in the longer term.
Ev 84  Treasury Committee: Evidence

ICAEW Recommendation

— The Government should discontinue its review of income shifting.
— The review of small business taxation must be re-energised as the most appropriate means of providing simplification, clarity and greater certainty to small business taxation.

8. Other Measures to Help Business

8.1 The ICAEW welcomes the Government’s announcement to introduce flexible payment arrangements which will help taxpayers struggling to pay tax bills. This approach will build upon HMRC’s approach to tax debt problems experienced by farmers during the Foot & Mouth crisis. We believe that this system worked well in ensuring the financial survival of many farmers who otherwise may have faced ruin.

8.2 The ICAEW also welcomes the proposal to extend loss relief carryback from one year to three years. This should help businesses offset current losses against earlier profitable years and thereby receive a tax refund. This announcement reflects a similar measure introduced in 1991 at the time of an earlier economic downturn. The three year carryback was maintained until 1997 when the carryback period reverted to one year.

9. Access to Finance Package

9.1 The ICAEW supports the Government’s efforts to improve access to finance for Small and Medium Sized Enterprises (SMEs) announced by the Chancellor in the Pre-Budget Report. However, given the relatively limited scale of intervention and the significant amount of time that it will take to set up and market new finance facilities, the ICAEW questions the overall impact on business confidence that the proposed measures will provide.

9.2 The ICAEW recognises the difficulties banks have in assessing the credit worthiness of businesses in the current environment. Commercial and domestic property value, which underpins much of the lending to SMEs, has been falling. In addition, adverse trading conditions negatively impact businesses’ profitability and cashflow. These factors cause banks, already inclined to be more risk averse, to seek to reign in lending facilities.

9.3 In the Pre-Budget Report, the Government announced:

— The creation of a Small Business Finance temporary guarantee scheme to enable up to £1 billion of new Government supported lending by banks.
— An Export Credits Guarantee Department’s temporary scheme to support a £1 billion facility to provide smaller exporters with better access to short term working capital.
— An RDA Loan Fund totalling £25 million, modelled on the Advantage West Midlands transition loan fund to help businesses over the next six months.
— A capital fund of £50 million providing equity or quasi-equity to SMEs who are overleveraged.

9.4 The ICAEW awaits details about how all of the above measures will work, ie when they will be available and how businesses will access them.

9.5 Within the overall small-scale equity market the proposed capital fund scheme does not represent a significant intervention. The ICAEW would also draw attention to the lack of previous experience for RDAs (apart from Advantage West Midlands) of RDA Loan Fund schemes to assist businesses in difficulties. Consequently we are concerned about the amount of time it will take to set up the appropriate structure to administer and market the scheme.

9.6 The Government also highlighted an EU announcement that the European Investment Bank (EIB) will make a £1 billion fund available to SMEs in the UK by the end of 2008. There are only three banks utilising the existing EIB funding—Barclays, Alliance & Leicester and Close Brothers. Their use of the current facility is on a significantly lower scale than that now proposed. Some banks, who are not part of the current scheme, have expressed interest in negotiating a facility with EIB, however these negotiations will take time. Even when these facilities are in place it will take time for the new banks to train staff, market the scheme and start receiving applications.

ICAEW Recommendations

— The Small Business Finance Scheme (SBFS) should be available for a maximum period of three years, after which time lending should return to more normal conditions.
— If the above measures are to be effective across the UK, the route for firms to access the fund must be clear and made available as soon as possible.
— SBFS funding should operate as the “Advantage Transition Bridge Fund” (ATBF) did when MG Rover collapsed into administration. The ICAEW regards the ATBF as an example of good practice and demonstrated the value of Insolvency Practitioners in evaluating which businesses had the best survival prospects, thereby saving hundreds of jobs.

— The ICAEW would encourage the Government to examine the viability of a state-backed credit insurance scheme for suppliers to companies that have had their cover withdraw—potentially similar to the recent proposals put forward by the French Government.

December 2008

Memorandum from Prospect

SUMMARY

— The Asset Management Strategy is the latest government review that has considered the ownership of a number of the organisations included in Box 6.4 in the PBR. Previous reviews have rejected privatisation, the latest review will add nothing new but will damage staff morale.

— The inclusion of a number of organisations already subject to the Trading Funds’ review in the Asset management strategy will hamper the Trading Funds’ review.

— The government has not produced a clear methodology to measure efficiency gains already made under Value for Money initiatives.

— The unique selling point for the organisations included in Box 6.4 is their association with the public sector this would be lost by privatisation.

— A decision to privatise would be questionable economically for organisations that currently make a profit and have a monopoly supply of information.

— In light of the current economic crisis, this would be a good point to review the wisdom of the asset management strategy in delivering efficient public services.

INTRODUCTION

1. Prospect is the union representing professionals and specialists in Civil Service, with a significant union membership in Ordnance Survey, the Land Registry, the Royal Mint, the Met Office, Oil and Pipeline Agency, Defence Storage and Distribution Agency, Urenco and the Forestry Commission.

2. Prospect’s evidence to the Treasury Select Committee considers paragraph 6.26 “Asset management and sales” and the associated Box 6.4, “Operational Efficiency Programme—Asset Strand”. The proposal to undertake a series of open-ended reviews and studies opens the door to wholesale outsourcing and privatisation of valuable public services in the name of efficiency. The uncertainty created by this series of reviews will damage staff morale at a time of great economic turmoil diverting these organisations away from their central purpose and therefore undermine their efficiency.

REVIEWS, STUDIES AND MORE REVIEWS

3. The Treasury Committee will already be very familiar with many of the organisations that are subject to review because most of them have already been subject to public scrutiny a number of times in recent years; in particular the privatisation option was considered at Ordnance Survey, the Met Office and the Forestry Commission. After a process of deliberation the evidence clearly supported the case for keeping these organisations in the public sector. However, rather than accepting this conclusion once again the government has included these organisations in the current review with the possibility of privatisation.

4. In June this year the government announced a review of Trading Funds to consider what public information is required by Government for public policy and to consider pricing policies to ensure that the information collected is available as widely as possible.24 The review would also consider any potential changes to the trading funds’ business model. By including a number of organisations that are already subject to the Trading Funds’ review as part of asset management strategy the government appears to be prejudging the outcome of this review process. Prospect is concerned that the Trading Fund review has now become subsumed in the broader asset management strategy limiting any possible benefits of that review process.

VALUE FOR MONEY AND WHAT IS MEANT BY EFFICIENCY

5. Prospect does not accept that the government has provided a satisfactory methodology to measure efficiency savings from the Value for Money programme. In particular we fully support the Treasury Committee’s proposals, included in the report on the 2008 Budget\textsuperscript{25}, which called on the government to explain:

— the method used to calculate expenditure and savings,
— the circumstances in which it is appropriate to treat reductions in service as efficiency savings, and
— the circumstances in which a net reduction in expenditure arising from a transfer of costs to the private sector by charging or other means constitutes an efficiency saving.

6. In our view this is particularly relevant to the future ownership of public sector organisations and their assets. Without a reliable and objective means of measuring efficiency gains it is not possible to make a judgement about whether proposals to privatise or sell off public assets represents good value for money to the taxpayer in the long term.

ORGANISATIONS INCLUDED IN THE REVIEW

7. Prospect does not intend to make a detailed submission on the organisations included in the Pre-Budget report, because the terms of reference for the reviews and studies are not clear, we will submit a more considered response to individual reviews at the appropriate time, but we would like to make the following general observations on the organisations included in Box 6.4.

8. The unique selling point for most of these organisations is the enormous public affection and trust for the services they provide. In large part this “value” has been created because these organisations have provided a professional and efficient public service over many decades and for some organisations centuries. In a number of cases the reliability of the information provided is essential to both public and private sectors and public servants working for these organisations are often a source of authoritative expert advice to both national and international governments, businesses and other organisations.

9. It is also questionable whether there will be any commercial benefits to the Treasury from selling organisations to the private sector that currently make a profit and have a monopoly over the information they provide.

10. However, what particularly concerns us is that the organisations included in the review appear to have been thrown together in haste, as shown by the typo in the reference to Ordnance Survey. It leads us to draw the conclusion that organisations have been included in Box 6.4 to make the portfolio of public assets under review more valuable overall without any consideration being given to their broader public value role. This follows a typically incoherent approach by the government towards Executive Agencies, Trading Funds and other public sector organisations over a number of years. Ministers often appear to stumble into decisions rather than working from a clear strategic framework to determine how to balance public service delivery with the maintenance of key public sector functions.

11. At a time of huge pressure on public finances there is clearly mounting pressure on the government to raise funds from its valuable asset base. But it cannot be good governance to undertake such a review without a broader consideration of the long-term consequences of selling off vital public assets. The current economic crisis clearly shows that the market cannot provide all the answers in the delivery of public sector reform. Any idea that there should be a sale of all public assets is surely restricted to dogmatic free market ideologues.\textsuperscript{26} Similarly the nationalisation of part of the banking sector does not mean that there will be a return to wholesale public ownership of utilities and other organisations privatised over the last 25 years. But it does seem to be a reasonable time to question the wisdom of the current asset management strategy. The loss of treasured public assets will not deliver a more efficient public service; these proposals are purely about raising money.

1 December 2008

\textsuperscript{25} Ninth report of Session 2007–08, Budget 2008, Treasury Committee, HC430, p. 51.

\textsuperscript{26} “Privatization—Reviving the Momentum”, Nigel Hawkins, Adam Smith Institute, 2008
Memorandum from Trades Union Congress

EXECUTIVE SUMMARY

The TUC warmly welcomes the fiscal stimulus set out in the Pre Budget Report 2008. We endorse the bringing forward of major infrastructure projects and welcome the extra, significant financial support being offered to small and medium sized enterprises during this period of very constrained credit.

As a long-standing campaigner for more progressive taxation, the TUC welcomes the proposed increase in the higher rate of income tax. We also welcome the temporary reduction in the rate of VAT. Whilst the changes announced in National Insurance Contributions in April 2011 are small, the TUC is concerned about any increase of the tax burden on low and middle earners. We urge the Government to reconsider the NIC rise and instead seek to raise equal amounts through limitations on the tax reliefs and allowances enjoyed by the wealthy.

We were disappointed that the Chancellor did not announce an increase in unemployment benefit in the PBR and we remain strongly opposed to the decision to go ahead with workfare. We remain committed to the uprating of the upper limit on Statutory Redundancy Pay, a manifesto commitment. Our long-standing opposition to the so-called “efficiency” agenda, which has led to a serious deterioration in the quality of government services, remains.

INTRODUCTION

1. The TUC is the voice of Britain at work. We represent nearly 6.5 million workers in 58 unions. Our overall objectives are to raise the quality of working life and promote equality for all.

2. The TUC welcomes the opportunity to make this submission to the Treasury Committee on the Pre Budget Report 2008. The UK and, indeed, the global economy have entered into uncharted waters; it is vital that politicians and other actors respond appropriately to the challenges that we face.

3. The TUC was one of the first organisations to call on the UK Government to introduce a fiscal stimulus. The details of such an approach were included in the TUC General Council Statement on the Economy issued in August. This statement called for tax cuts for low and middle earners funded through limits on the remissions and allowances available to the wealthiest. It also called for deeper cuts in interest rates, extra help for the housing market and homeowners facing repossession, extra resources to allow employment and training services to respond rapidly to redundancies, and a new pro-active approach from Government to provide support for high growth sectors across the UK.

4. It is extremely welcome that all these factors have been reflected in the Pre-Budget Report. In particular, the TUC welcomes the decision of the Government to do all it can to prevent recession turning into slump. We recognise there are risks associated with this approach, but they are considerably less than simply allowing unemployment and bankruptcy to spread through the economy unabated. The UK bears the scars of this approach, taken in the 1980s and 1990s, with highly deprived communities across the UK still suffering the consequences.

5. In this context, the TUC welcomes the bringing forward of major infrastructure projects and we welcome the extra significant financial support being offered to small and medium sized enterprises during this period of very constrained credit. We believe that full use should be made of state resources and influence to both prevent the drift into a deep and long recession and to restart economic growth in an economically, socially and environmentally sustainable fashion. We note the boldness and urgency with which the new administration in the USA is approaching these issues and we hope that the UK Government can emulate that.

THE FISCAL STIMULUS

6. The three most significant announcements in the PBR were: the decision to temporarily reduce the rate of value added tax (VAT) from 17.5% to 15%; the increase in the higher rate of income tax to 45%, for those earning above £150,000; and the increase in the rate of National Insurance Contributions by 0.5%.

7. Taking the first two announcements together, the TUC has long campaigned for more progressive taxation. We believe that those who earn the most should be prepared to shoulder a little more of the burden, in terms of taxation. Income tax is the most progressive form of taxation and VAT the least progressive, as poorer people tend to spend more of or, in some cases, all of, their income.

8. The TUC therefore welcomes the proposed increase in the higher rate of income tax. This increase will not come into effect until after the next General Election, which means the public will have the chance to decide, at the ballot box, whether or not they approve of this proposal. However, we note that a Daily Telegraph poll found that 72% of respondents welcomed the 45% rate. This is in line with the TUC’s own polling which found that 75% believed the tax system was weighted in favour of the wealthiest and needed reform.
9. The TUC also welcomes the temporary reduction in the rate of VAT. One advantage of this method of fiscal stimulus is that it can be introduced quickly. The jury is out in terms of how effective it will be. It could be argued that the lowest paid spend a large part of their income on zero rated VAT goods, such as food, or lower rated items, such as fuel. This could, indeed, blunt the effectiveness of the move to an extent. Nevertheless, we recognise that the Government has rapidly made £12.5 billion of extra funds available to the UK consumer at a time when economic activity is traditionally rising due to the Christmas period. This should have a positive effect, particularly on the retail and hospitality sectors, at a time of great economic stress for those sectors.

10. We were disappointed, however, that the Chancellor did not announce a rise in unemployment benefit. Research from America has shown that increasing this benefit is the quickest and most effective form of fiscal stimulus. There is also a strong moral and economic case for this, given that unemployment benefit has severely lost its value over the last 30 years, having been raised in line with inflation, rather than earnings. The shock for the newly unemployed of moving from a normal salary to only £60.50 per week will be very great, increasing the chance of ill-health and family breakdown. This very low level of social security will also foster a deep sense of insecurity amongst the wider workforce, thus further constraining spending and confidence.

11. The third announcement concerns the changes to National Insurance Contributions in April 2011. Although the increase is small, the TUC is concerned about any increase of the tax burden on low and middle earners, given the weight of the burden that already exists on this group relative to that on those higher up the income scale. We recognise that the NIC rise is offset by the welcome announcement that the rise in the Personal Allowance for basic rate taxpayers announced in Budget 2008 will be made permanent. However, we would urge the Government to reconsider the NIC rise and instead seek to raise equal amounts through limitations on the tax reliefs and allowances enjoyed by the wealthy.

12. We note that the Government has clearly acknowledged the potential of such an approach by announcing restrictions on the availability of the Personal Allowance to those earning over £100,000 in the PBR. This was a very positive move, which responds to a point made by the TUC for some time now that the progressive nature of our tax system is undermined by excessive use of reliefs and allowances by the very wealthy. However, we believe a great deal more can be done to address tax planning, avoidance and evasion.

13. We believe the Government now shares this view, given the Chancellor’s extremely welcome announcement in the PBR of a review of the activities of tax havens with constitutional and economic links to the UK. The TUC hopes to make a detailed submission to this review and to work closely with it.

**Industry and Business**

14. The TUC warmly welcomes the bringing forward of major infrastructure projects to give a boost to industry. Surely no-one will criticise the £800 million in the primary schools capital programme or the £100 million to advance the upgrading of up to 600 GP surgeries to training practices.

15. The decision to make £7 billion of credit available to small and medium sized enterprises is extremely welcome and should play an important part in forestalling the bankruptcies and redundancies which are the consequence of the constrained credit conditions currently in operation. Such measures can, however, only be a stop gap while the Government seeks ways to encourage greater bank lending. We recognise that the Government is working hard to ease bank credit for business and we welcome the clear message from the PBR that the Chancellor will “do whatever it takes” to achieve this. The TUC strongly supported the Government’s efforts to stabilise the banking sector in September and October, but notes that these moves were taken not for the sake of the sector itself, but to protect the wider economy. The TUC will continue to support the Government in its efforts to ensure this is the outcome of their earlier efforts.

16. The TUC is mindful that whilst attention is correctly focused on the need to respond to the immediate economic crisis, we must not lose sight of the need to build a stronger, sustainable economy in the long term. We remain committed to the introduction of a modern, intelligent economic strategy, which must be focused on the promotion and development of high growth sectors, along with a major commitment to a low-carbon industrial future. We therefore welcome the announcement in the PBR and in the accompanying document The UK Economy: addressing the long-term challenges that the Government sees itself as playing a key role in such a strategy. We look forward to working closely with BERR on developing this approach further.

17. In this context, it is also welcome that the PBR announced £535 million in new investment, plus money brought forward for environmental projects. In addition, the extension of the Renewables Obligation to 2037 will underpin investor confidence and help build low-carbon industries. We also welcome the proposal for a low-carbon skills forum.
ENDING CHILD POVERTY

18. Taken together, there was much to welcome in the Pre Budget Report. Of course, there were some disappointments and some areas for further action. One obvious area for further attention concerns the fight against child poverty.

19. The PBR announced that increases in Child Benefit, worth an additional £22 on average to families, and the child element of Child Tax Credit, up by £25 above indexation, will be brought forward to January and April next year respectively. This is welcome news. However, those on lower incomes could have done even better, through a mixture of increases in tax credits, Child Benefit and, as stated above, Jobseekers Allowance. This makes the PBR something of a missed opportunity, leaving a lot still to be done in the Budget of next spring. The Chancellor confirmed the Government’s plans to put into law their commitment to eradicate child poverty by 2020. This is good news, but a redoubling of efforts to deliver the 2010 target, of halving child poverty on its level of 1998, is necessary. This is, after all, the foundation for this new legislation.

20. The Chancellor’s announcement of £1.3 billion extra for Jobcentre Plus, including a substantial extra investment in the Rapid Response Service, is exactly in line with what the TUC was hoping for. However, we maintain our strong call on the Government to shelve their ill-judged plans for workfare. And whilst the mortgage rescue scheme and the increase in the capital limit for benefit help with mortgage interest payments are very welcome, the Government is still going ahead with their decision to limit help for unemployed people for two years. Anyone facing long-term unemployment will now face losing their house as well.

STATUTORY REDUNDANCY PAY

21. In our PBR submission, the TUC had called for the uprating of the upper limit on Statutory Redundancy Pay, which was a manifesto commitment. The maximum limit for what counts as a week’s pay is currently set at £330 per week. However, more than half the working population earns over £330 per week and, as mean pay currently stands at £452, the current limit is less than 73% of the average wage. To make matters worse, workers have no right to redundancy pay until they have been working for their employer for two years, a rule which excludes more than 30% of all workers.

22. When redundancy pay was introduced in 1965, the limit was £40 per week, more than twice the average wage at the time. The TUC believes that the statutory weekly limit for calculating redundancy pay should be raised to £500 and the service needed to qualify should be cut to one year. The limit above which statutory redundancy pay is taxed, currently £30,000, should be raised to £50,000. Redundancy pay is a very important financial cushion for those losing their job, which can also play a crucial role in funding retraining and job search and thus can lighten the load on the state at a time of rising unemployment. We would therefore urge the Government to revisit this issue as a matter of urgency.

THE “EFFICIENCY” AGENDA

23. The TUC’s long-standing opposition to the so-called “efficiency” agenda, which has led, as stated in the PBR, to a reduction of 86,700 civil service posts between 2004 and 2007, remains. Unfortunately, this agenda has led to a serious deterioration in service quality. As far back as the TUC’s submission to the Comprehensive Spending Review in 2007, we quoted evidence from the House of Commons Public Accounts Committee and the Child Poverty Action Group, describing the negative effects of cuts to the Department for Work and Pensions, for example. We note that the Government seems to have acknowledged this problem with its announcement following the PBR to reverse planned closures of Jobcentre Plus and allocate some additional posts to strengthen Jobcentre Plus services. However, wider cuts are still planned which risk damaging other vital DWP services and which need to be addressed before they only add further numbers to the ranks of the unemployed.

24. Other concerns include falling morale and productivity in Her Majesty’s Revenue and Customs, and the cancellation of important initiatives, such as tackling knife crime, in the Ministry of Justice efficiency saving programme. In this context, we are concerned at proposals for an additional £5 billion “value for money” target for 2010–11. We remain committed to genuine efficiency saving initiatives, such as better procurement. We will seek confirmation, in next year’s Budget, that none of the £5 billion will be achieved through staff cuts.

1 December 2008
Memorandum from the Public and Commercial Services Union

INTRODUCTION

1. The Public and Commercial Services Union (PCS) is the largest civil service trade union, with over 300,000 members working in over 200 civil service departments, non-departmental public bodies and related areas.

2. PCS welcomes the opportunity to provide evidence to the inquiry into the 2008 Pre-Budget Report (PBR) and would be pleased to supplement this with further written or oral evidence. Our submission concentrates on the efficiency programme, the impact of workforce reductions, and the proposed privatisation initiatives.

3. PCS are primarily concerned that the PBR offers no evidence of where efficiency savings have been made in terms of improving service delivery. We believe that these budget led workforce reductions have had a negative impact on services.

4. We are concerned that the government’s desperation to make savings to pay for measures to deal with the economic situation might lead to ill-advised sell offs of organisations which should remain in the public sector. Many of these have previously been considered for privatisation and the option rejected as inappropriate, not in the public interest and not in the interest of efficiency.

THE “EFFICIENCY” AGENDA

5. The government reports that as a result of the “Gershon Programme” undertaken as part of CSR 2004, it has made £26.5 billion of “efficiency gains” as against their original target of £21.5 billion. It also claims to have “over delivered” on Gershon’s civil service workforce reduction target of 70,600 by cutting 86,700 posts.

6. However, Gershon’s original report made it clear that going beyond his recommended targets would cut into the core fabric of the civil service and would damage service delivery. No evidential case exists that these workforce reductions have been had positive results, or are an “efficiency” in the sense of producing better services for the public.

7. PCS believe that these targets have had a negative impact on delivery of public services. The damage to services is being intensified by subsequent efficiencies such as CSR 2007’s £30 billion of “savings” by 2010–11, and put at further risk by the additional target of £5 billion of savings announced in the PBR.

8. The loss of 30,000 posts in the DWP since 2004 has led to office closures and longer waiting times for dealing with claimants. Complaints have risen, as have recorded attacks on staff by frustrated customers. Last month DWP announced a further 12,000 post reductions together with cuts to the number of sites in the DWP estate. Following the PBR the Secretary of State for Work and Pensions announced a moratorium on Jobcentre closures and that an increase of 6,000 posts was required for Jobcentre Plus. While PCS welcomes this move we are concerned as to whether this means there will still be a net cut of 6,000 posts.

9. In HMRC morale and productivity has plummeted as result of 16,000 posts being cut between 2004–07. The latest HMRC staff survey found that 70% of staff are dissatisfied with the Department. The current debt balance, the amount of tax and duties assessed as being due to the Exchequer but has yet to be collected, stands at over £21.5 billion and is projected to rise significantly because of the economic crisis. We would argue that when the average tax yield of a member of compliance staff (after employment costs) each year is £640,000, it would be more economical to employ more rather than to continue to cut them.

10. In the Ministry of Justice over 10,000 jobs will shortly go, which will lead to up to 100 courts closing, and the downsizing of promised initiatives for example to tackle knife crime.

11. PCS are concerned that there is no evidence in the PBR to support claims that savings made resulted in “significant extra resources being invested in front line delivery services”. Much of the savings in DWP and HMRC have been delivered through massive workforce reduction, which has resulted in cuts to front-line service and the closure of local job centres and revenue enquiry centres.

12. PCS believe that the government’s claims to make efficiency savings are purely focused on monetary considerations rather than on whether they have improved efficiencies in terms of service delivery. For example it claims that culture sector non departmental public bodies achieved £15 million of savings through better procurement practice, mainly outsourcing “certain workstreams”, achieving better value for money. However, some cultural institutions such as the British Museum simply privatised their facilities management (FM) functions, and there is no mechanism in place to assess whether private sector FM has delivered a better service or just a cheaper one.

13. The presentation in the PBR of the results of the Gershon “efficiency” programme ignores the negative impact of workforce reductions. In addition to the examples already given, we are concerned about the negative impact on local economies and employment diversity of the relocation of work.
14. The government launched the Operational Efficiency Programme (OEP) as part of Budget 2008 to examine still further “efficiencies” in five cross-cutting areas. The PBR includes a number of preliminary findings for each of these five strands. It reports that “Rigorous benchmarking, sharper management information and greater standardisation and simplification of back office functions will deliver billions of further savings across the public sector” (6.26). However, this is not supported by any verifiable cost-benefit assessment.

NEW MOVES TOWARD PRIVATISATION

15. PCS are concerned that the government’s desperation to make savings to deal with the economic situation is leading it to propose rash and illogical sell-offs of organisations which should remain in the public sector.

16. PCS has particular concerns over the organisations listed in box 6.4 of the PBR, as many of these play an important strategic role in defence, in the economy and society, and privatising them could be disastrous. Many of these organisations raise money and pay a dividend into the Exchequer. This revenue would be lost if they were to be privatised.

17. Below we cover some of our concerns over the proposed privatisation of the organisations listed. We would be happy to provide further supporting evidence on individual areas.

DEFENCE STORAGE AND DISTRIBUTION AGENCY (DSDA)

The DSDA was only formed three years ago after an in-house bid won a competition against two private-sector companies, in recognition of the fact that MoD civil servants are the best equipped people to do this work with their knowledge and experience. A further proposal to look again at privatisation more recently was rejected as recognition that the organisation was a critical defence asset which should be given a five-year bedding in period, and that making no change in its status as a government agency would be in the best interests of defence. We would ask what has changed since then. Surely it is still the case that such an important part of defence output is still best run by the MoD.

FORESTRY COMMISSION

A Conservative government proposal to privatise the Forestry Commission in the mid-1990s was rejected after a campaign involving unions and numerous organisations of forest users, wildlife and ecological organisations showed its public sector status was essential to continue the important role it plays in society, the economy, and in the countryside. This conclusion has been reaffirmed in response to similar proposals in recent years.

LAND REGISTRY

Land Registry has been considered for privatisation on at least three previous occasions, and each time this has been rejected on closer examination of what that would mean. Land Registry is an efficient and effective organisation within government which carries out a vital quasi-judicial function that is important in underpinning the property market. The organisation has the confidence of banks, conveyancing and the public, and privatisation could threaten this.

MET OFFICE

The Met Office is a crucial centre of climate change expertise, and numerous previous investigations on whether it should be privatised have concluded it should be left as a public service. The important climate change research and expertise is essential to the MoD, the Department of Energy and Climate Change and DEFRA, and privatising it would deny this intelligence to the government. As a privatised organisation, it is not clear how we could be sure that it would be still providing objective information.

NATIONAL OFFENDER MANAGEMENT SERVICE (NOMS)

PCS notes that the January 2008 Prison Service internal league tables demonstrated that 10 out of the 11 prisons managed by the private sector are in the bottom quarter of the weighted scorecard used to measure the overall performance of prisons, including Peterborough Prison, managed by a private firm for three years, coming last out of 132 prisons and prison clusters, with low marks for reducing re-offending, organisational effectiveness and decency. We also note that prisons run by the public sector consistently and significantly out-perform those that are privately managed, which have a particularly poor record at maintaining order and security. We believe that this demonstrates that marketisation is not the route to delivering better services across the public sector.
ORDNANCE SURVEY

PCS are concerned that if Ordnance Survey was run as a commercial enterprise then mapping would not be consistent across the country and mapping imperatives would be driven by markets. The organisation has an important role in providing data to other government departments such as Ministry of Defence, Department for Transport and Land Registry who rely on accurate data. Additional costs imposed by a commercial provider would be passed on to the taxpayer and consumer. Ordnance Survey generates income (5% returns on its revenues) by selling data and copyright and this would be lost to the Exchequer if privatised.

QE II CONFERENCE CENTRE

Any proposal to privatise the QEII Conference Centre would result in losing the income it generates, and could pose a security risk because of its location. We are concerned that a private company running it would profit from government-funded building up of the infrastructure.

It is an efficient operation with secure bookings and income that are expected to continue to generate revenue for the Government, with increases in business likely in the lead up to the Olympics.

ROYAL MINT

Previous reviews of the Royal Mint have always come out against privatising it. The organisation is a successful example of public sector provision, having made excellent progress in improving profitability and privatisation should not be allowed to jeopardise this. In the last financial year the Royal Mint met or exceeded all Ministerial targets and made a profit of over £10 million, and paid a dividend of nearly £4 million to the Consolidated Fund.

18. There have already been many well-documented failures where civil and public services have been privatised.

19. There are many examples of organisations that try to win DWP contracts being either unsuitable or unable to deliver. For example before it went into liquidation there was a police investigation into claims of irregular payments, concerning New Deal contractor Maatwerk. And the Manchester Evening News reported that a job seeker was complaining that A4e, a private back to work provider, in a period of over six weeks no training was offered, no job search facilities made available and no work experience placements were arranged.

20. An investigation by Channel 4 News and Computer Weekly into the Defence Information Infrastructure project (DII) found that the MoD and its main private contractor, the Atlas consortium, had delivered only about a quarter of the systems that were due under the original plan to have been implemented by the end of July 2007. Although the House of Commons were informed that the overall projected cost of the DII would be £4 billion over ten years, the cost is now estimated at more than £5 billion. The Chief of Defence Materiel, General Sir Kevin O’Donoghue, admitted in October 2007 that there were “major problems” at the first site to have DII installed.

21. In conclusion our submission explains our concerns about the efficiency programme, the impact of workforce reductions, and the proposed privatisation initiatives. We believe that these budget led workforce reductions have had and will have a negative impact on services. And we are concerned at the proposed potential privatisation of organisations which should remain in the public sector.

December 2008

Supplementary memorandum from Mike Brewer, Director, Institute for Fiscal Studies

Further information requested by Mr Fallon (Q74)

The figures below give the average annual gain and loss in each band, and the number of people in each band. These are in 2009–10 prices.

We have not computed any stats for those few people who earn more than £100K as our data is not representative enough for them.

<table>
<thead>
<tr>
<th>Band</th>
<th>Average Gain/Loss</th>
<th>Number of Winners/Losers</th>
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<tbody>
<tr>
<td>£5,720 (PT) to £10,000</td>
<td>+£47.71</td>
<td>2.4 million winners</td>
</tr>
<tr>
<td>£10,000 to £15,000</td>
<td>+£32.16</td>
<td>3.7 million winners</td>
</tr>
<tr>
<td>£15,000 to £20,072 (break even point):</td>
<td>+£8.31</td>
<td>3.3 million winners</td>
</tr>
<tr>
<td>£20,072 to £25,000</td>
<td>−£16.30</td>
<td>3.1 million losers</td>
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<td>£25,000 to £30,000</td>
<td>−£40.94</td>
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<td>−£77.80</td>
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</tr>
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<td>£40,000 to £50,000</td>
<td>−£124.32</td>
<td>1.4 million losers</td>
</tr>
<tr>
<td>£50,000 to £100,000</td>
<td>−£224.69</td>
<td>1.4 million losers</td>
</tr>
</tbody>
</table>
(we have contacted HMT officials about our inability to replicate their statement that the PBR means that the number of 10p losers is down to 0.5 million households by 2011–12. They have expressed a desire to work with us to resolve this, but nothing concrete has happened yet. It should not be interpreted as “IFS disagrees with HMT” as it is possible that the error is ours).

December 2008

Supplementary memorandum from HM Treasury

AIR PASSENGER DUTY (APD)

In the Travelmole submission, it is claimed that as a result of reforms to air passenger duty, a family of four will be able to save up to £292 from November 2010 on a long-haul journey if it flies via a European airport. This claim assumes that passengers travelling via a European airport on a long-haul flight will automatically be subject to the lower, Band A rate of APD.

APD is calculated on the passenger’s final destination. Therefore the APD liability of a journey from the UK to a long-haul destination will be the same whether the journey is made via a single, direct flight from the UK, or using connected flights (eg via mainland Europe). HMRC has an established set of criteria to govern whether the second or subsequent flight on a journey may be treated as connected.

“Disconnecting” a flight to hub elsewhere is often quoted as a means to reduce APD liability. However, there are a number of practical as well as financial consequences. A passenger with two unconnected tickets for travel will need to “land” themselves at the first destination airport, and then check back in for the second flight, and will be subject to any taxes or charges due for that country. Also, both airlines will incur handling charges for processing the passenger, which are likely to be passed on.

In addition, a passenger taking a connected flight enters into a contract for travel to their final destination. This protects the passenger against unforeseen delays or cancellations on any part of that journey, as it is the airline’s responsibility to ensure that they reach their final destination. In some cases this may mean rebooking a passenger on an alternative flight or providing or paying for accommodation until a flight is available. Unconnected flights do not carry the same protection, and an airline’s responsibility will cease once the passenger has reached the destination specified on the ticket.

SOCIAL HOUSING—FORMULA RENT GUIDELINE INCREASES

The Government formally announced a Review of Council Housing Finance in March 2008. The purpose of the review is to develop a sustainable, long-term system for financing council housing, one that is consistent with wider housing policy, including the establishment of a regulator of social housing. One of the workstreams of the Review is looking at social rent policy and what should be done once rent convergence has been achieved. The Review is expected to report to Ministers in Spring 2009. A formal consultation will follow the review.

The Housing Green Paper, published in April 2000, proposed a rent restructuring regime underpinned by a single national formula based on relative property values (30%) and local earnings levels (70%) to guide landlords in setting rents in the social housing sector. Current rent policy is guided by the principles originally set out in the Green Paper. These included:

— that social rents should remain affordable in the long term;
— that social rents should be fairer and less confusing for tenants;
— that there should be a closer link between rents and the qualities which tenants value in properties; and
— that unjustifiable differences between the rents set by local authorities and by registered social landlords should be removed.

Rent restructuring continues towards a target date for convergence with formula rent of 2012.

CLG issued the draft Housing Revenue Account Subsidy Determination consultation document in October this year.27 The determination proposes to fix guideline rent increases for the next two years in order to protect tenants from both high and variable increases in inflation, while continuing to deliver the rent convergence policy.

The determination sets out that average guideline rent increases for each local authority are to be based on an average of 6.2% in 2009–10 and 6.1% in 2010–11. A cap on actual rent rises above 7% has been proposed to keep rents at affordable levels.

27 http://www.communities.gov.uk/publications/housing/hrasubsidydetermination2009-10
ENERGY COMPANY SOCIAL ASSISTANCE AND PRICING DIFFERENTIALS

Social and discounted tariffs

Budget 2008 announced that the Government wanted to see energy suppliers increase their spending on social assistance to £150 million a year. Following subsequent discussions with John Hutton (then Secretary of State for Business, Enterprise and Regulatory Reform) the six largest energy supply companies (Centrica, EDF Energy, EoN, Npower, Scottish & Southern Energy, Scottish Power) agreed to increase their collective spend to £100 million in 2008–09, £125 million in 2009–10 and £150 million in 2010–11.

Ofgem published guidance in July on the types of initiatives that energy suppliers can include towards this commitment. Ofgem will continue to monitor supplier activity, and will report on an annual basis. It will shortly be publishing analysis covering the period to end March 2008.

Following the agreement, suppliers provided data which showed that around 600,000 customer accounts were going to benefit from a social or discounted tariff this winter. Indications are now that over 700,000 customer accounts are now receiving a reduced or social tariff, around twice the 370,000 customer accounts on such a tariff last year.

Differential pricing

As noted in the PBR, Ofgem recently carried out a detailed study of the retail markets for electricity and gas, which concluded that many customers have benefited from lower prices and better service. However, it also noted that certain groups of consumers have not benefited fully from the market and are disproportionately affected by practices such as unjustifiable differential pricing.

Ofgem has calculated that since its probe began, more than £300 million has been taken off the premiums paid by customers including pre payment meter users. The companies have also indicated further reductions that should reach at least £200 million for more than four million households who are off the gas grid and others who the probe identified as missing out on the best deals.

However Ofgem has also indicated that it is not satisfied with the overall pace of delivery and announced on 16 December further proposals to deal with the issues it has identified. It will be consulting in January on proposals to change the suppliers’ licences to ban unfair prices and ensure consumer interests are more fully protected.

WHITE CIDER

Alcohol duty is charged according to strength, volume and category of alcohol. Cider is taxed by volume in bands of the same strength. Most ciders including white cider fall into the same category and will be charged at the same rate of duty.

The alcohol duty increases announced at Budget 2008 and in the Pre-Budget Report apply to all alcohol products including all ciders. The primary purpose of alcohol duty is to raise revenue to fund the Government's spending priorities, and we do not see alcohol duty as a prime tool for tackling problems associated with harmful drinking.

White cider receives a great deal of attention from commentators. However, it is not possible to effectively target that part of the industry without affecting more mainstream products and niche/craft ciders made by small producers.

December 2008