House of Commons

Treasury Committee

Budget 2012

Thirtieth Report of Session 2010–12

Volume II

Oral and written evidence

Ordered by the House of Commons to be printed 17 April 2012

HC 1910–II
Published on 18 April 2012
by authority of the House of Commons
London: The Stationery Office Limited
£13.00

The Treasury Committee

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

Current membership

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

Powers

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

Publication

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

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

Committee staff

The current staff of the Committee are Chris Stanton (Clerk), Lydia Menzies (Second Clerk), Jay Sheth, Adam Wales, Dr Renée Friedman, Antonia Brown (on secondment from the Bank of England), and Lara Joseph (on secondment from the FSA) (Committee Specialists), Phil Jones (Senior Committee Assistant), Steven Price and Lisa Stead (Committee Assistants) and James Abbott (Media Officer).

Contacts

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

Witnesses

List of written evidence

Oral evidence

Taken before the Treasury Committee

on Monday 26 March 2012

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
Mr Pat McFadden
Mr George Mudie
Jesse Norman
Teresa Pearce

Examination of Witnesses

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

Q1 Chair: Thank you very much for coming in this afternoon. You have done another fat forecast for us. In your view, Mr Chote, given the way it is constructed, how much weight should people place on measures of the output gap?

Robert Chote: Necessarily, you have to place a lot of weight on measures of the output gap, because we have been tasked with policing a fiscal target that has been set in cyclically adjusted terms. By definition, we have to come up with a view of the size of the output gap at the end of the five-year forecast horizon to judge that. Even in the absence of a cyclically adjusted target, if you are going to take any sort of view of how activity is going to evolve over a five-year time horizon, as distinct from a much shorter one, it is hard not to take some sort of view implicitly or explicitly about the amount of spare capacity that there is at the moment and the growth rate of potential over that five-year period.

Needless to say, it is an extremely hard thing to measure. There is enormous uncertainty about it. We take great care to report the range of other views on the size of the output gap and the range of views on the evolution of potential. We have to do it, but I would be the first to say that it is an extremely difficult task, and it involves elements of art as well as science.

Q2 Chair: You are forecasting quite a number of variables here. In a scale of one to 10, where 10 is inaccurate and one is pretty much spot-on, where is the output gap in your list, as one that is likely to be off beam?

Robert Chote: The big difficulty with the output gap is that there is never a final, correct answer to compare it to, because it is not a directly measured variable. As we know, even with the directly measured variables, you can end up in the situation where what looks like a good forecast five years ago can look like a bad one 10 years ago. With the output gap there is no final, correct answer against which to compare it.

Q3 Chair: So therefore the answer to my question is you can mark your own prep.

Robert Chote: You are marking our prep, and everybody else who is looking at it is marking our prep. Clearly, one of the justifications for having the OBR is that the Chancellor is not marking his own prep. Arguably, that is a useful thing in itself.

Q4 Chair: But you are flagging up today the very high level of uncertainty that surrounds the output gap measure.

Robert Chote: Yes. If you look at the range of alternative estimates that we cite here, we are in line with the average at about 2.7% for 2011. The range varies from—½ to -4, so that gives you some sense of the variability.

Q5 Chair: Did you want to add something, Mr Parker?

Graham Parker: No.

Q6 Chair: You were nodding your head in vigorous agreement. On the other hand, Mr Nickell, you were not looking up at all, so it is difficult for me to know what you were thinking. Do you want to add anything?

Steve Nickell: Where we have put the output gap looks quite plausible to me, in terms of the amount of unemployment and that kind of thing, so 2½ sounds quite plausible to me—much more plausible than either a ½ or 4.

Q7 Chair: I am very pleased to hear that you do not think it is implausible, otherwise one would be wondering what was going on at the OBR.

Q8 Mr McFadden: Since we last saw you after your November report, your overall GDP forecast has not changed greatly, but there has been significant change within that about what will make up GDP growth this year. I want to ask particularly about household consumption. In November, you said household or private consumption would contribute only 0.1% to growth this year. You now say it is 0.3%. There was great criticism of previous economic growth, that it relied too much on household consumption and not enough on investment, manufacturing, trade and so on. Are the Government now relying, as they had hoped that they would not have to, more on household consumption to drive growth this year?

Robert Chote: You are right in characterising that the overall envelope for growth has not really changed very much since last time. We had a smaller contribution from investment and a slightly higher contribution from consumer spending. I don't think that that is reflecting things that the Government have done in policy terms that have consciously attempted to—or inadvertently—shift that balance. There are two things going on there. In terms of the picture for consumption, we have edged that up a little. In part, in the short term it reflects the fact that we think consumption could be boosted a bit by payment protection insurance pay-outs, which might have a similar short-term effect on consumer spending of the sort that you saw from building society demutualisation payments, albeit at a much smaller level. Asset prices are slightly stronger in this forecast than in the previous one, and that might provide a further source of upward adjustment on consumer spending.

On the investment side, which is the main offset to this, you have two things going on. In the short term, we have had a significant downward revision to the forecast for investment growth in 2012, which is largely a reflection of the big decline in the fourth quarter of 2011. As you see from the recent path, we have very big swings in business investment from quarter to quarter. It is not at all unusual to see +5 or -5 or more than that from quarter to quarter. That can have quite an effect, particularly if it takes place in the fourth quarter, on the numbers for the following year. Further out, we have also revised down somewhat our forecast for investment growth in the out-years of the forecast. There we have done two things, one of which is to look again at the health of the corporate sector's balance sheet. Even more so than last time, our sense is that official statistics may be overstating the support that the amount of cash that appears to be on corporate balance sheets might provide to investment in the longer term. The ONS may be attributing such cash balances to industrial and commercial companies when they may be less likely to be there.

We have also had a look back at the sorts of growth rates and investment that we saw in the 1990s, and we looked at the comparison with this recovery. Basically, we now have investment picking up by about 40% over the five-year forecast horizon, which compares with about 50% in the equivalent period of the recovery in the 1990s. Given what is going on with fiscal consolidation, credit conditions, et cetera, a robust recovery in investment that is somewhat weaker than in the 1990s seems to us to be a reasonable balance.

I would say that there is that set of issues both on the consumer side and on the investment side, rather than the Government deciding to rely, or policy driving the Government to rely, more or less on one sort of growth or another.

Q9 Mr McFadden: Even if this is not decided by the Government, do you think a fair interpretation of the contrast between your review in November and your view in this report is that rebalancing has been delayed?

Robert Chote: If you define it as the contribution to the recovery that is coming from consumer spending versus investment, by arithmetic more is coming from consumer spending and less is coming from investment. I would not necessarily say that an investment story is being delayed in some sense. That depends very much on the near-term picture and what happens to the growth rate in 2012, which depends a lot on the data revisions we see to investment in 2011.

Q10 Mr McFadden: Your colleagues may come in on this. I just want to ask for a little more on consumption, retail spending and so on. Retail sales fell by more than expected in February, and January's retail sales figures were revised down, too. Did you have access to that information during the preparation of your report?

Graham Parker: No.

Q11 Mr McFadden: In which case I have to ask you again about predictions that retail spending will rise. In the two most recent months we have seen lower than expected retail sales figures, so what gives you confidence, especially when Mr Chote's old friends at the IFS have told us that the squeeze on household disposable income is the greatest since the second world war? With everything consumers are facing—petrol prices are through the roof and other costs are rising—what makes you think they will be able to engage in more discretionary spending than you thought a few months ago, Mr Nickell?

Steve Nickell: Our forecast is for consumption growth this year to be 0.5%, which, relative to the average in the past, is extremely low. In other words, we are simply forecasting—

Q12 Mr McFadden: It's higher than you were predicting a few months ago.

Steve Nickell: Yes, that is basically for two reasons. One, the level of consumption towards the end of last year was higher than we thought because of data revisions. The other reason is that we have now incorporated the effect of payment protection insurance repayments to households, which adds a little to household income in the coming year. The increase over our previous forecast is not particularly great over the whole year. Basically, it relies on the idea that during this year incomes will grow reasonably steadily, but price inflation is falling fast. Whereas last year, as you rightly say, there was an enormous squeeze on real incomes because price inflation was much higher than earnings growth, in the coming year that is not going to be the case. By the end of the year, we expect earnings growth to start outpacing prices. That is why our consumption forecast is one of positive, though very modest, growth.

Robert Chote: It is a downward drag on the recovery until the point at which you start to see wage increases pulling significantly ahead of price increases, and so that is not until the out-years of the forecasts.

Consumer spending is dragging the forecast down in the short term rather than pushing it up.

Q13 Stewart Hosie: Pat McFadden made the point that the GDP growth forecast from 2012 to 2016 has changed little between this forecast and the one last November. Would you say that there is more uncertainty in this forecast than in the November forecast?

Robert Chote: I wouldn't say there was more uncertainty. I have an agreement with Steve that we will never use the phrase, "now is a uniquely difficult time to make a forecast", as it is always a very easy one to use.

The balance of uncertainties has changed a little bit. I think people are less concerned about the immediate financial consequences of difficulties in the eurozone as a result of the LTRO. People are a bit more concerned about the possible implications of higher oil prices than they were before, but that has been a change over a couple of months, and doubtless the balance of things to be worried about will change again in the coming months.

Q14 Stewart Hosie: So you have re-ranked those risks—the euro crisis down a little and oil prices up a little. Are there any other risks that you have re-ranked in this forecast?

Robert Chote: The oil price story is part of a broader one, which relates to the last question of how quickly will inflation fall. Will there be other factors—food prices, for example—that might mean that the fall in inflation is not quite as quick as the central forecast suggests, and therefore how soon will it be and with what strength will it be that earnings growth outpaces price growth? That remains an uncertainty, and it is not just down to oil.

Q15 Stewart Hosie: Obviously, those are drags on recovery. The Governor of the Bank of England has called for patience to allow space for current policies to work—this is on the up side. What would you say are the policies that are in train that will support the economic growth and demand that you are forecasting? What is the most significant policy area, change or development, either in this Budget or through this Budget, that will drive the growth you have presented?

Robert Chote: The main policy driver remains the accommodative stance of monetary policy. You have had some change in market expectations of where interest rates would go and, implicitly within that, what will happen to QE, but the foot clearly remains firmly on the accelerator on that score. In terms of the policy support, that will be a key one.

Q16 Stewart Hosie: Can I go back to some of the points raised by Pat McFadden? Looking at your last three forecasts—March 2011, November 2011 and the one this March—business investment is a huge driver of your forecast. In March 2011—these are for the same years—for 2010, 2011 and 2012, you said that business investment would grow by 2.5%, 6.7% and 8.9%. That changed six months later, for the same years, to 0.8%, -0.8% and then a rather heroic 7.7%. That has been changed again to -2.1%, 0.2% and 0.7% growth.

The oil price story isn't new. The euro crisis isn't new. Many of the other drags on economic growth aren't new. How can you have these hugely differing business investment forecasts every six months, when they are so important—they are core and key to the economic recovery? Why are these figures changing so much?

Robert Chote: I point you to chart 3.14 on page 59, which shows you how volatile the data are for these figures on a quarter-by-quarter basis. Not only that, we have, for example, going back over last four quarters, which covers the period you have just been discussing, a decline of roughly 7%, followed by an increase of roughly 11%, followed by what looked initially like a fall of 2% but is now a rise of 1%, followed by a fall of 5% to 6%. Whenever you are doing these sorts of forecasts for investment, the near-term forecast is obviously reflecting, to a considerable degree, what the news is in the data that you have just had. That moves around a great deal. When it moves around towards the end of a calendar year, it has big implications for the year after that. As I say, looking further out into the future—this is also partly a story for the short term—we have obviously had changes in the degree to which the events in the eurozone might be regarded as being a drag on investment plans. In the longer term, you have a debate over to what extent investment is going to be affected by things such as firms' confidence in the strength of demand over the long term and also the amount of money that they have available to invest, on which the information is frequently coming in and frequently changing, looking backwards and looking forwards, so I do not think it is hugely surprising that you see investment forecasts moving around quite a lot. It is inherently one of the more volatile series, and it swings—leaving aside the quarter-by-quarter volatility—around more than, say, consumer spending.

Q17 Stewart Hosie: I do not dispute the volatility at all. I am simply making the point that they were heroically high figures—I am sure that I have said this to you before—and they then fell and they fell and they fell. However, in this year's forecast, you are still telling us that, on this forecast period of 2014, 2015 and 2016, we are still looking at 8.9%, 10.2% and 10.1% rates of growth. I am struggling to see how you can be so confident that we are going to get those high levels of growth when similarly high levels were forecast and then corrected down to effectively near zero.

Robert Chote: On confidence, I am always the first person to point out the uncertainties around these things. If you look at chart 3.15, you get some sense of the sorts of growth rates and investment year-by-year that you saw in the wake of the 1990s recession. There, three years into that recovery, you had 10%, 10% and 15%, so we have double-digit increases—just—in the last couple of years of this forecast, but we do not have anything like 15%. What we have is a relatively robust recovery. It is something that is increasing as a share of GDP, which we would expect during the recovery phase, but we have a less dramatic increase than we did in the 1990s, which seems appropriate given the headwinds that the economy faces at the moment. However, I would be the first person to say that if we look at this chart in nine months, the numbers may look different again. We have to address the evidence as it comes in.

Q18 Stewart Hosie: Without stating the obvious that we do not have the erosion of capital assets that we had in the previous two recessions to replace, which may explain some of that, but we will park that just now, I have one final question.
Robert Chote: The decline in investment was pretty similar in the last recession to this one, so you had about a 14% to 15% real decline in the period running up to this 40% to 50% increase.

Q19 Stewart Hosie: Indeed, but there was the requirement to replace physical assets that had been completely eroded in previous recessions, which we have not seen this time. However, that is by the bye. I have one final question. On the main components of GDP growth—it is in the Budget Red Book—the business investment component running through that is the highest single component in most years of GDP growth. Of course, we have general Government consumption down almost across the piece. If this business investment growth is not what is forecast and if outturn ends up being as low as we have seen in the last couple of years, the Government cannot meet their fiscal targets, can they?
Robert Chote: Do you mean if growth overall is weaker?
Stewart Hosie: Business investment growth.
Robert Chote: You have to be slightly careful, because, for one thing, business investment growth, relative to other categories of GDP, is not as positive for the public finances. Ironically, when you revise down your business investment forecast, you have less use of capital allowances, and that is actually positive for corporation tax over this sort of horizon. You can argue that the implications in terms of the longer term strength of the economy and the desirability of investment would outweigh that, but if you actually look at the impact of changes in investment directly on the tax revenue forecast, it is not as straightforward as that. In terms of the overall contributions, clearly, the impact that a weaker growth performance has on whether you hit the fiscal targets depends to a considerable degree on whether that is telling you something about the structural fiscal position or about the cyclical fiscal position. Whichever of those it is, it does not help you get debt to GDP ratios down in 2015–16. If you have weaker growth that is pretty much entirely cyclical, that does not necessarily put you too far off course on the mandate, whereas if there is more structural bad news there, that would have a greater impact.

Q20 Stewart Hosie: So we could have a miserable and sluggish long-term recovery and the Chancellor can still say that he has met his targets?
Graham Parker: He could say that he has met the fiscal mandate. Whether he meets the secondary target of debt falling is another matter.

Q21 Andrea Leadsom: You refer to the inevitable downside risk, yet your core forecasts assume that those disasters don't happen. Specifically, I believe you used the OECD's model for a disaster in the eurozone: you took a definition of the disorderly breakdown of the euro, which would involve one sovereign leaving. Will you talk to us a bit about that? Why did you decide that that was a suitable definition of the potential downside? Were there other options that you considered?
Robert Chote: When we discussed this before, we made the point, also made by the Governor of the Bank of England, that there are so many different ways in which what you might describe as unpalatable outcomes for the eurozone could evolve that it is impossible to come up with a probability distribution of likely outcomes containing all the various narratives that might lead you to different outcomes. We were conscious of not wanting to pick out a particular scenario or novelisation that we had managed to come up with that we think would represent all possible difficult outcomes for the eurozone.

Q22 Andrea Leadsom: But did you look at what you three considered was the most likely plausible outcome? Mr Nickell, what do you consider is the most likely disaster scenario, if disaster befalls the eurozone?
Steve Nickell: By the most likely disaster scenario, you mean: if there is to be a disaster, what is the most likely disaster?

Q23 Andrea Leadsom: Correct. Yes.
Steve Nickell: I have not really thought very hard about that. Specifying the kind of disaster and ranking them in terms of probability, is not something we have devoted a great deal of time to. The main reason for that is that we are particularly concerned with what happens to the public finances if there is a disaster. A thoroughly representative disaster of the kind that the OECD constructed serves that purpose very well. It shows that it is, on balance, very detrimental for the public finances, to the extent that the mandate would be broken, missed. That, I think, was our main concern.

Q24 Andrea Leadsom: Do you not think that it would be right to look at this? Obviously, you are forecasting and always caveat everything you say with, "This is just an opinion and we are always wrong. You can count on us being wrong." Surely it would be relevant to say, "In our opinion, the most likely scenario is", for example, Greece deciding to default, or it might be Germany deciding to leave the euro and let everyone else get on with it.
You must have a view between yourselves which is the most likely outcome, if something major were to go wrong. It is important because, of course, in the past couple of years we have seen very significantly increased risk of a disaster. Surely it is not just an outlier; it is not just a once in a billion likelihood. It is something rather more real than that.
Steve Nickell: Frankly, it doesn't much matter what happens, to the extent that almost any form of disaster

will lead to a severe credit crunch. Precisely how the thing pans out is not really that important. The fact is that, however it pans out, if there is a disaster, it will impact very severely and badly on the UK banking system, and, thereby, because of the resulting credit crunch, on the UK economy.

Q25 Andrea Leadsom: So, for example, are you saying that Greece leaving the euro would have the same negative impact as an enormous oil spike or Chinese growth falling off a cliff? Would you extend that analogy to say that any disaster would have the same impact, or just a eurozone disaster?

Steve Nickell: The eurozone disaster has an especially severe impact on the banking system of the eurozone, whereas an oil price spike, which we have in another scenario, does not have such a detrimental impact on the banking system of the eurozone. That is the key. A eurozone disaster has one of its main impacts on the UK because of its effect on the banking system, so we get a repetition of what we had in 2008, but from another direction.

Robert Chote: So much depends in all these scenarios, again, on the extent to which the impact of the crisis on the UK manifests itself in a further structural deterioration of the sort that we have seen over the course of the last crisis. That is why, as Steve says, one would be particularly worried about the sort of crisis that led to severe difficulties in terms of the credit crunch—which, at the moment, is the best explanation we have for why the path of potential GDP seems to have moved so much off the previous, pre-crisis path—versus other sorts of crises that show up as a temporary hit to demand, movements in exchange rates or a change in Government bond yields, for example. One useful thing that the OECD study—we picked that because it was the most comprehensive, recent one carried out by an internationally reputable organisation—highlights is the fact that if this leads to a qualitative set of problems similar to those in the previous crisis, given that that has manifested itself in a structural deterioration, that is one reason why you might be worried about a repetition.

Q26 Andrea Leadsom: Have you looked at the impact of the LTRO programme on the likelihood of a future eurozone shock in the medium rather than the short term? Clearly, in the short term it has had a beneficial impact, but have you looked further to see whether it increases the likelihood of a shock in the medium term? In other words, how likely is a shock to happen and then impact on your forecast, bearing in mind that it is all stargazing anyway, to a certain extent? Should you factor in the potential for that downside and try to think about what it might look like because it is not such an unlikely outcome? Specifically, what change has the LTRO programme made to the medium-term outcome for a eurozone shock?

Steve Nickell: We have not specifically investigated the impact of the LTRO on medium-term dangers. Our main forecast is what we consider to be the most likely outcome. In these sorts of scenarios, we look at possible alternative outcomes that we think of as being less likely. We don't attach probabilities to them. About 15 months ago, you asked me about the probability of a collapse of the eurozone in the following year. I said, "1.7%"; I think that the probability of this kind of OECD stylised outcome is higher than that now.

Q27 Andrea Leadsom: What date?

Steve Nickell: Occasionally, I go and look at William Hill, which has the odds on these sorts of things. The last time I looked, I think the odds on Greece not using the euro by the end of year were of the order of 40%—a bit lower than they were earlier, after the latest Greek bail-out talks and "success".

Q28 Andrea Leadsom: Are you saying that we should use the OBR and William Hill when checking the forecasts?

Steve Nickell: William Hill gives you a good indication of the average view from people who are thinking about these things and putting their money where their mouth is.

Q29 Andrea Leadsom: Absolutely. I have one last question. You have only really looked at the OECD's assessment of a likely eurozone disaster and an oil price spike. Did you consider looking at any other scenarios? Specifically, as you might know, the Treasury Committee had a trip to China recently, and it certainly struck me that there had to be an enormous downside risk to China's having abolished boom and bust—I suspect that they have not done so any more than we have. Did you look, for example, at what would happen if China's economic boom stopped, or at any other potential disaster scenarios?

Robert Chote: No, we have not looked at that. When we were thinking about the range of scenarios, it is obviously driven in part by what people are expressing concerns about, and the eurozone—

Q30 Andrea Leadsom: So groupthink then—only look at the risks that everyone is talking about.

Robert Chote: No, we are responsive to our stakeholders. Those are clearly the two main ones on which people would say, "These are the obvious things to be looking at".

China is an interesting issue—we haven't looked at that. There is a question about whether that would be likely to manifest itself primarily as a demand shock, or whether it would simply show up as a greater weakness in terms of demand for UK exports, or a source for imports, and so on. Obviously, a broader global realignment or exchange rate changes could have a much more complicated story, but it is not something we have looked at specifically. The question is whether it would be something that went beyond a demand-shock story that merited looking at.

Q31 Chair: Just to be clear, Mr Nickell, since you are not attaching probability functions to these scenarios, you are saying that we may as well use William Hill.

Steve Nickell: You can use William Hill for finding out what the world thinks about the probability of certain sorts of events—yes, absolutely. It is a good method of finding out the average of people's views about probabilities of future events.

Q32 Chair: It certainly tells you what the groupthink is.
Steve Nickell: Well, not necessarily, because it could be an average of an extremely dispersed distribution.
Chair: It gives you an average of the groupthink—I think you'll find it does.

Q33 Mark Garnier: Robert Chote, to what extent do you think that a continued lack of bank lending will be a constraint on economic growth, and how have you factored that into your figures?
Robert Chote: The fact that it still takes some time for credit conditions to normalise is one of the key factors that explains why you have a relatively slow recovery, but it is also one thing that we have factored into deciding when the growth rate of potential GDP is likely to get back to its long-term trend growth rate. As we discussed when we met you after the last forecast, one of the judgments we took then was to assume that potential GDP growth would not snap straight back to its long-term average, but rather that it would come back over a couple of years, as credit conditions normalised. When we were talking about risks a moment ago, clearly one of the possibilities—that that process gets delayed—would be an important risk to the outlook for recovery, not just in terms of the actual path of GDP, but in terms of your expectations that potential GDP growth or productivity growth gets back to its long-term rate sooner or later.

Q34 Mark Garnier: You talk about normalising, but what do you mean by normal? Do you take 2006, 2007—prior to the crisis—as being normal, or does normal go back to, say, 1999?
Robert Chote: No, you would assume that the period immediately prior to the crisis was not normal, so you are going back to a situation where credit is not as available as it was in the heat of the pre-crisis period.

Q35 Mark Garnier: So when you look at long-term credit in terms of lending margins over the bank base rates, are you—when making your very long-term forecasts—going back to a certain period when that was deemed normal? How are you deciding how the interest rate premiums over the base rate will be determined?
Robert Chote: I think we're looking back, not to the immediate pre-crisis period, but to what would be familiar in the earlier period of the upswing.

Q36 Mark Garnier: So, still part of the upswing?
Robert Chote: Well, not going right back to the previous recession, for example. Clearly, an important difficulty—not just for these sorts of fiscal forecasts, but generally—is thinking what the new normal is likely to look like. That is further complicated, for example, by regulatory changes and what impact you think Vickers or the like might have in the long term on what the new normal is. I would be wary about saying there is a particular year in one's mind.

Q37 Mark Garnier: I will come to that in a minute, but do you think businesses have modified their expectations of what they can get from their banks in terms of credit?
Robert Chote: I am sure they have. You have both a demand-for-credit story and a supply-of-credit story, and there is a bit of both going on. On the demand side, obviously that is partly reflecting people's hopes for the recovery as a whole, and—

Q38 Mark Garnier: And the same applies to households as well, in terms of getting mortgages?
Robert Chote: Yes.
While we are still on the business side, the other distinction is for those companies that are able to access capital markets, as distinct from relying on banks. There is a somewhat different story there. Households have a similar adjustment to make, and clearly we have activity. For example, turnover in the housing market is taking quite some time to return to the long-term levels applied by what you might think of as an equilibrium number of years people typically stay in a house before they move. On current transaction levels, that is clearly very wide, so you have a gradual process of transactions getting back to what you might think of as the previous trend level.

Q39 Mark Garnier: And that is how you factor it into your forecast? You work it in gently.
Robert Chote: Yes, that is right. We have to make some sort of assumption on the transaction side, which obviously matters for things such as stamp duty revenues, as to how quickly you believe that it is reasonable. I think that we have a graph somewhere showing that it is recovering, which I might find in a second, but we basically have it going back to—

Q40 Mark Garnier: While you are looking that up, can I turn to Steve Nickell? Perhaps we can talk about the FPC and its effects in terms of your forecasting. Clearly, the FPC will have macro-prudential tools; I think that it published them this weekend. How will you factor that into your forecasts when you have no experience of how they will operate?
Steve Nickell: Gosh. The FPC has just published some discussion about what its macro-prudential tools might be. It was talking about the standard raising capital requirements, which it thought would be a relatively acceptable thing to do, and then there was the discussion about regulations on loan-to-value or loan-to-income ratios on loans. It seemed to be rather more anxious about whether that would be acceptable. I am trying to look forward into the future. In our current forecast, we do not have such a growth in credit that we feel that the new Committee will be intervening any time soon. I suppose that the way one might think about doing it is that if you constructed a forecast—this is ignoring the new Committee—and you discovered in the context of that forecast that you had very rapid rises in house prices and rapid expansions in credit, we would probably say, "Ah, but that will not be allowed to happen", because we suspect that the Committee will intervene to restrict the rate of credit expansion, either by using capital requirements and/or direct regulation of things such

as loan-to-value ratios. I can see that that would be how we might proceed on that score.
At the moment, luckily—or not so luckily—our forecast does not have any very rapid credit expansions, or at least not anything comparable with what has been seen in the recent past.
Robert Chote: I think that it will be interesting to see just how clear the FPC is in setting a road map, as it were, of how it would behave if things turned out like that in the future. It would make those sorts of adjustments a lot easier if you were clear about how it was likely to respond, so we will have to wait and see what sort of—

Q41 Mark Garnier: There has been a lot of discussion about this. I am slightly surprised—not necessarily surprised—at your candidness about the fact that you have not given it a huge amount of thought. It could have a very significant impact. For example, there is not only the direct impact of whether you have a huge credit bubble, but if you tighten up credit to mortgages, you are potentially limiting the mobility of your work force around the country. It could have all sorts of knock-on effects, both secondary and tertiary, that we do not necessarily know about. You have a lot of work to do, don't you think, in terms of looking at this.
Steve Nickell: Yes, but again, as I have said, if the world turns out the way that our forecast says it will, we do not see the Financial Policy Committee intervening in that scenario in any big way.

Q42 Mark Garnier: Essentially, you are saying that at some future point, things will change and at that point when things change, you will factor that in to create that environment, if you think that it is necessary.
Steve Nickell: Obviously, that will develop. What will happen first, with any luck, is that the FPC will put out some document that sets out how it might respond and what it will respond to. If, in our forecasts, those things happen that cause it to respond, we can make the appropriate adjustments. I can see this developing over time. It seems to be relatively clear that the FPC is moving in a relatively leisurely fashion, so there does not seem to be any likelihood that it will do one of its significant interventions any time soon.

Q43 Mark Garnier: One thing that has had significant interventions is the MPC, in terms of quantitative easing. In your report you noted: "Whether the second and third rounds of quantitative easing will provide as much support to the real economy as the first remains a risk to our central forecast." Why do you think that the second and third rounds of QE have been less effective?
Steve Nickell: I guess that it is a function of the fact that having acquired such huge quantity of gilts the first time round, it would have been very much smaller in the second and third tranches. There appears to have been some impact on the interest rate curve further out, but I guess that that is partly because it has been relatively small interventions done relatively slowly—whereas first time round, there was a big intervention done relatively quickly.

Q44 Mark Garnier: One thing that I have noticed on this is that, right at the very beginning—when the first £75 billion and £100 billion came in—the narrative was very much in terms of getting money into the system and getting liquidity. In the most recent discussions that we have had with the MPC in this Committee, it has not been about getting money into the system, but controlling bond yields. It has been a way of intervening on interest rates when you cannot, because of the base rate. Do you think that that is a fair assessment?
Steve Nickell: First time round was about getting money into the system as well, but the impact on interest rates was also important, especially the impact on long-term rates. I still think that they think of long-term rates as an indicator of whether they are having an impact, as well as money supply and numbers.

Q45 Chair: Did you discuss your view of QE with the Bank?
Steve Nickell: I am trying to think back. We have talked about QE.

Q46 Chair: Does the Bank agree with that assessment of the diminished effect of QE in round two?
Robert Chote: We do not have discussions with it of that sort.
Steve Nickell: Probably not.
Robert Chote: When it produced its initial article on the effectiveness of QE, we talked to it as we do in the run-up to most of the forecasts in a general exchange of views. We do not, however, say, "This is what we are going to say. Do you agree with that or not?" That is not the sort of relationship that we have with it.

Q47 Chair: So it has not had an opportunity to say, "We do not agree on this point."
Robert Chote: I have not had any communications from it regarding that. As I say, we are saying here that the risk that it is less effective is one that you have to bear in mind and is one that has been expressed more widely.

Q48 Chair: It is a big issue for the Bank and it is a big issue for you. We should be aware if two important institutions are operating off different views of its effects.
Robert Chote: Yes. As I say, we cite it as a risk and I have not had any communication from it to suggest that it is unhappy with that wording.

Q49 Mr Mudie: I want to ask you a couple of questions on the national loan guarantee scheme. You state, somewhat pessimistically, that it should lead to lower funding costs and some additional net lending. Did you quantify the reduction in funding costs or the additional net lending that might result from the scheme that leads you to qualify them in such pessimistic terms?
Robert Chote: There is the broad issue around to what extent, if this has an effect, it feeds through to additional SME lending—i.e. does it change the balance of lending to SMEs versus other borrowers—

and then there is the question of whether it adds to the total volume of lending as a whole. Those are both uncertainties which are reasons to be caveated there.

The view we have taken in this report is that we have looked at the first tranche and the magnitude of that does not seem to be large enough to justify material adjustment to the forecast. Then, looking forward to subsequent tranches, if the spreads move as we expect them to do then, then, as it were, the problem this is designed to address is not quite as serious as it would be.

In a sense, it is more like looking at the future tranches as a potential insurance against the rates that SMEs can borrow deteriorating by more than the improvement in our underlying forecast suggests. So we are not saying that this is a waste of time by any means. We are saying that we would not expect the first tranche to have a material impact but, depending on what happens to the pattern of spreads, that it might do in future.

Q50 Mr Mudie: Robert, that is a very successful two minutes that leaves me no wiser. But you were not supposed to make me wise; you were supposed to make me better informed. You say it should lead to lower funding costs. Is that your view? The simple question was, have you quantified your view of the financial effect?

Robert Chote: Yes. Our expectation is that it would lead to some rebalancing in lending towards SMEs from other borrowers. We are less convinced that it would have a significant impact on overall lending and therefore on the economic forecast.

Q51 Mr Mudie: Yes, but that is specifically not answering the question of whether it will lead to lower funding costs for SMEs. Have you quantified the amount of lower funding costs that the SMEs will be able to see as a result of this £5 billion tranche? Secondly, just to speed it up: you say that you anticipate some additional net lending. Let us just put a target down. Will it take the net lending this coming year over or up to the Merlin target? How successful will it be in terms of cheaper loans to SMEs and additional money to SMEs? You've gone through this. You've made this statement. Tell us what figures underpin it.

Robert Chote: I have not looked at it in the context of comparisons with the Merlin targets. We believe it will lead to lower funding costs to SMEs. It is not clear, in terms of what we have to draw from this, which is whether it affects the overall level of economic activity, that the additionality, in total, will be sufficient to justify changing the forecast. So on that basis we have not done so.

Q52 Mr Mudie: So it is too small and below the radar for it to affect the business aggregate investment that you were concerned about?

Robert Chote: That is basically the judgment.

Q53 Mr Mudie: If they put the full amount in—£20 billion—would that come on to your radar?

Robert Chote: I think that the way the tranching is supposed to be working depends on how spreads are evolving as you go forward—

Q54 Mr Mudie: Okay. Let me put that question a different way. What level of tranche would have been sufficient to make it interesting for your business aggregate investment?

Robert Chote: You mean if they had done it all upfront?

Q55 Mr Mudie: No. Steven, do you want to respond?

Steve Nickell: If they did £20 billion upfront, immediately, then we would have to sit down and think seriously about the additionality there. With £5 billion, you do not have to think very hard about the additionality, because £5 billion is just not very big. With £20 billion, we would have had to think very seriously about how much additionality there was. We looked at the additionality issue, and our general feeling was that it was not very great. In other words, the actual increase in lending you get—the bang for your buck—is not very great.

Q56 Mr Mudie: Just a last question, and you can just say, "No, that was not in my brief". The initial approach, when you read the scheme, is that it is hard to see why it will not merely lead to some SMEs getting a lower rate, rather than boosting additional lending. Did you give that any thought?

Robert Chote: The Government are in part trying to do this, presumably, to help SMEs specifically, and then as a contribution maybe as well to aggregate levels of business investment. There is the broader question of whether that also substitutes for lending to non-businesses. It is for them to decide what their success criteria are for this policy. They might be happy if it is showing up as an SME effect, because they are particularly interested in helping SMEs, and there is an offsetting effect elsewhere. We would argue that the likelihood of that is greater than the likelihood of its making a significant boost to aggregate lending and therefore to aggregate activity in the economy.

Q57 Chair: Actually, they briefed the press and did not deny when challenged that it probably would not lead to net new lending, but they argued that it would make existing lending cheaper and, therefore, would be of benefit to existing potential borrowers. Did you ask the Government about that?

Robert Chote: Not that issue specifically. When we were looking at the aggregate effect, that was the view that we reached.

Q58 Chair: Since it reduces the cost to banks, logically if they keep their risk appetites at the same level there will be more lending.

Robert Chote: To SMEs—yes.

Q59 Chair: Therefore, I am wondering where you got the assessment, Mr Nickell, that there would not be much.

Steve Nickell: Because we are not talking very big numbers here.

Q60 Chair: So you are saying that a large proportion of this might come through as new lending, but that because the sum is small, the overall impact is small.
Steve Nickell: Well, that, and also—
Chair: Is that correct? Are you saying yes to what I have just said?
Steve Nickell: I am saying "Yes, but", if you don't mind. We are talking one percentage point here. An SME line from a bank is often 8%, 9% or 10%, and one percentage point is not huge.

Q61 Michael Fallon: May we come back to business investment? In paragraph 3.64, you say: "Further assessment" of the official data "suggests that firms' cash balances may not be able to support as much investment as we previously thought." What is that further assessment? What were those findings?
Robert Chote: It is basically looking at how the way in which the ONS attributes the money that UK companies have on deposit with overseas financial institutions has changed, and whether that is correctly capturing the sorts of firms that are holding those financial deposits—whether it is the sorts of firms that are likely to use them for capital investment, or whether it will be other sorts of firms as well. The ONS is using a Bank for International Settlements survey, which records the claims of UK bodies on those foreign financial institutions. It attributes about 80% of those to the UK corporate sector that you might anticipate would be likely to invest them. Our concern is that a smaller proportion of that than 80% may be with the sorts of companies that are likely to invest this in capital. More of it, for example, might be held in by hedge funds and therefore it is less likely to be used for capital investment. That 80:20 split was come up with quite some time ago, since when the growth of non-bank financial institutions has been rather great. That concern is what primarily underlies the view that the apparent cash piles that lots of companies are sitting on may not be, as it were, just waiting to go out and be invested in capital investments, as the official statistics might suggest.

Q62 Michael Fallon: So you are not saying that the official statistics are wrong about this, but you are saying that, looking into these totals, a lower proportion might be available for investment than somebody else might have thought?
Robert Chote: Yes, the ONS is basically using this Bank of International Settlements data in an attempt to assess the proportion of this that lies with industrial and commercial companies. Our view is that that was a judgment taken some time ago. Given what has gone on in non-bank financial institutions, there might be less of that money available to invest than the data suggest, but it is a very difficult judgment for them to have to make.

Q63 Michael Fallon: Sure. I am just trying to pin down what the dispute is between you and the ONS. You think that they have overestimated the size of industrial and corporate lending inside that pot?
Robert Chote: The proportion of money held on deposit with overseas financial institutions—that is, in the hands of companies that might go out and use it for capital investment—yes.

Q64 Michael Fallon: So that is nothing to do with the current situation.
Robert Chote: No.
Steve Nickell: No.

Q65 Michael Fallon: It is just how the way they do it is interpreted?
Steve Nickell: Yes, exactly.

Q66 Michael Fallon: You were quoted on Budget day, or before, in the *Financial Times* as saying: "The recovery in business investment is somewhat weaker this time around than after the recession in the 1990s." Could you clarify how that fits with paragraph 3.63, in which you say that you "expect strong medium-term investment growth…repeating the pattern of the 1990s recovery"? I just want to be clear about what is different from the 1990s.
Robert Chote: It's repeating in the sense that it is strong; it's not repeating in that it is not quite as strong. Chart 3.15 basically shows you that. The chart shows the year-on-year changes in business investment for the four years of the downturn and the first five years of the recovery. The common pattern is that, for a start, you have a similar average decline in the years of the downturn, and it is common then to see a big rebound thereafter, a rebound that is large enough to see business investment rising as a share of GDP and, therefore, helping to pull up overall GDP growth. But, as you see, we have a slightly lower average growth rate for business investment over those five years than we had in the equivalent five years of the '90s. So that is what is the same, and that is what is different.

Q67 Michael Fallon: So that justifies the phrase "somewhat weaker"?
Robert Chote: Yes.

Q68 Michael Fallon: Okay. Do the changes to the forecast for business investment suggest that rebalancing the economy away from consumption is going to be much harder than we originally thought?
Robert Chote: If you define it as investment and consumption as a share of GDP, we have a smaller increase in investment as a share of GDP and a slightly stronger consumer spending forecast. In that sense, there is less rebalancing going on. Whether the Government regard that as being too much or too little rebalancing is a matter for them.

Q69 Mr Love: To what extent do the measures in this Budget affect or impact on your growth projections?
Robert Chote: Not a great deal. The aggregate Budget judgment over the five years of the forecast is pretty neutral. The net balance of takeaways and giveaways is no larger than £2 billion in any given year, so we are talking barely 0.1% or 0.2% of GDP. In that sense, there is no great net addition to or subtraction from aggregate spending in the economy as a result of the Budget measures. What we have done is note that

there are a couple of measures in which you want to pick out a specific effect, such as the broadening of the VAT base and the decision to increase tobacco duty more than was previously implied has a direct impact on an inflation forecast, and we have taken that into account—and the specifics of the reduction of corporation tax. That reduction has a modest offsetting effect on the downward revision in the business investment forecast to which Mr Fallon referred, but it is small in comparison with the overall reduction in the business investment forecast since last time.

Q70 Mr Love: In fact, it is very small. In business investment, you are suggesting 1% over the term to 2015 and for GDP you are suggesting 0.1%.
Robert Chote: That's right. So, you would expect the level of business investment to be 1% higher at the end of the forecast as a result of the change in the corporation tax rate and the consequences that has for costs for capital. That is a metric that has been used in previous forecasts. There is no new view about the potential impact of this.

Q71 Mr Love: Will the benefit of that reduction in corporation tax be sufficient to offset the cost of the measure itself?
Robert Chote: I do not think there is any argument about it being self-financing in that sense. If you were to increase GDP by 0.1% at that level then the equivalent amount of that is not offsetting.
Graham Parker: As we said earlier, the increase in investment actually reduces corporation tax. With capital allowances the immediate effect is to reduce corporation tax.

Q72 Mr Love: The Chancellor has made great play of the need to attract foreign investment, and the rate of corporation tax is very important in achieving that. Yet, after this measure is introduced, as I understand it, we will be fifth lowest in the G20. The others, who are lower than us, are not exactly our biggest competitors. Isn't there a declining benefit from continuing to reduce corporation tax in terms of what the Chancellor is trying to achieve?
Robert Chote: There presumably is an issue there. Partly, if you are thinking about a pool of globally mobile profits that you are trying to attract more to the UK by having a rate that is lower relative to other countries, that will obviously be affected by what the rates are doing in other countries and by other features of the tax system: the tax base as well as the particular rates that are imposed. The mechanical effect referred to is not based on where we are in a league table. It is more about the cost of capital and the likely impact that would have on capital investment.

Q73 Mr Love: Well, not according to the Chancellor who makes great play of this. I am pleased you answered in that way. There have been a number of questions in relation to bank lending. Is the lack of bank lending, in your view, a constraint on growth in the economy?
Robert Chote: Yes. It is one of the reasons, as I said, why we have not only growth taking some time to respond but also potential GDP growth to get back to normal. That is partly the fact that credit conditions have some way to go to normalise.

Q74 Mr Love: Yet we have already heard that the national loan guarantee scheme is unlikely to have any impact on new net lending. If you take it as £5 billion, you said that was too small to have an impact. Yet, by the time they build up to the £20 billion, it is likely that growth will have increased and the difficulties in financial markets will, hopefully, have resolved themselves. Therefore, the benefit of this measure tails off into the future. So, it is irrelevant to considerations of growth in the economy.
Robert Chote: Not necessarily. If the spread story is not as good as the central forecast suggests, the future tranches are more valuable and more growth effective than they would be if things improve on the path that we are suggesting here.

Q75 Mr Love: I understand that, but on your central projection—
Robert Chote: On the central projection, the spreads improve sufficiently that this would not have—as I said, we haven't adjusted the forecast in the future to take account of that, on the grounds that if the spreads improve, as we suggest, that will be less necessary.

Q76 Mr Love: A drop in corporation tax has had little impact on overall growth. We know that bank lending continues to be a problem, yet the national loan guarantee scheme—. Are we down to just waiting until growth returns to the economy, according to your projections, in 2014, before we get back to the norm?
Robert Chote: As I said, we do still have investment contributing, pulling the growth rate up. It remains a driver. You have investment rising as a share of GDP. As we were discussing with Mr Fallon, it is rising strongly but not as strongly as in the previous recovery.

Q77 Teresa Pearce: I want to talk to you a little bit about tax rates and the 50p tax rate. I believe that your analysis was based on the work done by HMRC. When did you get that analysis from HMRC?
Robert Chote: I do not know when we first saw drafts of it, but we had been discussing with them for some weeks before we knew what the Government were going to assume in terms of the responsiveness of taxpayers to the tax measures.

Q78 Teresa Pearce: So you have had some ongoing discussions with them. Did they give you access to the underlying data?
Robert Chote: Not to the underlying data. For reasons of taxpayer confidentiality, you do not see that material anyway. We obviously get a sense of where—this was especially the case with the self-assessment data—

Q79 Teresa Pearce: On self-assessment data, they would not have had 100% of those 300,000 tax returns. Do you know what percentage of those returns they would have been basing their figures on?
Graham Parker: It is in their documents somewhere.

Robert Chote: I think 90%, but I might be wrong.

Q80 Teresa Pearce: It is quite surprising that they have had a chance to analyse nearly all the self-assessment returns given the backlog in their work. They have obviously pulled them out as a priority, because they need to do this piece of work. For the reasons that you said, you did not have access to the underlying data, so what did you do to interrogate the figures?
Robert Chote: One thing is to look at their consistency with the first set of outturn data that were coming in. In the January public finance data, which we comment on publicly, you were already seeing some evidence of self-assessment receipts coming in weaker than we had anticipated at the time of the November forecast. In that sense, it was not counter-intuitive given the aggregate figures there. There was certainly then a question in our minds about to whether the subsequent February data were likely to come up with the same sort of picture. As they came in, that was clearer.

Q81 Teresa Pearce: Are you saying that the figures that they gave you tied in with what you expected, or are you saying that there was no interrogation of their figures?
Graham Parker: There was quite a bit of interrogation. We particularly asked them to ensure that what they were saying in this analysis actually was consistent with the receipts information that we were getting. There was a breakdown of the different types of income, which underlies the self-assessment. The concentration was on the self-assessment returns. We asked them to ensure that what they were saying about forestalling and behaviour was consistent with what we had seen in the receipts. We were very concerned about the effect on the receipts forecast of what they were saying, so we asked them quite a lot of questions on that.

Q82 Teresa Pearce: When you were briefly surprised by the level of receipts, because it was less than you expected, why didn't you challenge the estimate of the 50p tax before you did?
Graham Parker: We were not actually surprised. We did not actually know about the full extent of how bad the self-assessment was until the middle of February.

Q83 Teresa Pearce: You expected the receipts to be higher.
Graham Parker: Yes. Our forecasts in November were that self-assessment receipts would be about £3.5 billion higher than they actually were. It was not until halfway through February that we knew the complete scale of the shortfall. That is when we started asking them questions.

Q84 Teresa Pearce: So is the scale of the shortfall because of a lowering of income or a lowering of returns or income shifting? Do you know why?
Graham Parker: It is a bit of both. Well, a bit of everything. We have got a table. This is very complicated. In particular, self-employment income was quite a bit lower than expected. You also have to try to get the forestalling and people who brought forward their income.

Q85 Teresa Pearce: I have some concerns about forestalling. I used to work for PwC in tax investigation, so it came as no surprise to me whatsoever that people shifted their income, but it seemed to be a surprise to everybody else. Looking at some of the figures, it is estimated that £16 billion of income was shifted then, but what is obviously going to happen is that people are going to shift again, but the other way. Yet you have estimated only £6.25 billion for that, which seems quite low to me.
One of the things that happened with the shifting—obviously, the Government brought in the 50% and then there was going to be an election—was that a lot of people thought, "Well, with the election of a new Government this will all be reversed, so maybe it is not worth doing." The fact that, when a tranche of people thought the 50% would be only very temporary, £16 billion was shifted makes £6.25 billion seem quite a low estimate of what people will shift the other way.
Robert Chote: One issue is obviously that the differential in the tax rates is half of what it previously was.

Q86 Teresa Pearce: Half of quite a lot is still quite a lot.
Robert Chote: It is quite a lot. The other point is that in the case of avoiding the 50p rate, there were several years in the future that you could shift the income out of into the year prior to the rate change happening. In this case, you have only this year to shift it out of into the future year in order to take advantage of the lower rate, so there is a smaller pool of time period to shift your income out of.

Q87 Teresa Pearce: Even so, in your estimate, it looks as though in 2012–13 there will be a £3 billion drop in revenue, because of people shifting the income.
Robert Chote: That is right. Roughly, if you have £6 billion, that is the impact.

Q88 Teresa Pearce: That is a big number, and the assumption is that it will come in the later year.
Robert Chote: As I say, you are looking there specifically at the forestalling effect—the simple time shifting. There is then the separate issue of what has been the underlying behavioural response that you might expect to persist as a result of labour supply responses or of permanent changes to tax planning behaviour and so on. It is a heroic exercise to try to disentangle those two components and to quantify them.

Q89 Teresa Pearce: Do your forecasts assume a top rate of 45% throughout the spending review period?
Robert Chote: Yes. Until the Government announce that they are going to do anything different in the future, we take current policy.

Q90 Teresa Pearce: Have you been asked to do any estimates of a lower rate of 40% for the top rate?

Robert Chote: No we have not, but in an attempt to explain the costings that we have signed off in terms of the 45%, we have had reference to the way in which the revenue is likely to respond, so in fact we have an estimate that the cost of shifting from 50% to 40% is about £700 million—if memory serves me right—in comparison with shifting from 50% to 45%, which is about £100 million.

Q91 Teresa Pearce: This is not about income tax but corporation tax, but it picks up on what you said earlier. Looking at your figures, the figure that you claim will be lost in corporation tax because of the lowering of the rate seems really low: it is something like £400 million. This year, corporation tax receipts have been £42 billion, so a reduction of a couple of per cent would be a bigger figure than that, I would have thought. Have you got other things in that figure? Maybe you cannot tell me now, but perhaps you could write to me.
Robert Chote: There is a behavioural response.

Q92 Teresa Pearce: On corporation tax—I think the table is on page 180.
Robert Chote: If you look at this, it will break down the behavioural and the non-behavioural change, and that will get you to that number—if I can find it.

Q93 Teresa Pearce: What you are saying is that you are gambling on behaviour.
Robert Chote: We are not gambling on behaviour. If you have been at PwC, you know you have to think about how people respond to financial incentives in terms of the way they behave as regards that.
Graham Parker: But if CT is £42 billion, a 1% cut is about £400 million.

Q94 Teresa Pearce: It is a 2% cut, isn't it?
Graham Parker: No, we are costing only a 1% cut in this Budget—the other one had already been announced.
Robert Chote: The first 1% had already been announced, so we are costing only the 1% additional change.

Q95 Teresa Pearce: Does that include the behavioural as well?
Graham Parker: I do not think there is that much behavioural, is there? There is a bit. The theory is that these mobile profits are more likely to come to be in the UK rather than elsewhere, as we were talking about earlier.
Robert Chote: There is not a huge behavioural change. It makes about £200 million of difference at the end of the forecast period.

Q96 Teresa Pearce: Based on the figures that you have done and all the calculations, how much would the 50% tax have raised on an annual basis had it stayed?
Robert Chote: Rather than the £2.7 billion that it was estimated to raise in the March 2010 Budget, we would be looking at something between £700 million and £1 billion and a bit, depending on how you did the calculations, so it is about a third of the original estimate.

Q97 Teresa Pearce: Given that this group of people—these 300,000 people—shifted income in 2009 and are likely to shift income again, and they have these behaviours where they try and pay as little tax as possible, do you think rewarding them in this way is correct?
Graham Parker: That is not a question for us.
Robert Chote: It is for the Government to decide what their objectives are and change these things. One point to bear in mind, obviously, is that the scale of the behavioural response is not laid down by holy writ. Policy choices can affect the amount that you raise from these sorts of things. For example, the structure of the tax system will help determine the scope for avoidance. You can make changes that might affect the expected level of that.

Q98 Teresa Pearce: Given that we know, or you think you know, that £3.4 billion is going to be shifted, perhaps that is something that we should look at and plug that gap so that income shifting is not so easy.
Robert Chote: I would make a distinction. If you announce a tax change like this—the same was true when it went up to 50p in the first place—and if you do not do it immediately, you are obviously creating a one-off opportunity for people to shift—
Teresa Pearce: A window.
Robert Chote: Exactly, a window. I would distinguish that, which is hard to predict, with the also very hard to predict judgment of how will more long-lasting behaviour change in terms of concrete labour supply responses—do people work less, retire at a different time, leave the country—and do they tax-plan, tax-avoid or tax-evade more or less than they otherwise would? So you have those two effects. Obviously, when you have a change that has both of them going on at once, that is one of the things that has made HMRC's job so difficult—to try to disentangle those two things.
But in terms of thinking about the impact of the policy, you need to distinguish between the facts. By announcing a change that does not come into effect immediately, you have one set of behavioural responses that are a one-off, and then you have longer-term ones that, presumably, are more fundamentally about what the policy is aimed at in the longer term.

Q99 Jesse Norman: A quick question before the main one. Have you looked at any of the academic literature on prediction markets?
Robert Chote: Not recently, no.

Q100 Jesse Norman: I just wonder whether it might be a helpful adjunct to what you are doing in terms of thinking about predictions of the William Hill kind that we have been talking about. It is not a completely daft idea. They actually have quite a good record in some respects.
Steve Nickell: The answer is yes. I have looked at this. They are very good on predicting the results of elections—much better than surveys.

Q101 Jesse Norman: I wondered whether it was a new frontier for the OBR. On the Budget, it is interesting that in your book you have a couple of pages on monetary policy, which is arguably the biggest single influence at the moment on growth. Have you looked at the risks and benefit from unwinding quantitative easing?
Robert Chote: No, we have not. We basically take the market expectations of future rates in which, implicitly, you might assume that underpinning those is some view of how the Bank of England is likely to unwind this. There is not a policy out there for us to be able to incorporate in any specific way on that score yet.
As I understand it, the plan is that once monetary policy is back on a tightening path, they would intend to gradually reverse it. I presume that that expectation is in the price as far as the expectations of policy rates are concerned. It is not for us to predict or to say that the Bank ought to do it this way or that way.

Q102 Jesse Norman: No, except that there may be some risks involved, which, since we are in uncharted territory, are probably worth thinking about. Of course, the original point of QE was to provide credit support to industry, rather than to the Government. That is still in the instructions that the Bank has been given. From that perspective, do you think that it has been a well designed policy?
Robert Chote: The policy has clearly been designed—
Chair: You can speak frankly among friends. *[Laughter.]*
Robert Chote: The aim has been to do this through its impact on gilt yields and therefore the impact that that will have on other market rates. I know that there has been a lively debate as to whether this could have been done in a way that affected corporate borrowers more directly, but that is an issue for the Government and the Bank, not for us.

Q103 Jesse Norman: It is a question that I would be grateful if you could return to in your writing, particularly since other central banks seem to take different approaches and have more direct means of support to corporate sectors.
The final, very quick question returns to the question that has been sitting around for a while. If you look at these big-balance-sheet types of recessions and recoveries—one might be thinking of Sweden, Canada and Japan—it looks like it is six to 10 years; it is that scale of thing. We seem to be in a situation where large amounts of additional borrowing over and above the stabilisers may themselves have a depressive effect on growth. Do you think that there is much growth around at the moment? Are there things that the Chancellor could have done that would have had a sustainable increase in growth, on either side of the equation—either by reducing the fiscal impact or by increasing it?
Robert Chote: You, by whom I mean Parliament, have instructed us not to look to alternative policy paths, in the legislation that set us up, so I cannot go too far.

Q104 Jesse Norman: You do not need to comment on policy. Is there growth available? That is what I want to know. The evidence historically is that there would not be at this stage in the recovery.
Robert Chote: We have a central forecast that shows a steady recovery, one weaker than previous recoveries—weaker than the last three, certainly. Given what you have in terms of credit conditions taking time to normalise, balance sheet adjustments and fiscal consolidation, that does not seem unreasonable.

Q105 Jesse Norman: You are bringing this in a six-year level rather than a 10-year level.
Robert Chote: I forget now where our latest forecast suggests we return to the peak; if I made it up, I would get it wrong. Clearly, we are talking about, as I say, a weaker recovery on that basis.
In terms of the debate over what more could be done—as I say, it is not for us to get into the merits of plan A versus plan B—I would point out that we may have taken a view that there might be less potential out there than we previously thought, and that brings us into line with people such as the OECD and the IMF. But there is still spare capacity in this economy, and on our forecast, it has not been fully closed at the end of it.
This is not an economy that could not do with a bit more growth if you could get it. There is a perfectly lively debate out there, which we are told not to participate in, as to whether there is a policy change that would deliver that improvement without having counter-productive consequences.

Q106 Chair: We began the discussion about the output gap and the very high level of uncertainty there is with respect to forecasting at the best of times, and certainly at the moment. Would it be a healthy thing for public debate if the press—and the public, for that matter—placed less faith in forecasts?
Robert Chote: In most of the press that I read, I am not sure whether faith in our, or anyone's, forecasts is widespread.

Q107 Chair: Are you happy to downgrade the importance of your own work?
Robert Chote: I was very clear that this was one of the things—

Q108 Chair: Not the quality; the importance.
Robert Chote: No. What you need to do is set out the uncertainties. A key part of our job is to bolster the transparency of the fiscal forecasting process. That has to be based on economic forecasts, with all the difficulties that that involves. One should not hide away from that. Judgments have to be taken on these things in order to reach a view, as we have been instructed to do, on whether you are more likely than not to hit the target at the end of the day. That is the job that we have been tasked to do.
What we have done—more than was done under the previous regimes—is to set out as clearly as we can what the uncertainties are, to try to quantify those and to say which bits of the uncertainties matter more in terms of outcome for the fiscal position and others.

Q109 Chair: The message from this Committee, among other things, is that we want to see as much as possible about those uncertainties and your assessments of them. I suspect that that is the point that Andrea wants to come in on.

Q110 Andrea Leadsom: Actually, it is a point of process. Would you say that, in coming to your central forecasts, you have all the tools at your disposal that your predecessors would have had? Obviously, you are not part of the Treasury team, by definition. Does that hamper your ability to provide reasonable forecasts?

Robert Chote: I don't think so. If we have issues that we want to explore with the Treasury, we will go to them and ask whether they would like to share with us any analysis they have on a particular issue. They have been very responsive in doing that.

Q111 Chair: Which brings me to the question that I always ask. Have you had all the co-operation you need and have you any evidence to suggest that any of your team have been put under any pressure that has been inappropriate?

Robert Chote: No, we have not.

Chair: Thank you very much for coming. We have appreciated it.

Tuesday 27 March 2012

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Mr Andrew Love
Mr Pat McFadden
Mr George Mudie
Teresa Pearce
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Roger Bootle**, Managing Director, Capital Economics, **Brian Hilliard**, Chief Economist UK, Société Générale, **Jens Larsen**, Chief European Economist, RBC Capital Markets, and **Jonathan Portes**, Director, National Institute of Economic and Social Research, gave evidence.

Q112 Chair: Thank you very much for coming. This is a pretty intensive day for the Committee, necessitated by the structure of parliamentary business and decisions, the end of the parliamentary Session, and problems like that, which are all beyond our control. We have two newcomers to the sessions today—welcome aboard Jens Larsen and Brian Hilliard, and thank you very much for coming—and two old lags, whom we welcome.

I will begin with one of the new team. Mr Larsen, do you believe the OBR's estimate, and therefore the Government's estimate, of spare capacity, and, if you do, do you think the gap should be plugged by monetary policy—that is, the policy of monetary activism and fiscal conservatism?

Jens Larsen: First, thank you very much for the opportunity to appear here. Another thing I appreciate is the opportunity to glance at the output gap from the OBR's publications. I think that the fact that they publish one giving us an opportunity to look at it carefully and assess this, is a very important element that other forecasters don't provide.

I think the OBR's assessment of the output gap is reasonable. I thought the change they made in November, when they reduced the level of potential output—the rate at which the economy can grow sustainably—was the right judgment. I am a little bit more sceptical than them about the return to a normal growth rate, but that is small beer in comparison with the main assessment. So I think it is a sensible call; but the important thing is, of course, how that maps into decisions: how that maps into the assessment of the structural deficit, and how that maps into the monetary policy side—to monetary policy actions.

Can monetary policy close the output gap? Well, actually, if you look at the OBR's forecast, it takes the full horizon to close the output gap; that would mean expansionary monetary policy for a very sustained period of time. So I think the notion that expansionary policy, monetary policy alone, can do this, is probably flawed.

Q113 Chair: What should the Government be doing, then?

Jens Larsen: I think the strategy that is in place—the fiscal strategy, but also the monetary complement—overall makes a lot of sense, and it's certainly a strategy that has been understood in the market. So the strength of fiscal consolidation, the commitment to that, combined with the fact that the Monetary Policy Committee can respond to a slowing economy by expanding monetary policy, is very well understood in the gilt market, and very widely appreciated among the people I meet in the international investor community. So I think that's absolutely essential. There is a very real question of whether you could have chosen a different path, where you had perhaps a little bit less fiscal tightening and perhaps a little bit less expansion of monetary policy. In my mind, that discussion was very relevant a year or two ago when that strategy was set out. I think at this point you wouldn't want to deviate from the current strategy.

Q114 Chair: You would not want to deviate?

Jens Larsen: I would not want to.

Q115 Chair: Okay; so the Government's got a problem with its current strategy, but it shouldn't deviate.

Jens Larsen: Absolutely. I think it is clearly very important, both for the Chancellor and for the Governor of the Bank of England, that there is a perception that there is a commitment to achieving fiscal sustainability and a rebalancing of the economy. Is that rebalancing going as well as we thought, or as the Government thought it would, a year ago? I don't think it is; but it is very difficult to adjust the strategy when the perception out there is that this is a strategy that's working. You've got to take that into account in an environment where the European strategy for managing similar or in some cases much bigger imbalances is under question.

Q116 Chair: Mr Hilliard, as the other newcomer, have you got anything you particularly want to add? I know that the other two will get their views in whether I ask them or not.

Brian Hilliard: Yes; I think, really, the lines between monetary and fiscal policy in this kind of world are very blurred, and in fact the credibility of fiscal policy is actually delivering a monetary policy impact. As Jens mentioned, we are getting very low gilt yields, which I think are a direct result not only of QE but also of the fiscal credibility, so that is giving us a low yield curve. That is lowering financing costs for all entities in the UK, so to that extent I think the two are a marriage; and I don't think any fine tuning of fiscal policy would make a great deal of difference. I think actually we have to become reconciled to a fairly slow growth path. The kind of financial shock we have experienced, that has generated this great recession and then a modest recovery, suggests that we are going to see low growth for some years.

Q117 Chair: I think I know what you are going to say, Mr Portes, but by all means: you have published in this area.

Jonathan Portes: I will try to be brief. On the output gap, I disagree with Jens and with the OBR. I think the OBR is being too pessimistic. It is relying too much on survey-based indicators of capacity utilisation. I do not think it is credible to say that firms have only less than half a per cent. of spare capacity—within firms, I mean, given the current levels of employment, which is what the OBR's estimates are. It is essentially saying that firms, given their current levels of employment, are running pretty much at full capacity, and I find that quite difficult to believe, and I think the evidence that, for example, Bill Martin at Cambridge and so on have put forward shows that the OBR is being rather too pessimistic.

That is the first point. The second point, on gilt yields: I think Brian is just wrong in suggesting that the extremely low level of gilt yields is the result of fiscal credibility. We have fiscal credibility. We have always had fiscal credibility in the sense that nobody thinks that the UK is not going to pay its debts over the medium to long term. Our analysis, which is pretty simple and which can be easily replicated by the Treasury or by Mr Hilliard, shows that the fall in gilt yields is primarily driven by economic weakness. It has tracked what has happened in the US. It mirrors movements in equity markets and the pound. The analytical evidence is pretty strong.

Finally, I take Jens's point that once you have chosen a wrong strategy, you need to stick with it. I call that the Macbeth argument for carrying on. You know the quote from Macbeth: we are so stepped in blood, we must carry on to reach the other side. My view is that you do not enhance credibility by sticking with a strategy that does not appear to be working. I will leave it at that.

Chair: I think I was right; we could guess those views.

Roger Bootle: I am not sure you could guess mine. First, on the output gap, I want to emphasise how much this is an art rather than a science. Of all the numbers that are printed on this, it comes down to a matter of judgment. Although the words "output gap" are a fairly recent phenomenon, the concept or the surrounding concepts are not; they go back a very long way. What we are talking about is the margin of spare capacity in the economy and that is closely related to the concept of the natural rate of unemployment. It is not the same, but it is closely related. I well remember in the 1980s how the concept of the natural rate of unemployment in the United States was revised down massively in response to growth of the economy. The phenomenon of rapid growth had to persuade academics that their idea of where the growth limits were was completely wrong. It would not surprise me at all if the same thing happened here. My sympathies are very much with what Jonathan said. I suspect that the OBR is seriously underestimating the size of the output gap.

However, given that this is very uncertain, we need to ask ourselves what attitude should we take to uncertainty; where should we allow the margin of error to lie? That is to say, is there a sense in being too optimistic about the output gap? From the point of view of fiscal conservatism, it is probably the right thing to do—to run with an estimate of the output gap which is on the low side. I suspect that it is on the low side. If it is, the result will be that we will find that the economy can grow much further, much faster and the fiscal position will come better earlier and more than we actually expected.

On policy—this is a completely different issue—I incline much more towards what Brian Hilliard was saying. I think that again, this is another area of economics where there is not a great deal of science. Essentially, you are dealing with the psychology of the markets. It might well be that a £20 billion stimulus could be swallowed by the market without its turning a hair, whereas a £2 billion stimulus might cause a panic. It depends why, what the circumstances are, whether the story is convincing, whether it seems that this is the beginning of a flood or whether it is a one-off adjustment. I have written, right from the beginning of this Government, that I thought that their plans were fiscally too tight. However, the idea that having set those plans out, you can now announce some massive splurge in public spending or tax reductions that would not have consequences in the market, I find really rather bizarre. I think that the markets would probably react to that fairly adversely. Is there scope to do something? I think that there is. The Government should aim to boost private sector investment spending. They have made some attempts in that direction, but they could do more. If those attempts required a bit more public spending and a bit more public investment to prime the pump of private sector investment spending, I for one would support that, and I suspect that the markets would be reasonably sympathetic to such a move.

Q118 John Thurso: First, may I ask the panel this? The OBR says that the eurozone is a major risk to the forecast. Can I assume that nobody disagrees with that?

All witnesses: Yes.

Q119 John Thurso: With that in mind, do you see the risk as being mainly through the financial sector, the banking crisis and the euro crisis, or through the export sector? Which is the greater risk?

Brian Hilliard: I think that the banking sector is the greater risk. What I would also add though is that I think that the risks are diminishing. I am not saying that in any way we are out of the crisis, but the stabilisation measures taken by the ECB in particular are going a long way to reassure people. The way that the UK economy is going to react to it is by becoming battle hardened more than anything. They know that this crisis is going to grind on. We have many summits supposedly giving us the solution to all the problems. We find there are incremental improvements that allow the eurozone in total to manage the problem. If that sort of stability continues, that will help the UK. The direct answer to your question is that the banking system's interconnectedness is the main risk.

Q120 John Thurso: As that fades—kicking the can down the road and hoping for the best—does that lead on to the fact that they are our largest export partners, and their not doing so well is overtaking it as a risk?

Brian Hilliard: Eventually, yes. I have to say that one of the hopes rather than forecasts in a lot of these OBR forecasts and others, is the increasing contribution of net exports over the medium term. I hope that is right, but we are continually disappointed.

Q121 John Thurso: Any dissenters from that view?

Jonathan Portes: No.

Jens Larsen: No.

Roger Bootle: No.

Q122 John Thurso: Okay. May I turn to the other big risk that the OBR identified: commodity prices, particularly the oil price? How vulnerable is the UK economy to a bigger than expected increase in oil price?

Jens Larsen: I don't think from the demand side that the UK economy is directly that vulnerable to an oil price increase. However, it could obviously be very important for the global economic outlook, therefore eventually for our export markets, and certainly for market sentiment. In that sense, it is a very important issue in terms of the global outlook.

The direct issue for the UK might well be pressure on inflation; that we end up with higher inflation and further erosion of real income and a further difficulty for the Bank of England—for the Monetary Policy Committee—in supporting the view that inflation is going to come down quickly. I have certainly shifted up my inflation forecast significantly on the back of the news we have seen about oil prices and commodity prices more generally. That would be a worry for monetary credibility, but it would also be a worry for the outlook for the consumer. High inflation, as you know, has been one of the key factors in reducing disposable income.

Q123 Mr McFadden: May I ask you about bank lending? We have talked about this a lot in Committee recently with various people. To what extent is a continued lack of bank lending still a constraint on the growth forecast? I may as well start with our newcomers: Mr Hilliard.

Brian Hilliard: In the aggregate, not a great deal. The point I would stress is that the corporate sector is flush with money. I know the OBR had a look at this in the previous autumn statement report. Basically, the corporate sector, excluding banks, has been repaying small amounts of funds to the banking sector over the past two years. Lending is obviously important for SMEs—vital in the medium term—but in terms of the dynamic of a recovery, the larger companies are well able to power the recovery if they want to.

I think the issue is much more one of confidence—trying to dispel uncertainty—in two ways. One is the uncertainty of demand, which is pervasive and may be reduced if the eurozone crisis continues to stabilise. The other is the uncertainty of funding. It is puzzling that we have such a large cash pile. It is not just a UK phenomenon; it is in all the major western economies. During the deepest part of the recession, companies felt they had to go to the bond markets to get funds, because banks were at their most cautious at that point. Even though banks subsequently reopened their lending to large companies, I think large companies learned that lesson, and continue to do so. So, there is uncertainty both on the liquidity side of funding and on the demand side.

Q124 Mr McFadden: To paraphrase your point, there is not a lack of supply of lending; there is a lack of demand for lending that relates to a confidence issue about investment decisions. Do the rest of the panel agree with that view?

Roger Bootle: No. This part doesn't, anyway. I agreed with much of what Brian said, but I did not much agree, dare I say it, with your summary. It seems to me that Brian is right to suggest that large corporates have got substantial cash piles and are not heavily dependent on the banks, and they could step up investment even if there were not any renewed willingness of banks to lend. As far as the SMEs are concerned, it is a question of both demand and supply, and it is very difficult to disentangle them. There is considerable survey evidence to the effect that the terms facing small companies that wish to borrow from banks are substantially worse—tighter—than they were some years ago.

Q125 Mr McFadden: That is what they tell us constituency MPs.

Roger Bootle: They tell everybody. I sat on the Which? banking commission a couple of years ago, and we investigated this. There was a substantial amount of replies along those lines. Although it is often difficult to disentangle demand and supply, the key indicator is what is happening to margins. If you think the problem is lack of demand, you should find banking margins under downward pressure. You do not see that, actually. You see banking margins under upward pressure. I think that is an indication that the banks feel that lending to SMEs is a pretty risky business, and they are not as keen on it as they might be.

Jens Larsen: The only thing I would add to that, following on from Roger's comment, is that banks are seeing lending to small and medium-sized enterprises as a risky business. That is why they are holding back. The national loan guarantee scheme works by providing funding to the banks, but does not reallocate any of the risk. That is one of the reasons why, in terms of actually encouraging further flow of credit to the most exposed of the SMEs, it is not going to be all that important. There will be an important cash flow effect. Those that can get credit might get it a bit cheaper, but the small and medium-sized enterprises that are looking for credit—that are currently experiencing not just tight credit conditions, but actually not getting any credit at all—are unlikely to be helped much by that initiative.

Q126 Mr McFadden: On the question of bank lending, Jonathan, do you agree?

Jonathan Portes: I agree with what all the panellists have said. Roger is right that there is a problem with SMEs, but I agree with Brian that in some sense this is about the medium term and allowing SMEs to make investments for the medium and the long term. The main constraint on growth is probably coming from the lack of demand for investment, but I agree with what Roger said about the structural problems in the SME market at the moment, and I agree with Jens on the likely effectiveness of the NLGS. It is not a bad idea, but in itself it is not going to solve the problem.

Q127 Mr McFadden: I'm coming on to the NLGS. I want to try to paraphrase more accurately this time if I can. So, large corporates are sitting on cash piles. There is a problem with the price of credit for SMEs, which is reflected in the surveys and what they tell us, so in a sense we have a bit of both demand and supply in the answer.

Let's come on to the national loan guarantee scheme and get a view on this. The OBR has stated that the initial tranche of this scheme is not large enough to change its aggregate business investment forecast. Jonathan, do you think this scheme is likely to have a significant economic impact? If not, is it a question of the design or the size of the scheme? In other words, if the Government went at this in a bigger way, might that have a bigger effect?

Jonathan Portes: I tend to agree with Jens that it is in a sense about the design. It is not clear to me how this structure will allow credit to go to businesses that would not otherwise have been able to get credit. It may reduce the price of credit somewhat. It may make the banks' funding position somewhat easier for this sort of lending, but it does not seem likely to have much of an impact in getting money to the businesses that are currently in need of it. To me, it seems more a design issue than a quantity issue. I would not say that they should have done £40 billion rather than 20 and that that would have had a wonderful effect. I do not think that that is particularly plausible.

Q128 Mr McFadden: And that is because the scheme is about reducing the price of credit a little rather than changing the judgment on who gets it?

Jens Larsen: I agree with that summary. That is exactly the problem—no one wants to assume the credit risk. The banks are not keen to do it. The Treasury is obviously not keen, either. As you have explored on many occasions, the Bank of England does not think it belongs there. So it is very difficult to find someone who will do it. There is not a market that allows those cash-flush corporates to let their funding flow directly to those small and medium-sized enterprises. There are useful initiatives in the Budget and in the pipeline on this front, but that is very much a longer-term effort.

Q129 Mr McFadden: Mr Bootle, what is your view of this?

Chair: Briefly, please.

Roger Bootle: I have nothing to add, frankly. I agree with the others.

Q130 Mark Garnier: Mr Bootle, carrying on from your comments about lending to SMEs, do you think it is fair to say that SMEs have slightly over-optimistic expectations of what banks can offer them? Are they still stuck in a 2006, 2007 type of mentality and not yet adjusted to the new paradigm?

Roger Bootle: There is something in that. It is certainly not the case that all SMEs that want access to bank credit should be granted it. Sometimes you listen to groups lobbying on behalf of SMEs and you get the impression that the banks must be completely off their heads—that there is not really a risk. Of course, we all know from the evidence that lending to SMEs is extremely risky, but equally, that does not mean that the banks have not overreacted, too. That is to say, in being overly generous with credit overall in the run-up to the crisis, the banks have now been under-generous with particular sorts of credit as a direct reaction to the earlier behaviour.

Q131 Mark Garnier: Sure. Given all that, which I entirely agree with, do you think that things like the Business Finance Partnership initiative, which is trying to find a way of getting money—not through the banking system—is a better way of answering that? Jens Larsen, you are nodding.

Jens Larsen: That is a worthwhile initiative. It is difficult to get scale in that, but enabling a system of financing that does not rely entirely on the banking system seems a very good idea. It will eventually enable a broader set of investors, including pension funds and insurance companies, to invest not just in SMEs, but in a broader range of assets on the infrastructure side rather than in Government bonds.

Q132 Mark Garnier: Two questions on that point: first, one thing that banks do have is an outstandingly good distribution network, which some of these other people do not have. Secondly, do you think that £1.2 billion is not quite enough to find an alternative way of financing SMEs?

Jens Larsen: The point is that the market does not exist. I think you could achieve scale eventually, but you have to have a group of investors that wants that kind of product and a group of corporates that is willing to go through the discipline that comes with the process. There is no doubt that market finance for businesses will be more expensive than bank finance was before the crisis. There is a chicken and egg problem: you need to establish a market—establish both demand and supply—and that is not easily done, certainly not in the current environment.

Q133 Mark Garnier: Should we be doing more to source equity funding for businesses as opposed to this obsession with debt funding?

Jens Larsen: As a general proposition, I would agree with that, but the big question is, how do you design a mechanism to get it done?

Q134 Mark Garnier: Jonathan Portes, let me bring you in here. I want to be absolutely clear that I heard you right when you were talking about gilt yields. Did you link low gilt yields with poor economic performance?

Jonathan Portes: Yes.

Q135 Mark Garnier: First, can you expand on that? Secondly, does everyone agree?

Jonathan Portes: This is the simple expectations theory of interest rates. Long-term interest rates reflect the market expectation of the future path of short-term interest rates. That path, assuming that the Bank of England is roughly credible in achieving its inflation target, is determined by expected inflation and expected economic growth. Suppose that we were expecting that the UK would return to relatively healthy economic growth over the next five or 10 years. In that case, we would be expecting 2% to 2.5% growth, 2% inflation, and the Bank would be meeting its target. Therefore equilibrium and short-term interest rates would be at a "normal" level—4%, 4.5%, maybe 5%.

Clearly, 10-year gilt yields are not consistent with that—they just aren't. Either you believe that we are going to return to normal economic growth reasonably soon or you believe that gilt yields should be very low, but you cannot believe both. If you believe that economic prospects are reasonably good, the current level of gilt yields just does not add up.

Q136 Mark Garnier: But you are talking about the tail wagging the dog. Surely, with quantitative easing and monetary policy from the MPC, the Bank of England is determining interest rates depending on the economic outlook, rather than the economic outlook depending on the interest rates.

Jonathan Portes: The Bank of England determines short-term interest rates; it does not determine long-term interest rates.

Q137 Mark Garnier: It does long-term interest rates through quantitative easing interventions.

Jonathan Portes: Well, quantitative easing is having some depressive effect, but ultimately, if you believe that markets are rational, it is simply inconsistent to suggest that current level gilt yields are consistent with healthy economic growth over the medium term. Equally, the analysis backs it up. If you look at the correlation in movements of equity prices and gilt yields on, say, a weekly or daily basis—how the markets actually work—you see a strong correlation. When equity prices go up, gilt yields go up and vice versa. What does that tell you? People do not buy British equities because they think that the economy is weak, but they buy British equities at the same time as gilt yields go up. We see a positive correlation between equity prices and gilt yields. What does that tell you? Strong economy means higher equity prices. It also means stronger gilt yields,

Indeed, in the past few months we have seen gilt yields finally beginning to rise by 20, 30 basic points. That is a good thing. It means that we are slightly more confident that the bottom will not fall out of the economy and that we will see a recovery some time relatively soon.

Q138 Mark Garnier: I have two questions: first, do you agree with that? Secondly, on the wider subject of quantitative easing, when you look back at the beginning of quantitative easing, the narrative at the time was very much about pumping £75 billion/£150 billion into the economy to provide liquidity, which was sorely needed because of the problems we have. Now, with the Governor of the Bank of England and the economists, the narrative is not about providing liquidity, but about controlling interest rates on the bond market in terms of the longer-term interest rate. You can intervene all the way along the yield curve now, including 100 years on. Do you agree with any of what Jonathan Portes is saying?

Chair: Just try the first question.

Brian Hilliard: What I distinguish between QE1 and QE2 is that, when QE1 was launched, the world was a very, very dangerous and frightening place. The Bank of England embarked on QE not knowing what its impact would be, but having run out of conventional policy tools. What is a little troubling now is that we are seeing the Bank of England describe its continuing use of QE as a conventional tool, and that makes it rather too relaxed in using it. I do not think that the impact of QE2 will be as powerful as QE1. I know that that is not what the Bank of England believes. I do not see immediate inflation risks or anything like that, but there are distortions in the gilt market from doing that which should not be ignored.

On Jonathan's point, I agree in the general sense that expectations theories of the yield curve do drive it. If we saw high yields come through because of a general improvement in the economic background, the Bank of England would not react to that. It would applaud it, because it would indicate a better underlying situation.

Q139 Mark Garnier: The tertiary effect of QE was mentioned on the radio this morning. I think that it was HSBC. It was about the effect on the currency. The tertiary effect is that, by in theory putting more money into the system, you are dividing your currency and therefore you can boost your exports. Do you agree with that analysis?

Brian Hilliard: I think the impact on the currency has been overstated. The movement of the trade-weighted index of the pound over the past year or two has been minimal. It has been trading sideways. The big, once-in-a-generation adjustment to the trade-weighted index has already occurred. I do not think that the Bank of England MPC has uppermost in its mind seeing a sterling reaction when it does a QE.

Q140 Michael Fallon: In terms of business investment and the OBR's new assessment that firms' cash balances may not be able to support as much investment as previously thought, did you pick that up?

Brian Hilliard: I am surprised it says that. I am shocked by how weak its forecast is for this year. It could possibly be a little bit higher. Then, when we move to the medium term, it is relying on business investment to drive growth. Maybe I am just a good old English pragmatist. I think it will be somewhere between the two. My worry in the medium term about the growth outlook is that we will be disappointed in several demand components and that the investment one looks too weak at the moment, and a little bit too strong in the medium term.

Q141 Michael Fallon: Is anybody else pessimistic as to the extent that cash surpluses will translate into support for investment?

Jens Larsen: I agree with the OBR's negative assessment of the net amount for investment, but that is on the basis of the reading of the indicators. I do not think that there is much of a cash constraint on investment at that level. That is not the main explanatory factor. I share Brian's view that, looking further out, the whole forecast is one about this beautiful rebalancing with much stronger business investment and much stronger net exports. One can get a little worried that that will actually happen.

The OBR has moved in the right direction on that. The reliance on this business investment recovery is less than it was in November, and November was less than it was before, so the forecast makes more sense to me. However, I do not think that cash is the key constraint on corporates; the key constraint on investment now is the demand outlook.

Q142 Michael Fallon: Mr Bootle, do you think changes to the forecasts for business investment suggest that rebalancing will be harder than we originally expected?

Roger Bootle: Yes. I was just looking at the history of the OBR's forecast revisions, and I share Jens's view that the OBR has been too optimistic about business investment, but I doubt very much whether cash will be the constraint. After all, if we are talking about large companies that find they do not have enough retained earnings and that they have got access to bond markets or equity markets—indeed, better access to the banks than SMEs have—I would be surprised whether that is really a substantive issue. When you look at their cash balances, they are very high by historical standards. The question simply is: do they want to invest? That is primarily about the overall environment of aggregate demand and the confidence that they have in the future.

Q143 Mr Love: May I return to the questions from the beginning about the output gap? I want to start where you left off, in relation to whether we can do anything within the context of not challenging the credibility of the fiscal consolidation to try and boost growth. I wonder if our two new economists—who I think are probably the most conservative, with a small "c", in relation to fiscal credibility—think there are any measures that we might take in the short term to try and boost growth.

Jens Larsen: There was a crucial addition at the end of your statement, which was "the short term". When you are looking at closing an output gap over three to five years, you would talk about structural reforms. There is a lot of talk about structural reforms in the Budget, and in Government policy currently, but what I would be looking for here—if you wanted to boost growth substantially—is to have stronger growth in the labour force and stronger participation by the current labour force, or even inward flows of workers. From an economist's point of view, a strong labour supply response is what you would be looking for if you wanted stronger potential growth on the horizon for two to five years.

So that would be my answer, but it does not address the short term. In the short term, I do not think there is much you can do to close the output gap at a quicker pace. The OBR's assessment is really one about where the output gap is, more than how quickly we can close it. My worry is that the constraints are actually going to be coming from the reallocation of resources, the lack of investment in small and new firms, and the lack of job creation there that will hold back potential growth. Anything you can do to improve that reallocation is a good thing.

Q144 Mr Love: You mentioned earlier that we are not actually going to close the output gap, according to the OBR, in the forecast period, and that monetary policy will not do it.

Jens Larsen: It wouldn't do it by itself.

Q145 Mr Love: Mr Hilliard, you mentioned earlier that we have to be reconciled to a slow-growth path. Is there anything we can do, practically speaking, in the short term?

Brian Hilliard: A little more infrastructure investment would be useful. I think perhaps we have become a little too hung up on the precision of fiscal neutrality. When the Chancellor presents his Budget, does he have to balance it to the nearest £100 million to say that he has spent some money and he is going to pay for it with other things? The markets would be forgiving of £2 billion or £3 billion here or there—without being flippant—if it were seen to be driving the medium-term sustainability of the economy. So, a little more boldness on infrastructure is what I would identify.

Q146 Mr Love: Mr Bootle, you mentioned a scheme earlier on, and I wanted to pick up what Brian Hilliard said about there being a very slight boost to the economy, under £2 billion in this first year. Could we improve that with the prospect of taking it back towards the end of the forecast period? Do you think that might help, because the real pain that the economy will suffer will be during this year and at the start of next year?

Roger Bootle: I think it is possible that something could be done along those lines, but let's just remind ourselves how tiny these sums are. They might not do much damage but that is because they won't do much good either. These are ridiculously small sums of money. There is a genuine debate to be had about whether there is scope for a significant fiscal expansion. I think Jonathan will argue that there is, and he would be talking about numbers much bigger than £2 billion or £3 billion. I think 1% of GDP is £15 billion, and 1% is not an enormous number in terms of fiscal contractions or stimulus programmes. These are the sorts of figures you have to be thinking about if you are going to make a big difference: £15 billion, £20 billion or, dare I say it, £30 billion. Would that have an impact? I think it would have an impact, but it might have an impact on the financial markets as well as on the economy.

Where I think the Government should concentrate on—they have done this to some extent—is thinking about measures that make a serious difference without costing very much. That may seem like a free lunch, and in some ways it is. I was struck by the effort that the Government rather belatedly put into developing a plan for growth, which seems to have died a bit of a death. My own experience in talking to officials in both BIS and the Treasury is I don't think they are seriously interested in it; they haven't been all along. They thought that the objective is to give George Osborne something to put into a document or a speech, rather than genuinely believing that there are things that can be done.

Let us take something dear to the Government's heart—or the Conservative part of the Government's heart—namely, reform of labour laws. I happen to think that that is extremely important. If you are looking at the SME sector—we talk about finance—what is it that gets animal spirits going? What is going to give them the confidence to invest? I think a profound change in the labour laws would have a big impact.

I know that there is room for disagreement on this across the political spectrum, but my point is, that would not cost any money, and the Government have not done anything, or done next to nothing. It is in that sort of area that I think there is significant room for advance.

Q147 Mr Love: Let me ask Mr Portes. I know that you would like to have a significantly greater boost. I am struck that none of you has suggested that the national loan guarantee scheme should be redesigned or significantly boosted. The evidence we heard from the OBR was that £5 billion would make no difference whatsoever, but £20 billion and even greater sums might. I am rather surprised. Regarding infrastructure, as Mr Hilliard mentioned, many think that we could do a great deal more with relatively small amounts of money to trigger infrastructure expenditure, even in the short term. What is your view of what flexibility we have?

Jonathan Portes: First, as Roger said, I think Roger and I agree on 90% or 95% of this stuff on the macro and fiscal outlook. It really is a question of the balance of risk. Where we disagree is that Roger attaches somewhat more weight to the financial market risk.

This, in my view, is the case for action now. It is not because we get an extra 0.5 % growth next year; that really is second order. It is the long-term social and economic damage that we have by allowing the output gap, as Roger and Jens have said, not to be closed towards the end of the forecast period. What does that mean in real terms? When we talk about the output gap here, the OBR is basically talking about unemployment. So what we are saying is that we are allowing unemployment to remain much higher than the NAIRU and structural level for a very long period. We know that that does long-term social and economic damage and damages potential growth and output going forward. That is the case for doing something. It is not in order to get a short-term hit to growth, but to do something about that. That is the overarching point that is important to make.

What could be done? Within the fiscal rules, actually an awful lot could be done. You could do everything that I have suggested within the fiscal rules. For example, on infrastructure spending, public sector net investment has fallen, according to the ONS figures that came out on Budget day, from about £47 billion to somewhere in the low 30s—by more than a third in a couple of years. We are cutting public sector net investment very substantially at a time when we can borrow at the cheapest rates in generations, when there is lots of spare labour capacity and when we are in a very slow recovery. That cannot possibly make economic sense.

Regarding the sort of measures that I have been talking about on the demand side, a temporary, explicitly time-limited cut in national insurance makes absolutely no difference to the fiscal mandate. So there is plenty of flexibility to do that.

Finally, on what the Government could do without spending any money, I would point out that it could stop doing things that go in the wrong direction. I will return—Andrew will like this—once again to immigration. The Government allows the Immigration Minister, Mr Green, to go on television repeatedly claiming it as a success that the number of students coming to this country has fallen significantly as a result of the changes that the Government has made to student visa regulations. In other words, Government Ministers are saying that a reduction in UK exports is a success. If the Government meant what it said when the Prime Minister and Chancellor say that growth is the overriding priority, it would not be allowing Ministers to do that. End of story.

Q148 Chair: Mr Bootle, can I just take you back to where you said that the Government had no strategy for growth? Then you appeared to say that the Chancellor is being thwarted by a bunch of officials who think all he wants is a set of lollipops. Have I summarised it correctly?

Roger Bootle: I am not sure that they are not responding to what they perceive to be the degree of conviction on the part of the Government. All I am saying is that in my own experience of talking to officials I don’t think they are very advanced in thinking about a number of these plans, which is why the documents—

Q149 Chair: No. I am asking about the political will behind it.

Roger Bootle: I don’t know. I thought you would be more familiar with the degree of political will than I would be. I don’t know how much political will there is behind it.

Q150 Chair: You seem to be quite well informed about what is going on in Whitehall.

Roger Bootle: It does not take too much imagination to look back at the history of this. The Government was prodded by Conservative Back Benchers and business to do more for growth and out came a thing called “The Plan for Growth”, rather belatedly, and I think it was a rather weak document as well. So there is a suggestion that there is not a degree of political will behind it.

Q151 Mr Ruffley: Roger, from your earlier comments, you think that the negative output gap is slightly bigger than the OBR do?

Roger Bootle: Yes.

Q152 Mr Ruffley: It follows from that, doesn’t it, that the structural deficit is probably lower?

Roger Bootle: Yes.

Q153 Mr Ruffley: Are you aware of any figures which suggest when the structural deficit might be eliminated if the output gap is significantly bigger than the OBR say?

Roger Bootle: I have not got any precise figures to offer you on that. As I was saying earlier, it is a judgment call and it is as long as a piece of string. To the extent that the output gap is genuinely bigger then, as you rightly say, the structural deficit is smaller and could be eliminated more quickly.

Q154 Mr Ruffley: You said something very striking: to have a fiscal stimulus of £15 billion would only be about 1% of GDP. Do you think this Budget taken in the round will make any difference to economic growth?

Roger Bootle: No. I do not think it makes a blind bit of difference. There were some quite favourable measures in it for the medium-term growth outlook. I for one, and I don’t think I’m alone in this, thought that the corporation tax changes were pretty favourable because not only did they immediately produce the tax impact on business, but they were a signal to business of what the Government’s intentions were. So that is something that might well help to boost the animal spirits of business and therefore get investment going. I have said on many occasions in the past that I think we need something similar with regard to personal tax. There are a few straws in the wind and obviously there were some tax changes this time round. But I would like to see a forward commitment so that people could see what the structure of tax was going to be. There are major political obstacles to that, I realise.

Q155 Mr Ruffley: You said this time last year and you have repeated today that a fiscal stimulus would not necessarily spook the markets if it were for the right reason.

Roger Bootle: Yes.

Q156 Mr Ruffley: But you went on to say that it is very difficult to judge what might be acceptable to the markets given that there is a very clear plan. Were there not such a clear plan it would be perhaps easier to explain to the markets why you might want and I might want a £15 billion stimulus rather than a revenue-neutral Budget. Could you give some indication as to what you think the Government could do by way of tax cuts which would not spook the markets? You have lots of clients who are market players. If tax cuts—significant ones of £10 billion or £15 billion—were to be introduced and those were matched by commensurate further public expenditure reductions, what sort of things are we talking about? Are we talking about cuts in employers' national insurance? Are we talking about further cuts in corporation tax?

Roger Bootle: The last idea that you have introduced is an altogether different one, which is to say, without altering the overall balance between spending and tax and without altering the forecast deficit levels, cutting both tax and spending. I do not think that the markets will be spooked by that at all. Why should they be? They are concerned about borrowing levels and the path of public sector debt. If the Government were to take that sort of measure, there would be no direct implications at all. If you could persuade yourself that this would stimulate aggregate demand—some people think it would, and there is an argument that it would and one that it would not—the markets might actually take to it favourably. They might think that the structural changes that are brought about were actually going to be beneficial from a market point of view. However, that is an altogether different thing from the idea of cutting taxes without a corresponding cut in Government spending. It is completely different.

Q157 Mr Ruffley: Why is that argument not made more often?

Roger Bootle: It is not made more often because the Government have found it pretty difficult to come up with cuts in expenditure of the size that they have. They have run into enormous political difficulty. It is therefore judged that deeper cuts would get them into very deep water, but it seems to me that it is actually a serious runner to advocate further cuts in current Government spending, offset by reductions in tax.

Q158 Mr Ruffley: I think the IFS has calculated that, over the five years of this Parliament, it is about a 3.4% real-terms cut in total managed expenditure from 2010 to 2015, and that does not seem to many of us a particularly vicious axe attack on public expenditure: 3.4% in real terms over five years is not huge. Why, again, do you think that there are not more voices in the City saying that this is not really very serious?

Roger Bootle: There are some. In fact, there are more people saying that it is not serious in the world of broadcasting and journalism, but it is a very difficult question to get the balance right on, because when you look at the overall numbers the cuts do not seem to be that big. If you look at particular Departments, however, they are pretty big, and because you have the ring-fencing of, in particular, the NHS, the cuts in some Departments are going to be really very big indeed and bigger than we have been used to at any point in the post-war period, if not earlier. There is a serious debate to be had about this. If you look at the Irish experience, which I was looking at recently, there is a country that really has embraced public spending cuts in a seriously big way with, of course, big cuts in public sector pay.

Mr Ruffley: Can I just ask Jonathan Portes one question very quickly?

Chair: Yes, with a quick reply.

Q159 Mr Ruffley: On the issue of closing the output gap, what do you think are the three things that the Government should be emphasising in this Budget or implementing that will get rapid progress on closing the output gap?

Jonathan Portes: Infrastructure spending, cutting national insurance contributions for the low-paid, and house building.

Chair: That was an excellent short reply. Thank you very much. I am sure that, as a consequence of the fact that we have these exchanges, you may have further thoughts. If you do, please feed them in as soon as possible, but it would have to be pretty much by the close of play today or tomorrow if we are going to be able to incorporate them into our work. Thank you very much for coming. I am sorry that it has been somewhat curtailed, but we are on a very tight schedule.

Examination of Witnesses

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

Q160 Chair: Mr Johnson, may I begin with you and ask whether you think that the Government have a tax policy or what you described as a "hotch-potch" of reforms?

Paul Johnson: They have a bit of both. As the previous panel said, the changes on corporate tax, for example, have been laid out fairly well. It is pretty clear what direction the Government want to go on corporation tax and the same is true on the personal allowance, but in the Budget we saw a range of other things, which appeared to be somewhat unpremeditated—for example, what happened to the allowance for pensioners, which may not be a bad move over the medium run, but shows every sign of being rather rushed. The changes to stamp duty were certainly not what one would think of as part of a long-term tax strategy, because they make further reforms to stamp duty in an efficient direction more difficult to achieve.

The way that child benefit is now going to be taxed back, although probably less damaging than what was originally proposed, creates quite a lot of complexity in the system and, as an interesting aside, adds one more bit of the tax system that is not indexed. The point at which child benefit is to be withdrawn is not indexed, the point at which the personal allowance is withdrawn is not indexed and the point at which the top rate of tax starts to be paid is not indexed. There is a whole range of different bits and pieces in there, therefore, that look like less of a strategy than the two big things—the corporate tax and the personal allowance changes.

Q161 Chair: There is always a shade of grey. Which side of the line are you? Is it black or white?

Paul Johnson: I think that I would be on the negative side of the grey here. We knew where they were on personal allowances and corporate taxes, but there was nothing new, as it were, in the sense of moving towards a strategy.

Q162 Chair: So "hotch-potch" is better than "strategy"?

Paul Johnson: I think I stand by hotch-potch.

Q163 Mr Ruffley: Two-thirds of the tax consolidation for this Parliament has been done, but about 30% of public spending consolidation. Could you indicate, wearing your public-spending-expert hat, whether you think that the spending totals that are being published will be hit?

Paul Johnson: They are going to be extremely tough to hit and it will take a significant amount of political capital to hit them. What was interesting about what we saw this year is that there have been some underspends in departmental budgets, despite the scale of the cuts intended through this year. In one sense, that is perhaps not that surprising given the political capital that would be lost if there were overspends. It is clear where the balance of risk lies.

In some sense, we have seen the slightly easier wins happening, but I certainly do not think that the public have got their head round the fact that the large majority of the cuts are still to come. The numbers that you quote—the 30% already done—are off a baseline of assuming that real freezes is a reasonable baseline. It will feel tighter than that, because the normal baseline is to move up in line with the economy.

Q164 Mr Ruffley: Where is the extra £10 billion that the Chancellor referred to in his Budget speech? Could you tell us something about that? What do you think it means and where will it fall?

Paul Johnson: Sorry, the extra £10 billion? Oh, in the future, after the next election. My understanding of what that was saying was that if you are going to have total public spending falling on departmental budgets in the same way that it has over this spending review, then there is another £10 billion that you will have to find from, for example, welfare cuts. You could do it through tax increases. If you think of a budget constraint, you have departmental spending on one side and tax increases or welfare cuts on the other. One place you could end up on that budget constraint is to have a similar level of annual falls in departmental spending as we have had before. If you do that, then you have to find £10 billion through welfare cuts and tax increases. Clearly, you could do it all on one end, or all on the other. He is telling us one point on that budget constraint.

Carl Emmerson: To give some figures on that, the £10 billion is in 2016–17 prices, so in today's terms, it will feel more like £8 billion. If you do not want to cut departmental spending or central Government spending on public services in the next Parliament, it is not £8 billion that you need; you would need £20 billion from welfare. If you do not want to cut welfare, then instead of cutting departmental spending at 2.3% a year—the current rate of cut after economy-wide inflation—you would have to cut it by 3.8% a year on average. To keep to Mr Osborne's total spending limits, those are the kind of constraints that we will be operating with in the first two years of the next Parliament.

Q165 Mr Ruffley: He needs that magnitude of fiscal consolidation to meet his 2016–17 target, which it now is, for eliminating the structural deficit. Is that right?

Carl Emmerson: It is to meet his target for getting spending down and for borrowing, taking into account the fact that social security spending and debt interest spending are continuing to rise. For example, the number of pensioners is growing, so there are some underlying positive pressures on the spending side, so it is to offset that and to meet the spending cuts that he needs to bring the deficit down in line with his plans.

Q166 Mr Ruffley: Is it the case that this is the tightest fiscal consolidation since the second world war?

Carl Emmerson: It is the longest sustained cuts to public service spending since the second world war—if they are delivered. That is certainly the case. It is almost twice as big as the seven-year period of cuts delivered between 1975 and 1982 after economy-wide inflation. That is on public service cuts.

Q167 Mr Love: May I turn to the distributional impact? In your charts, you have excluded tax and benefit changes affecting mainly the rich. Can you tell us why you did that and which benefits and taxes you are talking about? Can you also tell us what the differences are between what your distributional chart shows and what the Government show in the Red Book?

Paul Johnson: Essentially, we have not put in there the impact of increasing stamp duty or of reducing the top rate of tax from 50p to 45p. The reason for not including the stamp duty change is that the numbers of people who are affected are tiny and who it will be is very hard to determine. The reason for not including the 50p change is that if you believe the Government analysis that the cost is only £100 million then the impact on people's incomes on average will again be extremely small. We probably want to come to the discussion of the 50p rate in a minute. So, if you take account of what looks like a very big behavioural change, then the impact on the distributional charts will be very small. At that end of the distribution, we have done very much what the Treasury has done in the Red Book.

The places where we have done different things are very much the same as the places where we have done different things in the past. For example, we have included allowance for changes to employment and support allowance, for council tax benefit changes and for some other changes to local housing allowances which, while you cannot identify the specific individuals in the data who will be affected, you can know that a proportion of a particular type of individual will be affected. We have modelled those, and the Treasury has not. That is why we see larger falls in incomes at the bottom of the distribution than it does in its charts.

Q168 Mr Love: One of your charts includes universal credits. How have you modelled that? What is the implication?

Paul Johnson: When we take account of universal credit, we have looked at a hypothetical world in which universal credit is fully in place by 2014. It will only just be beginning to be in place by then, but it is very difficult to model a transition system. What that shows is that universal credit does increase the amount of money going to particular family types towards the bottom of the income distribution, especially to couples with children. That makes the overall picture look more favourable to very low-income couples with children. One thing that I think has changed since previous charts we put out is that we know a bit more about the child care element of that, which again appears to favour those out of work with young children. The overall impact that we show is quite a significant change relative to a world in which you do not take account of universal credit. I should stress that that is a hypothetical world in which we assume the whole of universal credit is in place by 2014, which of course it won't be.

Q169 Mr Love: You are also assuming that the scheme as outlined will be delivered and that there might not be any reductions in the universality, if I can put it that way.

Paul Johnson: Indeed.

Q170 Mr Love: Okay. May I move on to the 45p tax rate? I am interested that HMRC turned to some work that the IFS had done through the Mirrlees review, particularly in relation to taxable income elasticity. I am surprised to discover that Arthur Laffer has made a comeback in the HMRC report. I am curious to know to what extent you can influence taxable income elasticity by changing the tax reliefs and the loopholes, if I can put it that way. Would an alternative choice for the Chancellor have been to accept the report but make changes that would have limited the elasticity, with regard to the report that you did for Mirrlees?

Paul Johnson: That is clearly one of the choices that you have. Taxable income elasticity is not necessarily a fixed given in all places and at all times. As the number of allowances changes, the taxable income elasticity will change. It is likely that the taxable income elasticity in the US is a bit higher than here. There is some evidence that in Denmark, for example, it is rather lower than it is here. That has to do with the structure of the tax system. It is absolutely right that this is not a number fixed in stone by some divine command. It is something that can be influenced, in principle at least, by changing the way in which reliefs and allowances work.

Q171 Mr Love: What is your overall assessment of the HMRC report and the Chancellor's response to it? There is the suggestion that 48p is the optimal level and that the reduction to 45p will therefore cost a very limited amount. You mentioned a figure of £100 million had been suggested. Does that all seem credible in the context of current circumstances?

Paul Johnson: A number of things are striking about the HMRC report, the most striking of which is the scale of change in incomes of the people on over £150,000. It is extraordinary that we see a fall in their recorded income of 25% in the years just before and after the introduction of it. The problem the HMRC had was that a lot of that was forestalling: how do you think about the counter-factual? What it has done, broadly speaking, as much as it could given the information, is try to compare what happened to the incomes of people between £115,00 and £150,000, with what happened to the incomes of those earning over £150,000.

We haven't seen the data and we haven't got to the bottom of all of it. We might have one or two quibbles with what it has done there, in the sense that the incomes of people just under £150,000 may have been influenced by the higher rate, in that some people might have brought their incomes down a bit. There is maybe a little problem there.

The real issue is: does it look from what it has done that its central estimate is broadly sensible? Probably, yes, but as you can back out from what it has said, it is incredibly uncertain, to the extent that we think that its estimate suggests there is only a two-thirds probability that a revenue-maximising rate lies between 30% and 75%. Those numbers are absurd in some sense, but that gives you a sense of the level of numbers of assumption and uncertainty that underlie what it has done.

If that were the only thing we knew, we would be pretty sceptical that its results bore a lot and sceptical about how much weight you put on the results. The thing that makes us think that you may want to put more weight on them is that they are actually pretty much in line with what previous studies here and elsewhere have got.

Q172 Mr Love: Is it your intention—just a very brief answer—to get the data and do more work in this area? I think shining a light of evidence, because of the very uncertainties you have talked about, would be welcome at this point in time.

Paul Johnson: The brief answer to that is yes, subject to us being able to get the data.

Q173 Mark Garnier: Continuing from that one, HMRC expects that the cost to the Exchequer in 2012–13 of taxpayers deferring income until 2014, for the 45p cut, is going to be about £2.4 billion. Do you agree with that?

Paul Johnson: Again, there are two things there. If people forestall in the other direction, in the same way as they did this time round, then that seems like a reasonable estimate. I suppose in our mind it does beg the question as to what the advantages were of delaying the change, because the estimates here are that there will be a substantial cost in the way that it impacts on people's behaviour, in terms of doing that kind of forestalling. So given that we have found out that the level of forestalling is so large, and we have had an estimate of what that will look like next year when it is put in place, I guess a question for the Government is do they think the benefit of delaying it for a year is large enough to offset the additional amount of tax planning that will result because it is being delayed for a year.

Q174 Mark Garnier: The other question of course is, if you were to leave it in any longer, do you think it would form any sort of structural damage to people's approach to the tax regime? If you left it for three, four or five more years, do you think tax avoidance systems would become so embedded—I don't necessarily want to suggest that everybody is rushing around avoiding tax, but do you think people would become much more thoughtful about tax, to the point where it would become structurally damaging to the economy at that high level?

Paul Johnson: As the HMRC document says, one of the uncertainties around our estimates of how much it will cost to reduce the top tax rate is that there may be some significant asymmetry, in the sense that if you have, because of the 50p tax rate, invested in avoidance schemes, it is not clear you will just unwind them as soon as it goes. They acknowledge that as a risk to their estimates. Presumably the longer that you keep the higher rate in place the more significant that risk might be. HMRC seem to think that it's a significant risk already.

Q175 Mark Garnier: Professor Laffer drew his famous curve on the napkin in the '70s, when we had a very different world, and exchange controls were still around to a certain extent. Do you think now that we have a very much more international sort of financial community, that actually the Laffer curve has so many different variables coming in on it, just simply looking at a low tax rate in absolute terms is now completely irrelevant, and we need to look at them on an international comparison as well as local rates?

Paul Johnson: Well, from the point of view of the UK economy, the way the Laffer curve works, and the way the analysis is done, as it were, implicitly takes account of everything that is going on elsewhere, because part of what you see in terms of behaviour changes—people moving income somewhere else, or moving themselves somewhere else—is of course determined by what is happening in other countries, so from the point of view of an individual country, I don't think the purpose or structure of the Laffer curve changes.

I think you are right in the sense that one of the things that will determine where the revenue-maximising point comes does depend very substantially on what's happening in a whole series of other countries, which is related to the previous question of the taxable income elasticity; the Laffer point will change over time according to what's happening to tax allowances, according to what's happening to tax rates in other countries and a whole series of other variables.

Q176 Mark Garnier: Turning to the child benefit cliff edge, do you think the Government's come any way close to addressing the cliff edge problem with those solutions?

Carl Emmerson: In terms of how individuals lose their child benefit as their incomes rise there is now no cliff edge. It is not the case that people will find themselves worse off after getting a pay rise, which would have been true for some individuals under the original system. It is now the case, as long as you have fewer than eight children, that you will not face an effective withdrawal rate of over 100%. So they have dealt with that problem. The other problem that people identified with the initial proposal was that one-earner households could be punished relative to two-earner households. You might not think that that is fair. Clearly there is still an issue, and people who were concerned about that before may well still be concerned about it.

Q177Mark Garnier: Do you not agree that this highlights a greater problem with the tax system itself? The number was picked because it happened to be the number at which you moved from the lower rate to the 40p tax rate. Of these two hypothetical households next door to each other, the couple with the single earner on £84,000 or £85,000 a year will still pay £4,000 a year more in tax than the couple earning £42,500 a year. That in itself is also unjust. This merely confirms that it is a problem in the whole tax system in general.

Carl Emmerson: I guess what you are pointing out there is the difference between the income tax system, which is based on individual income, and the benefit system, the tax credit system, which is generally based on joint incomes. So, for example, if you want a benefit targeted at lower income households, which is defined on the income of the total number of individuals in the household, you would want to use the tax credit system rather than the income tax system, which is not very well designed for that because it is based only on individual income and does not take into account the resources in the household as a whole.

Q178Mark Garnier: Do you think the method they are using of taxing the household in order to recover the child benefit is the best way of doing this or do you think there are simpler ways of addressing this?

Carl Emmerson: There is clearly an argument that can be made for just keeping child benefit universal. There is also an argument that can be made for saying, "No, we want to target lower income households" and perhaps using the tax credit system. It is harder to defend the kind of withdrawal that the Government have gone for.

Q179 Mark Garnier: So you think this is not a very good way of doing it?

Carl Emmerson: It is better than their initial proposals but it still could be improved further.

Q180 Michael Fallon: Mr Johnson, the change to the age-related allowance was described by Dr Altmann of Saga as an "outrageous assault on decent middle-class pensioners", but your comments seemed a bit more relaxed about it.

Paul Johnson: I think there are problems in the way that this was announced, particularly coming in so quickly without giving people much of a chance to plan. To get a sense of the scale here, the group most affected will be those who are retiring next year because they will not gain the expected benefit of it immediately. We think the maximum loss, which is quite significant for that group, might be up to £300 a year. If you are on a relatively modest income, that is quite significant. For all the other groups the loss is only the loss relative to what would have been indexation and the losses there are much smaller.

The loss over time also depends on what you think the counter-factual would have been. The Government policy is that the personal allowance will rise to £10,000 over the next couple of years and therefore some of that £300 loss will be offset by increases in the allowances over the next couple of years. That is one of the reasons why to have announced, for example, that this policy would happen at the point at which the main personal allowance hit £10,000 would have both given it the sense of a more strategic change and given people a bit more time to plan and have a less one-year effect. But for pensioners as a whole, the effect is relatively modest and it remains the case that if you take all of the tax and benefit changes that have been implemented by this Government, pensioners will have been less affected than other groups.

Q181 Michael Fallon: The tweaking that you are suggesting is only really a difference of a year then is it?

Paul Johnson: It is a difference in year—

Q182 Michael Fallon: One year, is it?

Paul Johnson: The £300 that I mentioned is only a one-year effect if you assume that that allowance will rise faster than inflation the following year. You can get a big number like £300 and you can get a much smaller number for the large majority of pensioners who are only affected by the lack of indexation. Even for that group affected by £300, they will be affected by less in the following year.

Q183 Michael Fallon: When you say that it is perhaps surprising that this is the first tax change specifically targeted on pensioners, what do you mean by that? What is the surprise?

Paul Johnson: I suppose that the surprise is that the scale of the fiscal consolidation is such and the scale of the cuts in benefits and increases in tax for other parts of the population are such that to have effectively not got any money from a substantial group of the population and, indeed, a group who again, on average, have seen their incomes rising significantly more quickly than the other groups, is clearly quite surprising. That is, I suppose, not surprising politically, but from the point of view of how you are going to share out the pain, it is quite striking up until now that this group has been fairly much protected.

Q184 Michael Fallon: To share the pain—just to be clear—you would have expected the Government to have taxed pensioners earlier and harder.

Paul Johnson: I am not saying that I would have expected them to, but were the Government to be saying, "We are going to share the pain equally across the population," then they would have done more that would have affected pensioners than in fact they have.

Q185 Chair: In drawing that conclusion, are you going back two years or to the start of the crisis?

Paul Johnson: What I am doing is going back two years, but I think the same would be true if we went back to the start of the crisis.

Q186 Chair: Would you be capable of showing us that analysis? Is that something that you would be able readily to put together?

Paul Johnson: Yes.

Q187 Chair: I think the Committee may want to see that if that could be done at speed. That is an interesting piece of work.

Just to be clear on your answers to Mr Fallon, are you saying that if there had been a one-year transition to the £10k allowance, there would probably have been virtually no losers and there would have been time to plan?

Paul Johnson: No, I certainly would not say that. There would have been losers in expectations. It is important to be clear that the group who are losing most here are those who are transitioning to state pension age, so it is not that they are losing one year on another; they are losing relative to expectation. Now, the amount that they would have lost relative to expectation would have been less if it had been delayed a year or two and if the personal allowance for everyone had gone up over that period, because the gap between the two would have been less.

Q188 Chair: But on reasonable expectations, what you have just said would imply that that loss would be very small. Is that correct?

Paul Johnson: I do not have the number in my head. It would go down from £300 to a number that was still reasonably significant. It certainly would not be going down from £300 to £100.

Q189 Chair: Why don't you give us a couple of reasonable assumptions and give us that figure as well to see what we are talking about?

Paul Johnson: Yes.

Q190 John Thurso: I want to ask you about stamp duty land tax, but before I do that, Paul, may I ask you a question? You gave a series of presentations in the week running up to the Budget, which were very good. What surprised you? What was your biggest surprise?

Paul Johnson: The pensioner tax allowance was the only significant tax policy that was not reasonably well trailed, and we, like everybody else, were fairly surprised by it. I have by now lost sense of what surprised me. Were we surprised by anything else?

Carl Emmerson: I thought the most significant number in the Budget was the £10 billion welfare cut. It is not a new policy, but it is the Chancellor now starting to point out the trade-offs between public service spending and welfare spending in the next Parliament if he is to get his public spending plans kept to. I thought that that was the most significant number, because it was drawing attention to something and it is a very big number, whereas most of the numbers in the Budget were actually relatively small.

Q191 John Thurso: You said earlier that SDLT is not part of a long-term strategy. Do you think it will have any effect on the property market generally?

Paul Johnson: It will certainly have some effect. One presumes that it will proportionately reduce the prices or values of properties that are above the £2 million level, and it will presumably increase the incentives to keep the price just below £2 million, just as each part of the slab of the stamp duty system has that effect. That is relatively small, and I think the Treasury numbers suggest about 3,000 transactions a year, which is a pretty small part of the property market. However, I guess that the longer-term concern is that if you are continuing to move in this direction at that end, unwinding some of these less desirable effects more generally through changing stamp duty looks less likely than it did three weeks ago.

Q192 John Thurso: This was brought in basically as a way of taking money from richer people. Will it achieve that objective? Will it bring the taxes in?

Paul Johnson: I think the Treasury is expecting £200 million or £300 million from this, and within that it has made some allowance for reduced numbers of transactions and it has also made some allowance—it does not tell us how—for avoidance of that, including keeping things below the £2 million level. We have no basis for thinking that its £200 million to £300 million is wrong, but even within those numbers, it is expecting a reduced number of transactions.

Carl Emmerson: It is worth noting that the OBR identifies five or six policies in the Budget in which it thinks that the costing is particularly uncertain. The changes to stamp duty is one that it flags up as falling into that camp.

Q193 John Thurso: Ultimately, this is not a particularly sensible or simple way of taxing. Is this not making the case for a better way to tax property, as in land value tax?

Paul Johnson: As we have said, there is a strong case for reviewing property taxation more generally, and thinking about the structure of council tax, whether we will continue to charge it on relative values as they were in 1991, whether we continue to charge it in a way that rises much less than proportionately to the value of the property and whether we want to continue with a transaction tax that has an impact on how the market works. Yes, it increases even further the need for a more substantial review and strategy on housing tax.

Q194 Chair: Have you anything that you have been unable to put into the public domain—either in written form, prior to this meeting, or orally—that you would like to add to the evidence?

Carl Emmerson: A very small comment on the child benefit withdrawal—you lose 1% of your child benefit for every £100 of additional income. That means that the withdrawal rate that you face will grow as child benefit grows in cash terms, because 1% will be a bigger number, which seems a rather interesting way of withdrawing a benefit in the benefit system. As Paul said, the £50,000 point at which you start to lose child benefit is fixed in nominal terms, whereas previously it was to be linked to the higher-rate threshold, which typically grows in line with inflation.

Paul Johnson: Another thing that the Committee might want to think about, which relates directly to that point about indexation, is that we now have a hotch-potch of different ways of indexing bits of the tax system. The allowances and so on are, by default, increased in line with prices, but the £150,000 number is not increased at all. Within the NI system, we even have this odd situation in which employer NI thresholds are increased by the RPI, but employee ones by the CPI. The combination of different ways of indexing is becoming less rather than more sensible.

Chair: The overall complexity is increasing rather than decreasing—that seems to be your verdict. Pat McFadden wants to add a quick rejoinder, but we will finish on time.

Q195 Mr McFadden: Following from John Thurso's question, we know fairly clearly the cost of some of the measures announced in the Budget—for example, increasing the personal allowance to £9,200 has a clear cost attached. We are less certain about the revenue-raising parts of the Budget, such as stamp duty, cuts in reliefs for high earners and so on. The Chancellor was careful to present the Budget as being a neutral overall package. Is there a danger that the costs are certain, but the revenue-raising parts are less so, and that this might end up being something of a tax giveaway Budget rather than a revenue-neutral one?

Paul Johnson: There is some truth in that. It is not only that the revenues are uncertain; the 50p to 45p is uncertain. The uncertainty might not be symmetric in the sense that, as I said, if people are getting used to using avoidance schemes, they might carry on using them.

Some of what we have said on this has been slightly over-interpreted in the press. If it does result in a fiscal loosening, it will be of a trivial amount. As the previous panel described, the Chancellor should not think that a £500 million loosening will spook the markets—I am not saying that because I think it is a £500 million. Equally, if it results in a loosening of a few hundred million pounds relative to what was intended, I don't think that will do any damage to anything.

Chair: Thank you very much indeed for coming. I am grateful to you for agreeing to supply those further couple of points on one of the most controversial issues. We will take a break and resume at 11.30 sharp.

Examination of Witnesses

Witnesses: **Gillian Guy**, Chief Executive, Citizens Advice, **Professor Dieter Helm**, University of Oxford, **Steve Hughes**, Economic Adviser, British Chambers of Commerce, and **John Whiting OBE**, Tax Policy Director, Chartered Institute of Taxation, and Tax Director, Office of Tax Simplification, gave evidence.

Q196 Chair: Thank you for coming to our third session this morning. I will begin with a question to John Whiting. Is the tax system now simpler than it was two years ago?

John Whiting: That is a good question to start with, Chairman. I heard the previous panel talk about a hotch-potch.

Q197 Chair: You are the key figure in the Office of Tax Simplification. I was hoping you would be able to give me a yes or no answer.

John Whiting: It is a bit of a curate's egg—the proverbial curate's egg: it is good in parts. It has got simpler where there has been good consultation and things have evolved carefully. Even if we end up with extensive legislation, it has been knocked into shape and well thought through both in terms of policy and the exact wording. It is less good where consultation is not followed. Child benefit, which you have just been talking about, is a good example. I think the Office of Tax Simplification is making a difference.

Q198 Chair: I was not asking that. I was asking whether the Chancellor has delivered net.

John Whiting: Yes, I appreciate that, but we are making a difference. It is getting a little simpler. To use another phrase, there are some green shoots of simplification around, but they need nurturing. Is it simpler overall? I can only quote a figure that I suspect I quoted to you last year, which was 100 versus 382, which is 100 pages of legislation chopped out by the OTS last year and 382 pages of new legislation brought in, so we are probably losing, but not by so much.

Q199 Chair: The Chancellor has given a pretty strong nod in the direction of retrospection. What effects will that have if it is embedded into the tax system?

John Whiting: I do worry about retrospection. It has great potential to do damage to the image and reputation of the UK's tax system. It damages it because it takes away some of the reputation for stability, certainty and fairness, which in many ways are the cornerstones of our system. Businesses in particular can look at our system and say that they know where they are. They know that if they settle something, it is settled. They know the operation of law is what it is today; it is not going to be changed retrospectively.

All of that said, I accept that you can never rule out retrospection completely, but it really is not something that you want to waive regularly. We at the Chartered Institute of Taxation put up a paper about 18 months ago as part of the tax policy-making discussion, suggesting it was time to really tackle this issue of retrospection and when, if at all, it would be used. It would be good to take that forward and bottom out why it is thought to be necessary, and when, because it really ought to be in a very tightly controlled box to avoid scaring things.

Q200 Chair: Is this one of those measures where, once politicians have an appetite for it, their interest in it may grow and grow?

John Whiting: I think that is a genuine risk. It becomes possibly a solution for some lazy drafting of legislation, because you could in extremis get to the stage of, "Well, it doesn't really matter what the legislation is, because we can always correct it later, and correct it retrospectively." That is certainly not what we should do. We need a certain system that people can rely on at the time. Members may be aware that India has just threatened a whole package of retrospective measures in its budget. I have already seen a lot of industry saying that that tends to suggest they should not go and invest in India, and they are considering making representations to the Indian Government. I am not saying we are going that far, but the risk is there that it damages the image for stability of the system.

Q201Chair: And it damages the stability from the perspective of inward investment into the UK.

John Whiting: Yes.

Q202 Mr McFadden: I want to ask Steve a couple of questions about bank lending. Is it your view that the current level of bank lending is a restraint on economic growth?

Steve Hughes: To a certain extent, yes. We now have evidence through something called the SME Finance Monitor, which was the first independent, big survey of bank lending conditions conducted post-financial crisis. It shows quite clearly that younger, high-growth, smaller businesses find it much more difficult to access finance. If those businesses are having difficulty accessing finance for their growth ambitions, that is certainly a constraint on economic growth.

More broadly, we do not know whether that is more of a structural problem or a precise problem created by the financial crisis. There has always been a problem—or market failure, as some call it—in the provision of finance to those businesses, but how much more acute it is following the recession is something that we do not know. In terms of the things that can help, or public policy that can be provided to aid those businesses in that situation, it is also very difficult to assess where help can come from. As for the schemes, interventions and initiatives that are already out there, there is the national loan guarantee scheme, the enterprise finance guarantee and so on; they are a bit of a mishmash of interventions that help some, but are ultimately not known widely and used by the business community.

Q203 Mr McFadden: I attended a very interesting talk by your new director general at the Banks's stadium in Walsall on Friday, at which he emphasised the need for economic growth as well as deficit reduction. Do you think that the current problems with bank lending are more about supply—the banks have been unwilling to supply credit to businesses at a reasonable price—or more about demand and confidence in the country's economic future, and a reticence on the part of businesses to invest and do the borrowing necessary?

Steve Hughes: To sit on the fence, it is a bit of both. On the supply side of the equation, the problem is that there has been a huge breakdown of trust between lender and lendee. Frankly, some businesses do not want to approach their bank even though they want finance, because they just assume that they are not lending. Again, the statistics to show that come from the SME Finance Monitor.

Equally, when you have schemes coming through the banks, or a system whereby—I have spoken to bank relationship managers who say that for 10 years prior to the financial crisis they were simply order takers, lending to those who walked in through the door. Now they have to be more proactive in how they engage with businesses, which gets back to the old argument about relationship management and understanding the business.

Obviously, there seems to be a bit of a skills deficiency on the front line of the banking system. When you try to communicate products such as the enterprise finance guarantee down through bank hierarchies, it is very difficult to explain how a business can walk into its branch and find out, when they ask about the EFG or the credit easing scheme, that nobody knows about it. A perfect example would be that state aid sign-off for the national loan guarantee scheme occurred on the Thursday; the banks signed up over the weekend and it was launched on the Tuesday. Somehow, all the bank relationship managers are meant to know and understand a scheme, so that when a business walks in after seeing it on the TV, they are able to explain to them.

On the demand side—the second part of your question—you have to look at the wider problems of the economy to understand why demand is muted. It is muted for several reasons, not least external problems, such as the eurozone crisis. In particular, chambers of commerce have reported numerous people asking, "What happens if there is a disorderly exit from the eurozone, and what happens to my contracts in that situation?"—so, contingency planning, fear of the unknown, and the risk associated with any kind of investment. The returns on that investment are simply unknown, and therefore, they do not want to borrow.

Q204 Mr McFadden: My final question to you is about the national loan guarantee scheme. We asked previous witnesses this morning whether it was likely to have much impact and their answer was no. What is your view?

Steve Hughes: My answer would be some, but little impact, not of material benefit. Ultimately, it addresses one aspect of the lending problem, which is the pricing of loans. It will make loans cheaper for some businesses, but those businesses are more than likely to be the businesses that would have been viable or deemed viable by credit scoring systems and allowed to have finance anyway. Ultimately, it is just giving them a bit of a bonus on the pricing of their loan. There are wider problems with the system that need to be addressed.

Q205 Mr Love: May I follow up that question by asking you this? The Government admitted, when they launched the scheme, that it was likely that there will be no new net lending as a result. Do you agree?

Steve Hughes: Sorry—no new net lending?

Mr Love: Yes.

Steve Hughes: One of the things about these schemes—and Project Merlin, going back to all the initiatives and setting them in the context of the Government providing initiatives in relation to bank lending—comes back to the trust issue. If there is a situation or a scheme that encourages SMEs to re-engage with their bank, or shop around and test the competitive nature of the banking system, that is a good thing. How much that will happen through these schemes is an entirely different question. We know that some banks are trying their hardest to encourage or generate market share within the business lending market, but we do not know why the others may not be engaging in that. In terms of new net lending, which was the original question, again—possibly not the previous answer I gave about lending just going to businesses that would have already applied for finance but under this scheme would just get it cheaper—that is the danger.

Q206 Mr Love: Would it have helped—a yes or no answer to this, because we have to move on—if the scheme had been larger, for example if instead of £5 billion, it had £20 billion or £25 billion initially?

Steve Hughes: Not necessarily. The scheme is coming in tranches anyway. It is coming in £5 billion tranches. There is another danger associated with this, which is that if one tranche runs out, you may have a gap before the next tranche comes in, which is a bit of a problem in terms of perception and attitudes towards the scheme. But if it is running out of money, it can be monitored.

Q207 Mr Love: The OBR is suggesting that the difficulties in the finance markets may well have worked their way through, and so the benefit of the scheme may well not be as great as it is currently, when markets are not functioning effectively at all. But anyway, I shall not continue on that.

Can I turn to Dr Helm? The Government have announced a number of specific measures to improve infrastructure. How important are these measures? Do you think they have gone far enough?

Professor Helm: On the one hand, it is extremely welcome that infrastructure has become part of a Budget, and significant enough for the Prime Minister to make a speech about it. But the scale of the shortfall on infrastructure investment against the policy still leaves a pretty big gap. I estimated back in 2010 that if you added up the previous Government's commitments in transport, energy, water and communications and took pretty conservative assumptions, some £500 billion of capital investment was on Government ambitions required over this decade. That is £50 billion a year, and my guess is that we spend about £10 billion or £20 billion. So the gap between what needs to be done and what is being done remains very large. It is a good news story that it is finally being taken seriously, but we are not anywhere near closing up those gaps.

Q208 Mr Love: We talked in earlier sessions this morning about fiscal credibility and how that limits the amount of infrastructure investment that can take place. Are there any other new mechanisms we could use that would directly impact on the way the markets perceive infrastructure being invested in?

Professor Helm: It is a fundamental question. My guess is that tinkering at the margin will not make much difference. The fundamental problem is this. If you ask what the deficit is, you can get an answer in cash terms, but you have no idea what has been done to the assets. So you can run down the assets and the deficit will not look so large, or you can build up assets and it could look huge. Any sensible way of taking accounting forward says that you should look at the Government's balance sheet. You should look at the assets that we are leaving for the next generation, and you should look at the liabilities that we are giving the next generation. When it comes to the infrastructure assets, there should be a capital maintenance charge against the revenue account. Net of that, we can work out what our deficit should look like.

Carrying that logic through, if you think that we have a lot of catch-up investment to do to make good our infrastructure, the capital maintenance charge should be pretty large. In that case, this generation's charge for the next generation has not been met. Until you have a balance sheet on which, if you borrow money for an asset, you have an asset and a liability, you cannot have a sensible discussion about what public investment in infrastructure ought to be. Whole-of-Government accounts are a first step on that road, but we are a long way from seriously distinguishing between investment and consumption. This is about investment, and it is about sustainable investment for the next generation.

Mr Love: I know the Chairman will not want me to go any further down that road.

Chair: Not because it is not interesting, but because it is not the focus of this particular inquiry.

Q209 Mr Love: But I take your point about all-of-Government accounts. It has taken us a long time to get that far, so maybe over a period of time we will move further.

Let me just ask you one final question. The Chancellor and the Prime Minister have been on record recently talking about aviation strategy. What should we be looking for in a new aviation strategy?

Professor Helm: I don't think anybody thinks that where we have got to at the moment is a very satisfactory position to have arrived at. Clearly, there is demand for more aviation, and clearly there is a constraint on infrastructure. Therefore, some decisions will have to be made about whether to meet that demand at all and whether the UK wants to be a hub airport as well as providing its own internal services. If the UK is to do that, there needs to be a proper environmental assessment of the options, as well as the other components of the assessment of the options. Everybody knows what those options are, but everybody seems to be unable to face up to doing that analysis in a clear and open way. Hopefully, that process will finally get under way.

Q210 Mr Love: Are we in a crisis? Some people are presenting it as a decision that we need to make because we are losing out to international competition. Do we have time to take this decision? Is it something that we need to think about very clearly over the next few years?

Professor Helm: There is a prior question: do you want to be an international hub airport? Many countries get by without being international hub airports. The interchanges take place through Heathrow and not through other airports that they could have gone through. There is a major decision to be made on whether we really want that. There are arguments on both sides of that equation. If you say that you do want to do it, certain things follow—"What is necessary to do to achieve that outcome?" Clearly, what is happening at the moment would not achieve that outcome, but the prior question is out there. Do you really want to do that?

Q211 Chair: Do you think we should have a major hub?

Professor Helm: My honest answer is that I am not sure, because I have not seen an analysis that convinces me either way.

Q212 Chair: If you did think we needed a hub, what would you do?

Professor Helm: If we needed a hub and that decision had been made, we would look at the options in front of us.

Q213 Chair: I am asking you to make an assessment of them.

Professor Helm: Well, I cannot do an assessment off the top of my head because I have not done the analysis. That is not a fair question.

Q214 Chair: You have said, "I do not know" to both of the questions that have been posed to the Government.

Professor Helm: Yes. If you are doing public policy on infrastructure, there ought to be an appropriate process that confronts the question head on, does the analysis to support it and then thinks through the policy consequences. For people to say off the cuff, "I'd do this," or, "I'd do that," is exactly how we shouldn't go about the process. I say that with due respect.

Chair: I think you have made your point about the broader perspective of these decisions very forcefully.

Q215 Mark Garnier: John Whiting, may I turn to the 45p/50p tax rate question? Looking at the international community, both in terms of people who live in London or the UK who come from overseas and people living overseas who might want to come to London or the UK, do you think that that cut in the top rate of tax is likely to change people's behaviour and make the UK more attractive to them either to stay or relocate here?

John Whiting: Undoubtedly, it is going to make the UK appear more attractive because it is a signal. It is part of the UK's shop window for individuals and entrepreneurs, just as the corporation tax rate is part of the shop-window advert for businesses. Of course, the two come together, so cutting it is bound to make the UK look that bit more attractive.

Q216 Mark Garnier: Do you think it is an effective addition to the shop window?

John Whiting: I think it is a useful addition to the shop window. As you alluded to, Mr Garnier, if you tabulate the rates, at the moment the UK's rate is at the top. Most sensible investors will, of course, look underneath the shop window rate at everything else, including the infrastructure that Professor Helm was talking about, but it is an important signal. It probably comes back to something I have said very often, which is that my feeling is that the 45p rate or the 50p rate is almost more symbolic than a matter of how much it actually raises, as you heard in the previous session. It is a bit like the points on infrastructure. What is it you are trying to achieve? In many ways, tax needs as much of a strategy as infrastructure. Where are we going with this? What are we trying to achieve?

Q217 Mark Garnier: That is a very interesting point. On that basis, do you think there is an argument for reducing it back to 40p, where it was before?

John Whiting: There is an argument, no doubt.

Q218 Mark Garnier: Sorry; do you think there is a convincing argument for reducing it? Of course there is a general argument.

John Whiting: I am going to sound like Professor Helm, my friend to my right. There are arguments on both sides. I go back to the point that there is a bit of symbol here.

Q219 Mark Garnier: But with your huge experience as a tax consultant—you have more experience, perhaps, than anybody else in this country in terms of what behavioural effects taxation has—do you think, if you were Chancellor of the Exchequer, that it would send a much better and much clearer message to the international community if we were to reduce the tax rate to 40p?

John Whiting: It would send a clearer message to the international community. You have to balance that with the message that it sends domestically. You cannot just look internationally. Clearly, with this there is an element of the rich sharing the pain of everybody. As with so much of tax, it is a balancing act. It is for the Chancellor to take that decision and balance the various factors.

Q220 Mark Garnier: Can I ask a specific question about other countries? A company in my constituency that manufactures carpets with a manufacturing operation in Portugal has been offered an amount of money to relocate its carpet manufacturing facilities from Kidderminster to Portugal, with a cash incentive to pay the costs. Yet, of course, the top rate of corporation tax in Portugal is 29%, compared with the 22% that it will be here. Do you think that the fact that the Portuguese Government are prepared to offer a cash incentive demonstrates that we as a country are becoming increasingly competitive by reducing our corporation tax, and that—it may not be enough to effect the move—it reinforces the argument that we are now coming back to a leading position on the global stage in terms of assistance to manufacturing through the tax system?

John Whiting: Yes, I think it shows that the tax system is getting broader and better, in that sense. There are an awful lot of nuances in this. It is interesting that you used the example of carpet manufacturing. They might want to invest a lot in equipment. They might therefore look to capital allowances. The capital allowance rate has been coming down at the same time as the headline corporation tax rate. I presume you are talking about a large business that might actually benefit from the headline rate cut. Let us not forget that the vast majority of businesses gain no benefit from the headline corporation tax rate cut, because they are paying at the small profits rate or, of course, are unincorporated and are losing on capital allowances and gaining no benefit on rate cuts.

I think the answer, as with so much, is that it depends, but I come back to the fact that it is a signal. It is interesting that the Portuguese are trying to pick winners. Obviously they think it is a good business to try to pick. I am not sure that is really the sort of business [of picking winners] we as a country should be in.

Q221 Mark Garnier: Gillian Guy, can I bring you in on child benefit? What is your view of the child benefit changes for higher earners?

Gillian Guy: We welcome the changes introduced in the Budget, because they will take less from people than previously proposed. It is also helpful to have a tapering of that effect for the margin between £50,000 and £60,000. The issue still remains, however, that there is an anomaly between single-income families and couples. It is possible for a couple to earn almost as much as the limit and not lose their child benefit, whereas a single person very quickly goes over the threshold and loses it. There is an anomaly that has been carried through from the original proposal to the Budget.

Q222 Mark Garnier: It is marginally reduced. But do you not agree that that anomaly is carried through to the tax system generally? You have two hypothetical families, one with a single earner on £84,000 a year who is paying £4,000 a year more than the household next door where there are two earners on £42,500, so the anomaly carries through anyway, doesn't it?

Gillian Guy: I think that it does, but if we have an opportunity not to reinforce it by propositions that come forward, that would be a good thing to do, and it has been missed as an opportunity here.

Q223 Mark Garnier: As an overall point, given the people who have been asked to lose this benefit, do you agree that it is not an unreasonable proposition that those people who are on higher earnings are in a better position to contribute to the sorting out of the financial problems?

Gillian Guy: I think that it is commensurate with the argument that there ought to be an even spreading of pain. Those who are more capable of dealing with that ought to be the ones who take the brunt of it. This is a small piece, though, of that argument. When we look at things such as the personal tax allowance and the impact that it is said to have, the impact that it actually has on real people is that the headline—it is a bit like corporation tax—applies to only a certain number of people and not to those who are in greatest need. So, it feels as if child benefit is just a very small part of that. It is welcomed by us, and it is welcomed as a new proposal subject to that anomaly, but it does not deal with the pillar of the Budget, which is supposed to be fairness, or with the impact, on lower-income families particularly, of the personal tax allowance.

Q224 Mark Garnier: This is my last question. Child Poverty Action Group and Mumsnet argue that it is absolutely right that people with broader shoulders should bear the greater burden, but that it is wrong that this should be levied on families with children and that it should be done as general taxation. Do you think that that argument holds any water?

Gillian Guy: If the argument holds water it is not one that we—

Q225 Mark Garnier: I am sorry, but do you agree with it?

Gillian Guy: It holds water but it is not one that we are promoting because we think that there are other arguments that need to be promoted more strongly. For example, if there is not a disregard in terms of benefits and universal credit for the addition in personal tax allowance for low-income families, that benefit is going to get eroded completely, and it is those things that we want to draw attention to more than the other point that you raised.

John Whiting: May I add a quick point on child benefit? I am sure that you will not miss it, Mr Garnier, but the sheer amount of extra administration and checking that the process will bring in must not be underestimated. There is a great deal more work to be done for the Revenue and for a cadre of people in pursuing them.

Q226 Mark Garnier: That is a very good point. Richard Murphy mentioned this the other day, in terms of tax forms, with having to work out what is going on and the extra cost that there will be. Do you think that the Government have it completely wrong with the way in which they are raising the money? Do you think that there is a far better way of doing it?

John Whiting: You could say that there would be an easier way of doing it, which would be to scrap child benefit and just compress it and fold it into tax credits, but that has a major impact and huge distributional shifts. Almost as soon as you say that you want to withdraw child benefit from a sector of those who would collect it, you are imposing an administrative burden, with all the connotations of people mixing things up, having to repay, misclaims, and all the rest of it that we saw so much of with tax credits. We start from a very simple all-but-universally-taken-up relief and are putting an administrative burden on it.

I totally agree with the points that Gillian made about it being better than it was, but I am simply saying that the administrative load must not be underestimated. There is a big need for proper and careful communication, and for making sure that people do not get the wrong message about things such as having to give it up, or not staying on the register in case they lose their job. It is all an extra problem.

Q227 Chair: Mr Whiting, since you said that it must not be underestimated, perhaps you could give us an estimate? Would you be prepared to have a go at that?

John Whiting: I can give you an estimate.

Chair: Thank you very much.

Teresa Pearce: John, the HMRC report says that 500,000 more people will have to do self-assessment forms because of the child benefit changes, and that it will cost £100 million in staff over five years and £8 million in IT. That is quite a large amount. I want to ask about child benefit—not about how we tax but about the principle. We remember when women were not taxpayers and we had wives' income allowance and, under Margaret Thatcher, independent taxation came in. At the time it was said that she ran the country but could not sign her own tax return. It was ridiculous and changed to independent taxation. What concerns me about this, although it is better than what was suggested before with child allowance, is that it is a step back to family taxing. You will have a situation in which one person's income, be it benefit, will have to be declared on another person's tax return. Do you think that that is a step backwards for women's financial emancipation?

John Whiting: I think that it is. The point is very well made: we have a very uneasy meeting of benefits, which tend to be on a family unit because tax credits are like that, with a tax system that is independent taxation. I do not think that that division has ever really been tackled since tax credits were in force. The moves on child benefit erode that independent taxation even more. You are going to end up with the need for HM Revenue and Customs to use some of those extra resources that you pointed at, to police family units and to monitor relationships that come together and that break up. That has an implication for one of the halves' tax bills. It all seems as you suggest, a bit of a backward step on independent taxation.

Q228 Teresa Pearce: Do you think that there would need to be a change to the independent taxation regulations to police this?

John Whiting: It almost comes back to the previous point. What is the strategy? As Mr Garnier was driving at and, as Gillian Guy said, one argument is that we should, for example, compensate the family unit by transferrable personal allowances. If one half does not use it, it should be transferred. It would be a bit like the wife's relief that there used to be in the system that you and I perhaps remember. It needs looking at and, fundamentally, I wonder if, 20 or so years on into independent taxation, it will not be time to have another look and decide strategically where we are going with this. Are we really going down the independent taxation route or are we perhaps looking at family units? It is more than tax. It is, of course, tax and benefits.

Q229 Teresa Pearce: I want to ask you a few questions, Gillian, about the age-related allowances. When he announced it, the Chancellor said, "over time we will simplify the tax system for pensioners" by doing away with the complexity. He then announced that the changes would not be made over time, but now and in 12 months' time. It was quite sudden. Do you support the changes? If you do not, would you have supported them, had they had been more phased-in?

Gillian Guy: There is a degree of phasing, which I suppose is what allows the Chancellor to say that it is not a significant immediate impact. A large number of people coming up to pensionable age will be impacted straight away, of course. In the current circumstances, the costs of living, as we all experience, are rising as are debt levels . People come to us with 7 million issues a year, and debt and benefits are the number two issue, so we don't want to see particularly vulnerable groups—I put pensioners in that category—actually suffering a loss, but obviously, large numbers will do so.

As we catch up with the rest of those pensioners, they will also lose out, something to the tune of £83 a year. That may not be a huge amount, but it has to be considered in terms of the cumulative impact. Fuel prices continue to rise, and that is a key worry; 43% of the people who come to us are worried that they will not be able to meet their fuel bills. We have examples of people coming into our bureaux who do not heat their homes because they are worried about not being able to afford it. Again, it is another impact on those people. This group of people very often have to rely on their savings in order to live in their retirement, and they are getting very low interest on them. They cannot bank on them in the future in the same way as they used to.

It is the cumulative impact, as always, of such measures that needs to be taken into account. I have been in this Committee before talking about that. I also think that there is a slight perverse incentive in terms of what is tantamount to higher taxation. We are asking the younger generations to save for retirement, but then to say "Actually, you'll be worse off in the end" does not offer them much of an incentive to do so.

Q230 Teresa Pearce: Do you think any behavioural changes will be brought in by this change? Do you think people may decide not to continue to work after a certain age or to do part-time work? Given that their tax allowance has gone, will there be any changes in the way in which people approaching retirement plan?

Gillian Guy: There may well be changes in that because they will have to make a different allowance for what they can expect to come to them in the future, and also, how much will be taken away out of the income that they manage to derive. There are far bigger things causing choices at the moment. As I have said, it is that cumulative picture that is important to take into account. This is a group of people that ought to be protected and we tend to forget them and concentrate on other generations.

Q231 Teresa Pearce: Given that the whole issue of pensions and retirement is being debated at the moment, with extensions to the age at which people retire and the auto-enrolment into pensions, do you think that there should have been more of a joined-up thinking piece on retirement and ageing rather than just a one-off?

Gillian Guy: I think that from Citizens Advice point of view, we would say that all of it should involve more joined-up thinking. When we look at things such as another large chunk—say £10 million by 2016—coming out of welfare reform, for example, in the midst of all of these other measures coming forward, we urge Government to think about joined-up thinking across the piece, and pensioners are not an exception to that.

Q232 Teresa Pearce: Mr Whiting, you are the tax director of the Office of Tax Simplification. In your report, looking at the simplification of taxation for pensioners, you said that none of your findings had been formulated into final recommendations. Were you surprised by this announcement?

John Whiting: I was surprised that it was taken forward so quickly, yes. The context is that we undertook to do a two-stage review of pensioner taxation. The first would document the problems and codify all the problems. Hardly surprisingly, the complexities around age allowances were raised by some people in virtually every group that we talked to the length and breadth of the land—difficulties in making sure that the right amounts were given, coding problems and all those sorts of issues. Hardly surprisingly, it comes through as a source of complexity. Having logged it, we listed a number of ways in which it might be worth considering how you might tackle the complexity. Unsurprisingly, getting rid of age allowances is in the list. Stage two was to go ahead and look at them and try to work out what might be the best way forward. We would have to do that within our remit of being broadly revenue-neutral. So, we would be looking at a balance.

Q233 Teresa Pearce: So what would have been top of your simplification list?

John Whiting: You cannot get away from the fact that if there is a measure that adds to complexity, the easiest way of solving that complexity is to get rid of it. In pure simplification terms, clearly abolishing age allowances would be a contribution to simplification. Then again, one could look a little larger and say abolishing income tax would be a great contribution.

Teresa Pearce: It would be very popular as well.

John Whiting: It might be more popular than some. Obviously, these things have to be put in to a certain context. I am not going to deny that abolishing age allowances had to be on the list. My personal view, rather than that of the report, is that this is an issue that has been on the cards for the last two years with the intention to move to a £10,000 personal allowance. It is something that virtually everybody in receipt of age allowances wants to know about. I am sure that Citizens Advice and the Low Incomes Tax Reform Group have consistently asked what is happening to the age allowances. Had it been known and planned, people could have adjusted for this and come to expect it a little sooner. It may be precipitate now, but, arguably, it is almost two years after the point when it might have been tackled.

Q234 Teresa Pearce: Tax is complicated, and people do not understand it. People often do not try to understand it because they think it is complicated. One of the suggestions that has been made is that people should get an annual statement about how their tax is spent. From what I have seen, the annual statement is going to look like a council tax bill, with a pie chart. Welfare will be one chunk, and that will include pensions. Do you think that that will simplify the matter or will it confuse people that it is all out-of-work benefits?

John Whiting: I wholly support the concept of the tax transparency statement and something that will encourage people to engage more in the tax system. I think that it is an admirable idea and an admirable aim, because you are right—people do not engage enough with the tax system. They are just automatically put off. If a brown envelope arrives, the tendency is to put it behind the clock or whatever, or just bin it and hope it goes away. So I think that the concept of a transparency statement is admirable; I very much support it. Regarding the detail of what exactly it shows and how, we are back to the need to communicate and to communicate clearly, so that when your constituents get all these statements, they don't form a queue outside your surgery, asking you to interpret them, because there is clearly that risk. We do not want to end up with HMRC's phone lines being in meltdown, with people asking what the statements mean. There is a lot of design work to be done on these statements, but I think that the objective is to be wholly supported.

Chair: We don't want our phone lines in meltdown either.

Q235 John Thurso: Professor Helm, may I come to you? I want to talk about the measures designed to promote investment in energy. The usual hierarchy for decision making in energy supply is security first, affordability second and emissions third. We seem to have been doing that slightly the other way round, with emissions first, affordability second and security seeming to come third. Is the UK continuing to underestimate the importance of energy security over the next five to 10 years?

Professor Helm: Let me take it in two very quick bits. The first bit is that you are right; everyone seems to agree that there are three objectives of competitiveness in some sense, security and emissions. And security is within that frame. If you look where we are, on emissions, globally nothing has been done to do anything about climate change. Coal-burn goes up, the rate of increase of emissions goes up and in 25 years nothing whatsoever has been achieved in addressing those questions, and I mean that seriously. In the UK, carbon consumption is going up. It is just because we measure carbon production that it looks like we are doing well—we are not. So, if you ask, "Is this a policy framework to address climate change?", the answer is, "No."

If we look at security—the question you asked—in 1990 our system was roughly 80% coal and 20% nuclear. Nearly all of that capacity will be closed by 2023, bar one nuclear power station. So there is an enormous wall of existing capacity from the'70s that is coming off the system.

Are we addressing the provision of an investment framework to ensure that we have security of supply? By that, I do not just mean the lights going out, but sufficient security so that we do not see price spikes all over the place to achieve that security. Not yet—it's a mess. We have been reviewing energy policy for years. There have been 12 years of reviews of energy policy after each election, and White Papers, etc. Do I have any confidence that we have a framework yet that will provide sufficient incentives to build the power stations, to provide one of the basics of an economic system going forward? No.

Q236 John Thurso: I saw some research—I think that it was produced by Nomura—that indicated that capacity and demand would be pretty close to being equal at about 60 GW in 2016, 2017, 2018 and 2019. Do you concur with those figures?

Professor Helm: I think that trying to estimate precisely how the balance will be in five years' time is not how we should think about energy policy. Remember that if you go back really recently in investment cycles—back to 2005—you would expect GDP to be about 18% higher today than it actually is. That is why we do not have an energy crisis. Compared with the 3% growth rate, if you work out what has happened since 2005 there is a lot less demand on the system than we previously had. The question that one really wants to address is, "How do you provide a proper, long-term capacity contracting market in which you can ensure you have sufficient investment in that system by having contracting to have that system there?" That is what we do not have. I used to think that we would have a problem in 2011. We would have had a problem in 2011 had that economic downturn not taken place. If economic growth is 3% to 4% per annum from now onwards to the end of this decade, we will have a serious problem. If it's nought, we probably won't.

Q237 John Thurso: So, in the likelihood that there will be growth, and that the rate of growth will grow, that problem you have identified comes forward. The Chancellor, therefore, is absolutely right to do a dash for gas, is he not?

Professor Helm: I read very carefully what the Chancellor said, and I think what he said was that the Government were going to look at the investment incentives in respect of gas. There is a really important problem here, in Germany and in a number of other countries: if you bring more intermittent power on to the system, such as wind, which has a zero marginal cost, when you invest in a gas station or any other base load station going forward, you can no longer rely on that station running at base load for some time to recover your costs.

Therefore, in Germany, here and elsewhere, anyone now wanting to build those kinds of stations needs some kind of contract to do it. That is the right question to ask. Whether there should be a dash for gas—meaning lots and lots of gas—is a completely separate question. The problem we have at the moment is that there is not any incentive to build any of it. Clearly you are going to need some of that to get through that period, regardless of what your energy policy framework looks like.

Q238 John Thurso: The point, presumably, being that you have to have base load. Therefore, we will have to build twice the capacity, because for every capacity of intermittent renewable, you would need an equal gigawatt of base load for the three or four days a year when the wind does not blow.

Professor Helm: With due respect, that is slightly confused. We need back-up capacity, so that when intermittent generation isn't available you have other capacity. That means flexible capacity. However, you also need base load to take up some of this load from the coal stations going off the system and from the nuclear stations going off the system. Remember, we are closing most of our nuclear industry. Even if we build a few more, we are actually reducing the share of nuclear in the frame.

You need both of those things. What are the incentives to invest in this world we have created? Secondly, within that framework, we now no longer have the luxury of this massive surplus of supply that came from the 1970s, because we de-industrialised and we didn't need it so much. Now we don't have that, do you have a policy framework that ensures that sufficient capacity is effectively built, because you have to have that for the system benefit? My answer to that question is, not yet.

I think the energy market reforms, although they ask some of the right questions, have created an immensely complicated system. I am sympathetic to the comments made about simplicity of the tax system. It is very complicated. You have individual contracts for feed-in tariffs, for different kinds of technologies, plant by plant negotiations, separate capacity market, and separate energy market. That is a recipe for confusion and expense and I think it is going to be costly on the cost of capital for investment.

Q239 John Thurso: There appears to be relatively widespread agreement from industry, green organisations and lots of others, that the carbon reduction commitment scheme is simply too complex and burdensome, and therefore it is not achieving the goals for anybody. What would be a sensible alternative?

Professor Helm: Most economists would immediately answer the question by saying, "What you want to have is a price of carbon, have a carbon tax, get it done, fix it, make sure that you set it low originally but have a rising trend, and people know in the long term what is there." Instead, what we have is the European Union Emissions Trading System, which is short term, volatile and very low. We now put a carbon floor price in because the EU ETS cannot deliver the price we want. Then we extend these commitments on a company by company, case by case basis. Again, what you create is, by definition, an enormous bureaucracy and lots and lots of costs, but what for? What you really want to do is not say you know exactly what firms and individuals should do, but set a price and let the market sort it out. We will eventually get there.

The trouble with lots of different ways of getting at the same problem is that you create a whole industry of people involved in it, but you have to look at the bigger picture. Are you actually achieving the objective you set yourself, which is to reduce the emissions at the least cost, given that anything you do to reduce those emissions will have cost effects? As we know, we have lots of people in fuel poverty and lots of people facing these constraints.

I welcome the step that has been made, but I would have it as a more radical discussion about what we are really trying to do here and how that fits with our security and competitiveness, as well as our commitment to addressing global climate change, and therefore our carbon consumption, not our carbon production. Between 1990 and 2005, carbon production in this country under Kyoto fell 15.4%. If you add back the imports and the carbon we actually consume, which is our genuine carbon footprint, our emissions went up 19%. That is why at the global level, emissions keep going up, the coal burn keeps going up in the developing countries and we are destined for beyond 2° already in the frame we have constructed. That is why I say nothing has been achieved in this way. We ought to clarify what we are trying to do and address what is a really urgent global environmental problem as best we can, without incurring costs without benefits.

Q240 John Thurso: Okay, thank you very much. Can I just quickly ask Steve Hughes for the business take. What is the view of the Chambers of Commerce on what was done for the carbon tax floor price?

Steve Hughes: I don't know what work we did on that piece of policy, but I can submit it to the Committee afterwards.

Chair: Well, thank you very much for coming. I am sorry that it has been somewhat concertinaed, but that is the way of things with the parliamentary schedule we have been faced with. Thank you very much. You have given extremely interesting evidence on all fronts.

Tuesday 27 March 2012

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Stewart Hosie
Mr Andrew Love
John Mann
Mr Pat McFadden
Mr George Mudie
Teresa Pearce
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Right Hon. George Osborne MP**, Chancellor of the Exchequer, **Sir Nicholas Macpherson**, Permanent Secretary to the Treasury, and **James Bowler**, Director, Strategy, Planning and Budget, HM Treasury, gave evidence.

Q241 Chair: Chancellor, thank you very much for coming this afternoon. May I begin by saying congratulations on the Red Book, which is half the length and twice as factual as Red Books have been and is now full of interesting information? The Committee also thanks you. We asked, over a year ago, that you start producing some distributional material. While recognising the difficulties of the work, you have started to produce some very interesting distributional charts and tables at the back. My only additional thought on that is that there is probably still more that could be done to improve it and I am sure that you have that in hand.

Were any of the measures in the Budget briefed to the press?

Mr Osborne: First, thank you for your comments on the Red Book. Not just the Ministers but the official Treasury has put a huge amount of work into trying to get this into a shape where it is a factual document that is packed full of information people might find interesting. We would be very willing to take on board any suggestions you have for improvement, because improving the Red Book is a work in progress.

In terms of the contents of the Budget, clearly some parts of the Budget were in the newspapers before I delivered the Budget. I think every single Budget that I've seen in the 20 or so years that I've been involved in politics has involved a lot of speculation beforehand. Sometimes entire Budgets have leaked and sometimes that speculation has been very well informed. What I can confirm to the Committee is that no Treasury official, no Treasury Minister and no Treasury special adviser briefed before the Budget any specific information on tax rates or tax allowances.

Q242 Chair: So when, for example, *The Herald* appeared to have details of the changes to the North sea tax regime—I'm quoting: "North Sea oil and gas industry is to get a major boost in next week's Budget"; it says lower down in the piece "Last night, a Treasury source told The Herald"—*The Herald* was making that up, was it?

Mr Osborne: The discussion about the North sea oil regime and, indeed, the consultation—although it's not scored in the Red Book—on high-end TV production were two stories we did engage with the press on, but as far as I'm aware—

Q243 Chair: Sorry, there were two stories that—

Mr Osborne: We did engage with the press on, but they were—

Q244 Chair: What do you mean by "engage with the press"? You mean you briefed the press before the Budget.

Mr Osborne: On the North sea oil tax regime, this is a discussion we'd been having with the industry, so everyone in the industry knew about the discussion we were having on decommissioning relief and there was a lot of speculation about that. I haven't seen the *Herald* story specifically, but I'm not aware—maybe you can correct me—that in the *Herald* story there is any discussion about the specific measures—the tax rates, the reliefs and the like—that are set out in the Red Book.

On high-end television production, it is not scored in this—

Q245 Chair: I will come on to that in a moment; at least I might do. I want to do one at a time. I just want to be clear: where it says "Last night, a Treasury source told The Herald" and then there's a quote, is that made up?

Mr Osborne: As I said, I have not seen the *Herald* story, but I know that specifically on the question of North sea oil, there was an enormous amount of industry speculation because we were quite open with the industry, discussing what we were seeking to do with field allowances west of Shetland and also decommissioning relief, because the advice from this Committee and others after last year's North sea oil tax changes, which I think it's fair to say caught the industry somewhat by surprise, was that this time we had a much more consultative process with the industry, so there was not a huge amount of secrecy surrounding the North sea oil tax regime. There were certainly other measures in the Budget—other taxes—that I wished to keep secret.

Q246 Chair: On 14 March, *The Guardian* carried a story saying that you were going to unveil plans in the Budget to relieve the debt burden on future generations by introducing 100-year or perpetual bonds. Was that briefed to the press?

Mr Osborne: Yes, that was, but that's not a Budget measure.

Q247 Chair: I see. So there wasn't actually a statement by you, but you decided that you would brief the press beforehand?

Mr Osborne: I draw a distinction. You have a perfectly legitimate concern, and I have a concern, about things like rates of income tax and personal tax allowances, some of which did appear in the press beforehand, but the fact that the Debt Management Office is going to consult in the future on gilt maturities is the sort of thing that, frankly, the Treasury and every other Government Department engages with the press on every day—I would not regard that as Budget purdah, it is not on the score card. I am talking about, and I suspect your Committee is concerned about, what pertains to things in the classic definition of a Budget and what is on the score card.

Q248 Chair: You would agree, wouldn't you, that that was an important announcement, or at least an important briefing?

Mr Osborne: It is an important briefing, but I don't think it would have warranted an oral parliamentary statement, for example.

Q249 Chair: What about a written one?

Mr Osborne: Maybe not even a written one.

Q250 Chair: Not even a written statement. You do not think that you are stretching the ministerial code, which reads that "important announcements of Government policy should be made in the first instance, in Parliament."

Mr Osborne: I certainly agree that important announcements of Government policy should be made to Parliament but, in the case you are citing, this is talking about the fact that the Government might, at a future date, bring forward a consultation on their gilt policy. That is not—I would hazard to argue in front of you, Chair—something that has to be done in an oral statement to Parliament; it could easily be in the kind of material in a speech that I would give, whether at the Mansion House or anywhere else. There is a distinction, which I am keen to preserve, between Budget measures such as tax policy, rates, reliefs and so on, which are on the score card and, in an ideal world—it has never happened in a Budget that I have seen in the past 20 years—would all be kept secret until Budget day, and general expressions of future Government policy intent, of which the one you mentioned is an example.

Q251 Chair: Now just tell me, how was this measure briefed? What exactly happened to secure the briefing and therefore the press stories?

Mr Osborne: What? The—

Chair: The story of the perpetual bond, which appeared in the newspapers on 14 March.

Mr Osborne: I think the Treasury press office told people.

Q252 Chair: They didn't tell me. But they told the press. I am just trying to clarify: what did you do? Did you authorise this?

Mr Osborne: Yes.

Q253 Chair: I see. And you authorised the press office in the Treasury to brief the press?

Mr Osborne: Yes.

Q254 Chair: Without putting out a statement of any type.

Mr Osborne: Well, every single day we receive inquiries from the press, and every single day we respond to those inquiries and, quite often, we make expressions of intent and talk about the future direction of policy. Let me give you an example. I have been talking about planning policy, before this Committee, in television interviews and in Parliament for the past year. As it happens, today the policy is published. With the consultation of the Debt Management Office, I suspect that when the day comes, when we publish the formal consultation, of course it will be accompanied—probably, I suspect—by a written parliamentary statement, but it is perfectly reasonable for the Government to engage in a conversation with the media and everyone else about the future direction of policy. What is not appropriate is to announce significant policy changes outside the context of a parliamentary occasion.

Q255 Chair: What explanation do you have for the fact that, if this was briefed in London, the lead journalist who broke it was with you in Washington at the time?

Mr Osborne: I didn't say it was broken in London, actually, but the Treasury press officer and the Treasury team involved told the press who were interested in the story. They did not, by the way, confine it to one newspaper, so it was not an attempt to do a scoop for a newspaper. Every day No. 10 Downing street conducts a press briefing with the lobby, and the Treasury, being a Department that people are interested in, conducts press briefings on a pretty regular basis. But I do draw a distinction, although I do not want to repeat myself—

Chair: You have made that point a couple of times.

Mr Osborne: It is a perfectly reasonable distinction—

Q256 Chair: Well, we will hear it a third time, but—

Mr Osborne: There is a very sensible distinction between significant policy announcements, which should be made to Parliament, and the future direction of policy. I can say that I presume—you may correct me—that the Government are interested in changing the planning laws, just as they are interested in changing their gilt policy, and then when the actual policy is announced that should be done in a parliamentary context.

Q257 Chair: Even by the standards of what you described earlier as Budget leaks, you must agree that this Budget was exceptional, wouldn't you, Chancellor?

Mr Osborne: First, suspecting that I would be asked about this, I have done some research. In 2005, the rate of alcohol duties, fuel duty, inheritance tax rates, stamp duty rates, council tax refunds and the winter fuel allowance were all leaked in advance. In 2008, there was heavy and accurate speculation.

Q258 Chair: In previous year's Budgets, there was speculation and, if I may say so, when you were shadow Chancellor you were very critical of it, weren't you, Chancellor? For example, you described a leak in 2008 about the Government's decision to brief out the possibility of the stamp duty holiday as completely reckless. You were pretty critical of leaks when you were in opposition.

Mr Osborne: As I said, there is always speculation about Budgets, and Oppositions always make a great fuss about that. May I make a serious point about the Budget process? Two things have changed, and perhaps I am the first of many Chancellors who have to deal with this, but to my knowledge I am certainly the first to have to deal with these two features of Budget making, which I think Parliament must understand. First, I must agree my major Budget measures well over a week in advance. On the Monday before the Budget—not the Monday of the Budget week, but 10 days in advance—I must give the Office for Budget Responsibility the major Budget measures, and by Friday I have to have confirmed absolutely everything. No Chancellor has had to do that before. I think it is a good thing that I must do that, and it dramatically improves Budget making, but I have heard folklore—you used to be the special adviser to Lord Lawson—that previous Chancellors finished their Budgets at midnight or 2 in the morning, and that much of the last-minute haggling was in the previous 48 hours. It is difficult to leak a Budget that has not been finalised. Because of the OBR process, which I think is a good process, the Budget exists 10 days before it is given.

The second thing is that I must negotiate in a coalition. Inevitably, a process whereby the Chancellor came up with a Budget in secret with the Treasury, occasionally consulted the Prime Minister, and perhaps intensely engaged the Prime Minister in the last couple of days before the Budget was given was very different from a process in which I must engage two political parties to make sure that I have their consent to proceed so that, as last night when we voted on the Budget resolutions, I can be confident that I will have a majority. This is genuinely not pointing the finger at any individual, but many more people know in a coalition what will be in a Budget because I need to get the consent of both political parties.

Q259 Chair: What you mean is that many people in the Liberal party know about it, but not many more people in the coalition, because it is very restricted on the Conservative side.

Mr Osborne: I am just saying that the sort of classic constitutional model of a Chancellor of the Exchequer producing a Budget that he has to square only with the First Lord of the Treasury does not apply in a coalition. As I suspected that the Committee would be exercised by this, I have looked at Budget making in other European countries where there are coalitions, and inevitably there is a huge amount of speculation.

Q260 Chair: If you want to come forward with proposals for reform of the way you do Budgets, we would be interested in having a look if you produced a paper.

Mr Osborne: Those are two realities that I must deal with.

Q261 Chair: But Chancellor, while we have the system we currently have, we would like to find out whether it will carry on working in the way intended. On the basis of what you have just said, am I to conclude that, for example, the 7% stamp duty change was leaked as a consequence of coalition discussions?

Mr Osborne: I genuinely don't know.

Q262 Chair: I noted that David Gauke said on the Floor of the House that it certainly wasn't sourced out of the Treasury.

Mr Osborne: I genuinely don't know where the stories come from. I don't know the individual or individuals who—

Q263 Chair: Do you agree that we need tighter—?

Mr Osborne: First, I can assure you that to the very best of my knowledge, and I have investigated, no Treasury official, no Treasury Minister, no Treasury special adviser leaked, briefed—however you want to describe it—changes to the personal allowance, changes to the top rate of income tax, the stamp duty change and the like. No rates or allowances were briefed. I don't know where those stories come from. I completely agree with you—I would rather they had not appeared. Of course, I am always seeking to improve the Budget-making process, but we have two practical constraints: first, I have to complete my Budget 10 days rather 10 hours before giving it; and secondly, I am in a coalition and, completely understandably, I need to take all parts of the coalition with me.

Q264 Chair: Do you agree with the Committee's conclusion after the leaks in last year's Budget that leaks are to be deprecated and are corrosive of good government?

Mr Osborne: I completely agree that it would be much better if the announcements that I referred to—on stamp duty, personal allowances and the like—had been made on Budget day. I am happy to hear recommendations from the Committee about how, within the constraints of a coalition Government who have set up an independent auditing process for Budget measures, which means that these things are available for 10 days, when the entire Westminster press pack is trying to find out what is in the Budget—

Q265 Chair: You say available; they are only available as far as the OBR.

Mr Osborne: They are available—in other words, there is a—

Q266 Chair: But you are not suggesting that these leaks may have emanated from the OBR.

Mr Osborne: No, I am not.

Q267 Chair: No, right, but you are suggesting that they may have emanated from the coalition, are you not?

Mr Osborne: What I am suggesting is that the—

Q268 Chair: You are, aren't you, Chancellor?

Mr Osborne: Of course, they emanate from within the coalition Government, because, as far as I know, the document fell into the hands of the Opposition before the announcement.

Q269 Chair: And therefore the Liberals.

Mr Osborne: No, I am just making the point that this Budget is not completed at midnight on Budget day. It therefore exists for 10 days in a coalition Government, in which I have to get—and I was glad to see that we had a majority of 83, I think, for my Budget. I need the consent of the coalition to proceed with the Budget.

Q270 Mark Garnier: Sir Nicholas, may I ask how long you have worked for the Treasury?

Sir Nicholas Macpherson: For 27 years.

Q271 Mark Garnier: For how many of those years have you been involved with the formation of the Budget?

Sir Nicholas Macpherson: About 26.

Q272 Mark Garnier: Fantastic. If I were to ask you to cast your mind back 26 years, could you give us a flavour of what the culture was like at the time, in terms of the secrecy surrounding the Budget and the expectations of Ministers and civil servants?
Sir Nicholas Macpherson: I think it fair to say that that culture has changed over time.
Q273 Mark Garnier: I am anxious to hear what it was like. I am a relative newcomer to this trade.
Sir Nicholas Macpherson: The Budget process of the 1980s was different from how it has evolved over the past 15 years. The convention in those days was that there was extraordinary secrecy about nearly every aspect of the Budget.
Q274 Mark Garnier: When you say extraordinary secrecy—
Sir Nicholas Macpherson: We had strange paper on which the whole Budget process was photocopied, which was amazingly time consuming and, in relation to a lot of measures, was completely pointless. The culture of politics has changed. If I were stuck in 1980s-think, I would probably be utterly appalled by what goes on now, but the reality is that through the 1990s and 2000s, the way in which the Government of the day engaged with the media changed. I do not think that is a bad thing. Exposing policy, ventilating ideas and encouraging debate is all to the good.
May I also say that a whole lot of features of coalition Government are extraordinarily positive? The fact that there has to be a dialogue between two parties improves the Budget process hugely. On the other hand, there are other features of coalition Government. I hasten to add, for the Liberal present, that there is a Liberal Democrat Chief Secretary and there are Liberal Democrat special advisers in the Treasury. As the Chancellor says, to the best of my knowledge there has been no pre-briefing by any Treasury Ministers, special advisers or officials of rates, allowances or reliefs. There is a reason why you do not want to pre-brief these things. As the Chairman pointed out with the stamp duty rate, some of these things are market sensitive. If you publish the stamp duty rate two months before the Budget, you guarantee that a whole lot of property transactions will be brought forward. These things do matter, but it would be a mistake to look at it through the lens of the 1980s.
Q275 Mark Garnier: I think that is fair enough, but you will clearly understand that a great many people are deeply concerned about the amount of leaking that has gone on and the information that is coming out—I think the expression is trailing. You have said that it has moved from being an incredibly secretive process prior to the earlỳ 90s, to a situation where you can almost read what will be in the Budget a few days beforehand. I take your point that it is not necessarily an awful thing if some of this gets out, and perhaps there can be a good debate about it a few weeks beforehand. I also take the Chancellor's point about things such as 100-year bonds. Clearly, we need to have a public debate on that. None the less, it is causing a great deal of anguish, certainly in this Committee, that so much trailing—or perceived trailing—has been going on. You talked about the fact that that changed during thè 90s. Can you think of any specific political event that happened in thè 90s and marked a significant change to the process?
Sir Nicholas Macpherson: I think the style of government shifted hugely through the '90s, and it has continued to shift during the current century although I would not identify any particular event.
I want to return to the point about market sensitivity. I recall certain information finding itself in the hands of others in the run-up to Budgets during the previous Parliament. Because the information was market sensitive and appeared to me to be getting into the wrong hands, I initiated a leak inquiry. I do not comment on leak inquiries as a general rule, but in this case I was satisfied that nobody in the Treasury was in the business of leaking tax rates, allowances, reliefs and so on.
Q276 Mark Garnier: What about 26 years ago? If you had leaked a bit of paper to a newspaper, what would have happened to you if you were discovered?
Sir Nicholas Macpherson: It is exactly the same now. If I discovered an official leaking information of a sensitive nature—a stamp duty rate, for example—that would be taken very seriously indeed. Unless they were incredibly naive and had turned up only the previous day, I would generally take the view that they did not have a future in the Treasury.
Q277 Mark Garnier: Summary dismissal.
Sir Nicholas Macpherson: This is a very serious business, and sometimes you need to encourage the others.
Q278 Mark Garnier: Chancellor, many years ago Hugh Dalton resigned on account of the fact that he slipped out with something—
Mr Osborne: He briefed it himself.
Q279 Mark Garnier: Absolutely, and I am not for a moment suggesting that you would necessarily put yourself in a position where you need to resign, but presumably you would take a similarly dim view if you knew that someone—
Mr Osborne: As I said, in some senses I am as angry as you are that bits of the Budget appeared before it was delivered. I have satisfied myself about the political net with Treasury Ministers and Treasury special advisers, and you have heard from Sir Nicholas about Treasury officials. It is at least worth thinking about the question that the Chairman asked and the fact that the Budget is finished a long time in advance compared with the 1980s. In his memoirs, Nigel Lawson talks about finishing one Budget at 4 o'clock in the morning during the 1980s. We are also in a coalition so, given the nature of things, I have to tell many more people what is going to be in the Budget, and we have to accept that that is the world I am operating in. I think it would be worth the Committee noting that the permanent secretary, with all his years of experience, has said that the Budget-making process is more orderly, more sensible and less rushed than it was 20 or 10 years ago, and, of course, it is independently audited, which is crucial.
Q280 Chair: Sir Nicholas, will you clarify one point? You said you were satisfied that the leak did not come from the Treasury. Presumably, the only way of knowing that for certain is if you know who did leak it.

Sir Nicholas Macpherson: There are usually tell-tale signs about where things come from. Having looked at the stories and the relevant facts around them, I am confident that they didn't come from Treasury sources.

Q281 Mr Love: Sir Nicholas, have you initiated a leak inquiry? You sounded very robust in defending your civil servants. Have you initiated a leak inquiry to find out whether one of your civil servants was engaged in this process?

Sir Nicholas Macpherson: Although, as a general rule, I do not comment on leak inquiries, I am happy to say that I have not initiated a leak inquiry inside the Treasury. The reason for that is that I do not have any prima facie evidence to warrant such an inquiry.

Q282 Mr Love: So we are to assume you are confident that the leak came from another source? What makes you confident that that is the case and that it has not come from Treasury civil servants?

Sir Nicholas Macpherson: Over the years, you develop a bit of a sense of where stories come from. Sometimes, it is the way that journalists report it. Sometimes, it is because people have got actual copies of tables or documents. In this case, there is no evidence that anybody had copies of tables or documents. You would have seen it. Mr Ruffley will remember a night when Ken Clarke discovered that the *Daily Mirror* had large amounts of the Budget and there were unfortunate occasions—

Mr Ruffley: It didn't come from me

Sir Nicholas Macpherson: It certainly didn't, Mr Ruffley.

There were certain unfortunate times when the then Opposition got information towards the end of the last Parliament. I took a very dim view of that and, despite inquiries over a number of years, I have yet to find out where they found those documents.

Q283 Mr Love: You are not taking a very dim view of this.

Chancellor, are you satisfied that that the civil service and the Permanent Secretary have taken this issue of leaks seriously enough?

Mr Osborne: Yes, I am. I come back to the central point. This is Budget-making in a coalition. It is not a secret process between the Chancellor and the Prime Minister of the day, but even that process over the past 15 years threw up some extraordinarily accurate Budget speculation, for example, just before the 2005 General Election. We also have a different process where this is all done before we get to Budget week. Materials have been leaked because there is a Budget, whereas if you are still doing the Budget on the night, inevitably it is quite difficult to leak anything in advance.

Q284 Chair: We have had a very good canter around the process. We are going to move to the substance of the Budget.

Q285 Mr Love: May I turn to the economy? Chancellor, what difference will this Budget make to the real economy of jobs and growth?

Mr Osborne: I hope that it will enhance growth and increase jobs. To put it in the most straightforward sense, I think that it adds to supply-side reforms that we have initiated to the economy. Obviously, it did not involve a change in the fiscal stance. I suggest in that sense, in terms of the fiscal judgment, a more significant event was the autumn statement.

Q286 Mr Love: You mentioned—indeed, prayed in aid—earlier the independence of the Office for Budget Responsibility. According to its judgment told to this Committee yesterday, over the five years of the forecast there is no impact of this Budget at all. Is it irrelevant to the real economy?

Mr Osborne: I don't accept that characterisation. Robert Chote said that the main thing that is doing the heavy lifting in short-term demand is monetary policy. I argue that my fiscal policy is allowing that monetary policy to do the heavy lifting, and the OBR certainly does take that into account. Indeed, the OECD came out immediately after the Budget and said that the confirmation of the UK's fiscal consolidation programme should keep bond yields low and support the recovery. Now, low bond yields are absolutely part of the OBR's economic analysis. If we did not have low bond yields, those figures would look very different. The short-term demand in the economy is primarily being supported by monetary policy. That monetary policy can be as loose as it is because we have credible fiscal policy. What we are also doing, whether it is changes to the top rate of income tax next year, whether it is increasing the personal allowance next year, or whether it is the planning reforms, which were foreshadowed in the Red Book but announced today, and the like, is improving the productive capacity of the economy and helping it to become more competitive.

I have seen Chancellors make the mistake of banking those things before they happen, assuming that they had magically increased the trend growth rate and making all of their public finance forecasts on the back of that and usually living to regret it. The fiscal stance, which is integral to the Budget—of course, a lot of the commentary from my political opponents and other critics before the Budget was, "Change the fiscal stance"—was not changed. It did not happen. I would argue that it is the credible fiscal stance that supports the accomodative monetary policy.

Q287 Mr Love: Referring again to the independent Office for Budget Responsibility, when it was asked yesterday whether there was capacity for growth available in the economy, it indicated that there is spare capacity. You will know about the output gap, which is measured at 2.6%. Not only is that available now, but it will not be fully closed by the end of the forecast period in five years' time. We were also told today that quantitative easing will not close the gap, so there is spare capacity there. Does that mean that you are running the economy at a lower than optimum level and that we are not fully utilising the capacity of the economy and that we are keeping unemployment, particularly youth unemployment, at a higher level than it need be?

Mr Osborne: I am the first person who wants to reduce unemployment and youth unemployment. Of course, I want to close the output gap as well. I suspect—you can ask the Governor of the Bank—that he would not be running such a loose monetary policy if he thought that the output gap was closed. He is interesting on the challenges of trying to calculate the output gap. Of course, we are in the recovery phase and what the OBR said this year and last autumn is that the impact of the financial crisis or financial crash, which, let's be clear, is on some measures the worst in British history, has had a real effect on the pace of recovery. Chuck in the external factors, such as the euro crisis at the back end of last year and the oil price, and those are additional headwinds. I can tell you that I am doing everything that I possibly can to speed up the recovery and ensure that the accomodative monetary policy can work for as long as possible. The idea that I am tolerating this is not true; I am doing everything I can to speed up the recovery.

Q288 Mr Love: Well, let's look at that. The OBR was asked to comment on areas in which it could usefully contribute to this debate. It resisted the temptation, because that is not part of its remit. As you have said, you have introduced a number of measures. One measure associated with this Budget is the setting up of the national loan guarantee scheme, which was described by *The Economist* as "tiny", just £5 billion initially, compared with a reduction in business investment of £35 billion over recent months. The OBR said that it would have no material impact. Do you accept that characterisation?

Mr Osborne: My reading of the OBR document and the evidence that Mr Chote and others gave you is that it will have an impact on small business lending, which is exactly what it is designed to do. I think that he said that to your Committee. It is targeted at that. The initial tranche is £5 billion, but the total allocation is £20 billion. I have made it clear that if the scheme is working and if the money is coming out of the door, I am prepared to look at increasing that £20 billion. No British Government has attempted this before. It is a very complex operation to try to guarantee lending to banks, which is then passed on from the banks to small businesses. When I launched the scheme in Parliament, I said that I did not expect that we would get it 100% right when we started and that we would have to improve it as we went along. I am really pleased with the way it has been launched, and we have not found any problems yet, but I am certainly prepared to increase its capacity if we can show that it is getting to those small and medium-sized businesses, which is something that the OBR thinks, in its document and in its evidence to you, will happen.

Q289 Mr Love: I think the message coming clearly from all the sources that we have looked at is that you need to make it much larger and that you need to make it much larger now, but that is no doubt an issue that you will take up.

Finally, let me ask about your growth strategy. You could go for a bigger national loan guarantee fund. There was a lot of talk about infrastructure, and indeed you and the Prime Minister have both talked about it in speeches. Whatever happened to that growth strategy? One of the commentators this morning said that it seems to have been forgotten. Where are we in terms of a growth strategy that will make a difference to the real economy in the foreseeable future?

Mr Osborne: Again, I do not accept that characterisation. First of all, to give you an example, when I launched the growth strategy last year, I said that planning reform was a critical part of it and one of the absolutely central measures. A year later we have, with all the challenges of ensuring that it is properly consulted on and so on, implemented a policy that comes into effect today. No one, to my knowledge, has changed planning rules in this country in a generation as quickly as we have. If you look at the corporate tax rate, it is now aggressively lower than our main competitors, and that is being commented on around the world. The CBI said of our Budget that that is "the big game changer". Larger companies are getting a clearer signal that they need to invest in the UK, because we have the lowest tax rates of any major economy. If you look at the components of the growth strategy, which were things such as planning reform and other supply-side changes to regulation and the like, and if you look at tax reform, those things are taking effect. When it comes to investment in infrastructure, we have had the Chinese sovereign wealth fund confirming that it is investing and taking a stake in Thames Water. That is the first major western infrastructure investment, and I am very keen to get British pension funds investing as well.

Q290 Mr Love: One of the commentators this morning took a view similar to your own and suggested that we have to reconcile ourselves to a slow growth path for the economy. Is that what you are asking the British public to do?

Mr Osborne: Look, we are having to recover from a very deep recession—the deepest of our lifetimes—and from the largest banking crisis in British history, and we have the additional headwind of a sovereign debt crisis in our major export market, which we have avoided. So of course the recovery is a challenge, but I think that everyone knows that. The questions are whether we are taking the right measures and what the alternatives are. The suggestion that I sometimes hear, which is that we spend a few billion pounds more and have a temporary cut in VAT and that somehow magically solves Britain's economic problems, is a little bit simplistic.

Q291 Chair: You said earlier that you had a strategy for tax reform, which you set out a year ago. John Whiting told us this morning that, while 100 pages had been removed from the tax code, over 300 pages had been added. That does not sound like tax simplification or tax reform.

Mr Osborne: I am keen to make the tax code simpler, and John Whiting is helping, through the Office of Tax Simplification, to do that. You will find in the Finance Bill that a great amount of the pages and clauses in it are around changing the tax regime for insurance companies, because of the solvency II directive. The other bit that takes up the bulk of the Finance Bill is changes to the controlled foreign companies regime, so these are complex areas of tax law and they replace some existing tax law.

Q292 Mr Mudie: You said in response to Mr Love that, in enhancing growth and increasing jobs, the heavy lifting is done by the Monetary Policy Committee through the Bank of England. That is not how we see it on this side of the table. Every time the Governor comes before us and we press him on jobs and growth and measures related to them, he says that it is a matter for you. He says, "I am here for monetary policy linked to the inflation target"—which might be useful—"but for jobs and money going into the economy, it is the Chancellor."

Mr Osborne: The Bank of England has the important role of supporting demand consistent with its inflation target. The Governor of the Bank and the Monetary Policy Committee believe they are doing that, but I would argue that as the output gap as calculated by the OBR shows, there is room for accommodative monetary policy. I have always believed and have consistently argued this for years—by the way, until the very last part of the last Parliament, it was the view of my immediate Labour predecessors and indeed, we have mentioned Nigel Lawson, going back to the Mais lecture. There has been a consistent view in British politics for 30 years that demand is best supported by monetary policy.

Q293 Mr Mudie: Supported by monetary policy, but you and Alistair, through quantitative easing, wanted the Governor—the Bank of England—to put money into areas other than gilts, which would have helped the economy grow and would have got some liquidity into the real economy. The Governor has ignored you and Alistair Darling, so there is a paralysis on the jobs and growth side, while the Governor is sitting, using quantitative easing to help him meet his inflation target. Millions of people are unemployed, looking for help from either you or the Governor. The Governor is quite happy with what he is doing, and you are leaving it to him on the jobs and growth front.

Mr Osborne: I am not leaving it to him on the jobs and growth front. What I would say is that we are running a large—at the moment—structural deficit, which we are seeking to reduce, but we are not trying to balance the Budget in one year. We have a very accommodative monetary policy. We have introduced measures in this Budget that, for example, deliver a tax cut to millions of working people, to get some money into their pockets. We are doing a variety of things, but on your specific point, Mr Mudie, I would say that I accept the Governor of the Bank's argument that he does not want the central Bank involved in the sort of quasi-political fiscal space of buying car company assets, or whatever it is, and that he thinks that if he does that, he crosses a line and turns his central Bank into an instrument of politically controversial policy. When it comes to credit easing, it was clear that if the Government wanted to undertake it, the Government should undertake it—well, I have undertaken it.

Q294 Mr Mudie: I hear that, but in passing, I would say that in your letter to the Governor on quantitative easing, you referred him to Alistair Darling's list of assets that he could buy, which were much more than gilts. The Governor ignored you and Alistair, so help that could have been going to the real economy has not. However, if we are just looking at what you are doing, Andrew raised the issue of the loan guarantee scheme. The Breedon report reckoned this month that there would be a shortfall in small and medium-sized enterprise business funding of up to £190 billion over the five years. The response from the Treasury is to put £5 billion in this year. It sounds disproportionate, doesn't it?

Mr Osborne: First, we are putting £20 billion in over a couple of years.

Q295 Mr Mudie: Over three years, which means £6.5 billion—

Mr Osborne: Over two years, and I am very happy to increase that amount if the scheme is working. It is £20 billion of guarantees. We also have £1 billion of direct lending into a business finance partnership that is being established at the moment. If you are telling me that credit conditions are not what we would want them to be, as we survey the aftermath of this enormous banking crash, I would completely agree with you.

Q296 Mr Mudie: Two years now—it is getting a bit lame, isn't it?

Mr Osborne: To be honest, Mr Mudie, when you think what the British economy has been through and you look at how we have done, relative to some of our neighbours, I do not think actually—

Q297 Mr Mudie: If you are going to take refuge in something that happened two years ago, let's take you back—

Mr Osborne: Can I just say the thing that happened a couple of years ago was the largest banking crisis in British history and the deepest recession since the 1930s?

Q298 Mr Mudie: It has been the largest global financial crisis.

Mr Osborne: Well, if you want to characterise it as the largest global financial crisis in history, it reinforces my argument that if you think 24 months after that, you can just bounce back and everything can be hunky-dory, I suggest that that has not happened either here or in any other country.

Q299 Mr Mudie: George, let's take you back to your conference in October. When you were discussing credit easing, the scheme you stated to conference was that the Treasury would provide credit direct to companies through an arm's length operation, with the Bank of England acting as the Treasury's agent. Under the scheme, the Treasury will buy small firms' corporate bonds, providing cash directly to struggling firms unable to gain funds from the banks. Is that another one that the Bank of England turned you down on?

Mr Osborne: The business finance partnership that I mentioned, which is the £1.2 billion scheme, is the Treasury directly providing money into funds that lend to small businesses. The national loan guarantee scheme, which is the £20 billion scheme, is done through Treasury guarantees of lending, and we use the banks. When we considered how best to deliver the policy, it was clear that rather than try to establish an alternative bank funding network around the country, which would have taken at least a year and perhaps much longer, we should use the existing banks, but guarantee lending to them so that they could pass on low interest rates to small and medium-sized businesses.

Q300 Mr Mudie: The scheme that you suggested in October you were going to bring is suggested in the Breedon report. The real problem you had, apart from the Bank of England refusing to do it, was that it meant gathering up small firms' loans to make them big enough to securitise and get them on a market.

Breedon suggested that. You suggested it last October. Is it actively being looked at? When can we and the small firms expect this much-needed initiative to be in operation?

Mr Osborne: It is actively being looked at, and trying to restart the securitised market for small business lending is something that we are considering, but let's be clear: it completely shut because of the financial crisis. Securitised products were one of the main causes of the loss of confidence—people's lack of certainty about what was in them. Restarting it is not easy and I am not aware of any country that has successfully done this on a large scale since the crash. With small business lending, there is the particular challenge of people having enough information about the small businesses that are part of the package. Mortgages, at least, can be a bit more standardised. I am trying to crack that nut; it is a big challenge, but we are actively looking at it. That is why, rather than waiting until we had solved this problem—I think that the previous Government also had a report on restarting the securitised markets three years ago—

Q301 Mr Mudie: Was that the Major Government?

Mr Osborne: No, that was the Gordon Brown Government, which you supported so loyally, Mr Mudie.

Q302 John Mann: Chancellor, in the 22.5 months since you became Chancellor, by how much have petrol prices gone up in this country?

Mr Osborne: I am not sure that I know the exact price the day I came into office, but it is about £1.40 a litre today.

Q303 John Mann: So you do not know how much. I will give you a clue: £1 a gallon since you came in. Why, therefore, are you increasing it further?

Mr Osborne: Petrol duty today is 6p lower than it would have been if I had stuck with the plans that you voted for in March 2010, and from April will be 10p lower than it would have been if I had stuck with the plans that you voted for in March 2010.

Q304 John Mann: Is it true that you are taking £10 million a day extra in fuel duty since you became Chancellor?

Mr Osborne: The examination by the OBR into this last year showed that the effect on the public finances of increases in oil prices was basically neutral, because what we might gain in additional taxes on petrol duty, we lose in squeezed incomes and companies not having as much profit. I think that the Treasury Committee was very interested in this last year. We asked that independent body to look at that and it concluded that we are not net beneficiaries of an increase in the oil price. If anything, the overall impact on the economy is pretty deleterious.

Q305 John Mann: On drawdown pensions, my constituents, Mr and Mrs Matthews, have found out in the past seven days that, due to decisions that you made that you failed to correct in this Budget through previous Budgets, their joint pension has reduced in the past week from £30,000 a year to £13,000 a year—a 60% fall. There are 300,000 pensioners with drawdown pensions, who are suffering in exactly the same way because of gilt rates, but many of them, because of the vagaries of the Government Actuary's Department renewal dates, do not know it. Do you regard this 60% reduction in the pension of my constituents Mr and Mrs Matthews that you are responsible for through your decisions as morally acceptable? Secondly, do you regard it as practically acceptable for them to continue? If not, what are you going to do about it?

Mr Osborne: So that your constituents fully understand what you are suggesting, you are suggesting that interest rates should be considerably higher, that we should have higher gilt rates, that all of us should be paying—

Q306 John Mann: No, no, no.

Mr Osborne: That is the implication. You are saying that I am responsible for the low gilt rates. I am certainly trying—

Q307 John Mann: With respect, you are here to answer questions. I will be happy at another stage to say what I propose. I am asking what you are going to do about it.

Mr Osborne: Well, the implication of your question is that we should have higher gilt rates than we do at the moment.

Q308 John Mann: No. My question is what are you going to do about drawdown pensions and my constituents whose pensions have fallen by 60% this week?

Mr Osborne: What I would say to your constituents is that, of course, low interest rates are a difficult environment for savers but the Governor of the Bank made a very good point and, indeed, Charlie Bean also made this point recently: policies like quantitative easing have increased asset prices, including the value of pension pots. So there is a benefit, even to savers with pension pots, of asset price increases and it cannot be in the interests of anyone in this country that we have very high interest rates that throttle off any recovery and lead to higher unemployment.

Q309 John Mann: So we are all in it together and my constituents Mr and Mrs Matthews have a 60% reduction and there are 300,000 other pensioners in the country with comparable types—

Mr Osborne: Could I just say—

Q310 John Mann: If you are not prepared to do anything about it, I suggest—

Mr Osborne: The solution to this problem—

Q311 John Mann: I am asking what you are going to do about it.

Mr Osborne: To be fair to you, Mr Mann, the policy that you and your party advocate would, indeed, bring about a sharp increase in interest rates—

Q312 John Mann: No, Chancellor, you do not understand what you are paid to do. You are paid by the taxpayer to come here and answer questions. If you want to have a debate with me on party policy I am happy to have it outside afterwards.

Mr Osborne: Let me tell you what the Governor of the Bank said this year.

Q313 John Mann: I am asking you what you are doing.

Mr Osborne: Well, I agree with this: "Well, we could put up interest rates to 4%, 5% and then maybe the return on savings would appear to go up. But I'm absolutely confident that, if we were to do that, you would see that the value of assets, all financial assets would go down; that there would be a sharp rise in the exchange rate; that investment in consumer spending would fall; we would go back into a recession." That is not in anyone's interests in this country.

Q314 John Mann: There are a range of things you could have done on drawdown pensions. I suggest that this is your 75p tax issue and that you go away and think out an answer and write to me and other parliamentarians about it

Mr Osborne: The state pension under this Government is going up by £5.30 next month, not 75p as it did when you were in government.

Q315 John Mann: Mr and Mrs Matthews and 300,000 others are losing massively. Let me ask you a question at the other end of the scale. When was the last time you bought a pasty in Greggs?

Mr Osborne: I can't remember the last time I bought a pasty in Greggs, to answer your question.

Q316 John Mann: That kind of sums it up. As you are putting up the price of hot pasties in Greggs, if I buy a pasty from Greggs that is cooked hot, but by the time it gets in the paper bag and I take it away it is cold, will it be vatable or not?

Mr Osborne: If it is cold when you buy it, it will not be.

Q317 John Mann: So if they do a hot pasty that gets cold, that will not be vatable.

Mr Osborne: The intention was very clear.

John Mann: If that is clear—

Mr Osborne: Hold on; let me just say. In 1984 Parliament decided that hot takeaway food should have VAT on it. Now, in the years—

John Mann: We are asking about your Budget.

Chair: John, let the Chancellor explain the position on hot and cold pasties, because this is a matter of burning significance in the west country.

Mr Osborne: Burning is partly the issue. In 1984, 30 years ago, there was an intention to make sure that hot takeaway food was vatable. Since then, under all Governments, there has been a load of legal action to try and get around that. Lots of reasons have been given for why some hot products are not designed to be hot when they are eaten. I am seeking to—of course, this was voted on last night by Parliament—just stick with the position that hot takeaway food has VAT on it. If you buy your pasty in a fish and chip shop, it almost certainly has VAT on it. If the pasty is heated up in a microwave in the shop, it has a VAT on it. What we are trying to do is make sure that hot takeaway food has VAT on it. That was a decision made in 1984, 28 years ago.

Q318 John Mann: In your consultation document, with the weather as it is today, a lukewarm pasty from Greggs is not vatable, because the ambient temperature outside is the reference point, whereas if it is in the middle of winter and freezing cold, it is vatable. It is an extraordinarily complex situation, isn't it, when you have to check with the Met Office on whether or not to charge VAT on pasties in Greggs? That is what your consultation document does.

Mr Osborne: I'm surprised that you didn't therefore choose to vote against it last night—you didn't.

I will just point this out. It is the intention when there is hot takeaway food to have VAT. That is a perfectly simple thing for people to understand. The way we operate with companies, large retail chains and the like, is that we do not do as you suggest, in the tax system you would want to run, which is a check on every single product sold. We come to an arrangement with a company—a sensible arrangement between Inland Revenue and the company—about what proportion of its products are sold hot. We do it like that. There are perfectly sensible ways of working this out.

Q319 John Mann: Indeed there are.

My final question is a very simple one—a yes or no will do. In your Budget, you described tax avoidance, which of course is the legal, rather than the illegal, avoidance of tax, as "morally repugnant". Will you therefore be repaying the capital gains tax that you avoided when you flipped your home?

Mr Osborne: No. The Select Committee on Standards and Privileges looked into this and cleared me. It is exactly that sort of personal attack that has come to characterise your questions on this Committee every time I appear before you.

Q320 John Mann: You're the one who raised morality—

Mr Osborne: There was a parliamentary Committee that looked into that three or four years ago—whenever it was. You can read the conclusions of that. As I say, it is absolutely typical of you, Mr Mann, and that is how you behave yourself every time we appear on this Committee.

Chair: Chancellor, this is not the Committee in any case in which we would want to be asking those questions.

Q321 John Thurso: May we return to your fiscal policy? What have you identified as the major risks to achieving the fiscal target?

Mr Osborne: I guess I would agree with the OBR. First of all, I do not think the euro crisis has disappeared. I think the action from the European Central Bank is extremely welcome, but that is not a long-term solution to the problem. I think that high oil prices are a cause of concern for every western Government at the moment, and indeed other Governments. I think there is also the challenge that the OBR always puts to us, which is whether we have properly assessed—it includes itself in this—the depth of the effects of the financial crisis.

Q322 John Thurso: With regard to the eurozone, which is the greater worry—the financial crisis or the trading implications, if they are sluggish or in recession?

Mr Osborne: I think the financial crisis, as you saw at the end of last year, has potentially the most catastrophic effects. Of course they are connected, and you want these economies growing in order to reassure people that they can pay their debts. But I think the fear last autumn, which was very clear at the time and I think is also clear now, was that there was going to be some catastrophic event—either a collapse of a eurozone bank or a failed sovereign debt auction for one of the peripheral countries. In November or December, that was a very acute fear. You can see that the impact on business investment in this country, let alone in eurozone countries, was pretty acute.

Q323 John Thurso: May I turn to one of the announcements that took some of us by surprise? That was the announcement you made of an extra £10 billion of welfare savings that would be required in 2016–17. What work have you done to look at the area that those savings should come from?

Mr Osborne: That work is starting now. Let's be clear: the £10 billion figure is the figure if you assume similar spending rates for the Departments. That leads you to the calculation for AME savings. That is the £10 billion; it will only confirm that number in a spending review. I thought it was a good guideline for both Government and Parliament to work off. In other words, if we don't do anything about welfare bills, this country is going to find itself again running a high deficit, unless there were a very dramatic increase in taxation. We have to tackle that head on. If we want not to put additional pressure on Departments—more than they have seen in this spending review—that is where you get the £10 billion figure.

Q324 John Thurso: Does that welfare include pensions and benefits? Is it the complete welfare?

Mr Osborne: Yes, it is all annually managed expenditure. So, that is all parts of welfare, all transactional payments and, indeed, other things such as contributions to the European Union.

Q325 John Thurso: So, we have the triple lock on pensions, which will provide, as we wish, an upward pressure. We are moving to the universal credit, which will also hopefully add to the fairness of the system in due course. Where is the deliverability of an extra £10 billion, given the pressures we have already decided upon?

Mr Osborne: As I say, this process is just starting in Government. I hope to provide an update on this at the autumn statement. This is the work for the next spending review. We need to start the big thinking on future welfare reform, having undertaken very significant welfare reform with the Welfare Reform Act that has just become law, and the introduction of universal credit. I am saying that the job is not done. It is right that Parliament and the public, and not just Whitehall, focus on this issue.

Q326 Chair: Could you explain why you introduced an export target into the Budget, rather than a net trade target?

Mr Osborne: I thought it was a good ambition to set the Government. It was recommended to me by Stephen Green, who has been an excellent Trade Minister. He thought that would help lift the eyes of Government Departments to what more they could do to promote exports.

Q327 Chair: Why only exports, rather than net trade?

Mr Osborne: Because in the end we can have a more direct impact on the promotion of British exports. I think the net trade figure is more difficult for the Government to target.

Q328 Chair: If exports rise by £1 trillion and imports rise by £1.2 trillion, you would not be so happy with the export target, would you?

Mr Osborne: It is much simpler to get Government focused on what they can do to promote exports.

Q329 Chair: Is it a real or nominal target?

Mr Osborne: It is a nominal target.

Q330 Mr McFadden: I want to ask you about the child benefit changes, Chancellor. You introduced this sliding scale between about £43,000 and £60,000 for people to lose their child benefit. You didn't deal with the anomaly that a couple where one partner earns £60,000 or above will lose all their child benefit, but another couple, where two partners are earning £49,000, I believe, will keep it. Why is it fair for one household where the total income is almost £100,000 a year to keep child benefit, but another household where the income is £60,000 a year to lose all of it?

Mr Osborne: First, between the higher rate threshold and £50,000 they keep their child benefit. We are talking about when someone in the family has an income of over £50,000. The child benefit is then in effect tapered away through a tax charge. The alternative, implied in your question, is to assess total household income for people on household incomes of £40,000, £50,000, £60,000, £70,000, which is not something that the Government do. We would have to create an entirely new system to assess the total household income of 6, 7, 8 million people. I do not think we need to do that. Let me be blunt: we do not assess the household income of anyone sitting around this table. The tax system does not do that because the welfare system does it. Of course, people on higher incomes are not in the tax credit system or the welfare system.

The only way to remove child benefit from better-off families in a way that assesses household income is to create a system that means-tests every household and assesses every household income. I thought a simpler thing to do was to say, "If someone in your family has an income of over £50,000, we will taper away your child benefit through a tax charge." That is a much more administratively simple way of doing it than means-testing every single household in the country.

Q331 Mr McFadden: But HMRC estimates that, as a result of what you have just outlined, an extra 500,000 people will have to fill out self-assessment forms. This is hardly a simplification, is it? We heard this morning that this adds significantly to the complexity of the tax system.

Mr Osborne: Once you accept the premise—of course, there are some people who don't accept the premise—and take the decision to remove child benefit payments from better-off families, and we are talking here about the top 10% of families by income, you then have to consider how best to do it. The alternative implied by your question would put 7 million or 8 million people into some form of household means test requiring a complicated form. Now, some people argue that we should not be taking money away from these people at all.

Q332 Mr McFadden: That is not what I am arguing. Some households earning almost £100,000 will keep it.

Mr Osborne: My Labour opposite number makes that argument. I have to tell you that, without the child benefit change, people in the top 10% or 20% of the income distribution would not have made, in terms of the fiscal consolidation, any significant contribution. In other words, all the other changes would affect people on lower incomes. This is the one measure that affects people on the highest incomes, and I thought it was perfectly reasonable to ask people in the top 10% or 15% of the income distribution to make a contribution to the spending component of the consolidation.

Q333 Mr McFadden: Let me ask you about another cliff edge much further down the income scale. One of the measures that you didn't change in the Budget but that is just about to come into force is the cliff edge for families with children where a parent works part time between 16 and 24 hours a week. Families in those circumstances are going to lose £3,800 a year in tax credits. Their average incomes are around £17,000 or £18,000 a year. The benefit to such families of changing the personal tax allowance is, I think, about £170 a year. These are, I stress, families in work. These are benefits for people in work. You said that the Budget was a Budget to encourage work. How can it encourage work to take away almost £4,000 a year from 200,000 families working part time?

Mr Osborne: I completely accept that dealing with a budget deficit requires some very difficult decisions. The tax credit bill had gone up from £18 billion in 2003 to £30 billion by 2010. If you can propose to me a way of dealing with a 10% or 11% budget deficit without touching welfare spending—you and your party voted against the child benefit changes last night—and without touching a £30 billion tax credit bill, I have yet to hear it. These are difficult decisions. Of course, the cliff edge to which you refer exists at 16 hours, and it exists for lone parents at 16 hours and was introduced for couples by the Labour Government at 16 hours. We are not asking lone parents to work more than 16 hours, but we are asking couples to work more than 16 hours between them. Given the difficult decisions we have to make across the board, it is a reasonable thing to ask.

Q334 Mr McFadden: The purpose of welfare reform should be to encourage work. The effect of these changes if the families cannot get extra hours—surely you accept that in a constituency like mine, which is among the top 20 in the country for unemployment, getting extra hours of work is not easy—will be that many of these families will be better off on the dole. Surely the purpose of welfare reform should be to make work pay, rather than make the dole pay.

Mr Osborne: I completely accept that the welfare system is not doing enough to encourage work. That is why we are introducing universal credit. The tax credit system has very high marginal withdrawal rates. That is why we are replacing it with the universal credit system. But your arguments about the cliff edge, frankly, are arguments you could apply whether it was 16 or 24 hours. They are exactly the same argument. I would say—let me put it this way—it was rather strange that the previous Government had decided that a single parent should work 16 hours and a couple should also work 16 hours.

We have not changed the hours requirement for the lone parent, but we have changed it for the couple. I completely accept that these are difficult decisions, but if you are not prepared to tackle the tax credit bill and you are not prepared to tackle child benefit going to better-off people, and if you voted against the changes to benefit uprating from RPI to CPI, what exactly are you proposing that we do to deal with the fact that we were borrowing £1 in every £4 that we were spending?

Q335 Mr McFadden: We will probably come on to discuss the 50p rate in some detail in this session, but I will end with one question on it. Do you not think people will find it odd that the argument about the 50p rate is that to encourage work among not just the top 10%, but the very top earners above £150,000, we should cut their taxes and put more money in their pockets, but to encourage work among people who are earning £17,000 or £18,000 a year, it is necessary to impose a cut in their incomes of £4,000 a year? How do you think that makes the Government look?

Mr Osborne: I would argue that the purpose of universal credit is also to reduce these high marginal tax rates that exist in the welfare system, so we are also trying to improve work incentives for people on welfare. I do not know whether you want to begin the discussion on the top rate of tax, but for Britain to have a top rate of tax that is higher than in France, Italy or Germany, that Robert Chote and his independent body assesses costs £100 million to reduce from 50p to 45p, and that is only the direct cost—indeed, the indirect cost in terms of forgone VAT receipts may mean it raised absolutely nothing, the gap between 45p and 50p—if we want to carry on with that rate just because it looks good on our press release, but makes our country deeply uncompetitive and damages jobs and growth in our economy, fine. My predecessor took the view that it should be temporary. I took the view that it should be temporary. We are removing it once the public sector pay freeze comes to an end next year. As I say, if you felt so strongly about it, Mr McFadden, you should have voted against it last night, as indeed your SNP colleague sitting next to you did.

Q336 Mr McFadden: I will just remind you of what your predecessor said in the debate last night. You are right—he did say he thought it should be temporary, but he also said he would not have withdrawn it when asking those further down the income scale to continue to make the kind of sacrifices that you are asking them to make, so I do not think he can be prayed in aid for the Budget that we have before us.

Mr Osborne: The question was should Britain continue with a tax rate, which had been identified around the world as deeply uncompetitive and a deterrent to investment in Britain, simply to make Members of Parliament feel good that somehow they were levering a rate, which we know people were not paying. That work has been done independently of me. What I have instead tried to correct are abuses that have existed for years in the tax system, where people were able to claim unlimited tax reliefs to reduce their income tax rate to zero, not 50p to 45p, but people on incomes of £5 million or £10 million a year reducing their income tax rate to zero.

What I am trying to do is tackle those uncapped reliefs and make sure that we have a competitive top rate of tax. I think that is a fair way of dealing with the tax system. My numbers are audited by Robert Chote, and the score card shows that we are raising five times as much money from the wealthiest people in our country through the tax measures we announced in the Budget.

Q337 Michael Fallon: Continuing with the 50p rate, were you surprised by the HMRC study showing that the underlying yield was so much lower than originally forecast?

Mr Osborne: I am not sure I had a particular expectation in mind of what it would reveal, although it was pretty clear from all the surveys done of the British economy and all the conversations that have been had with some of our big FTSE companies that it was having a very serious impact on our competitiveness.

Q338 Michael Fallon: This survey is only of one year, isn't it? I asked the OBR more than a year ago what work they were doing on the dynamic effect of tax changes. Are you going to continue to look at the effect of the new top rate in the same way that HMRC has done for the 50p rate?

Mr Osborne: First, at every fiscal event the OBR assess how much money they are getting from particular taxes, so there will be an ongoing assessment of how much revenue we have raised from 45p, and HMRC in their document talk about that. I think there is an interesting question about whether the Treasury should undertake more work on dynamic scoring, in other words trying to take into account more of the economy effects of different tax rates. I am not proposing we change the way the score card is calculated, and I am not proposing we change the way that the OBR does its work—I think we should be cautious about making these changes—but I think the Treasury can now, and I have asked for this to happen, start undertaking some real research into dynamic scoring and what the broader-economy effects are of changes to taxation.

Q339 Michael Fallon: The 50p rate was described by your predecessor as temporary. Do we now assume that the 45p rate is permanent?

Mr Osborne: I keep all taxes under review, which is what all Chancellors say. The 50p rate was assigned a special status by my predecessor, and by me, of being temporary. I do not assign a special status to the 45p rate. It is now, like all other tax rates, something we keep under review.

Q340 Michael Fallon: So it could change in the future?

Mr Osborne: It could change, and it could not change. It is like any rate of income tax. My predecessor gave it a special label. He did not say that the basic rate of income tax was temporary, although he might, if he had continued in office, have changed that. He did say that the 50p rate was temporary, and I repeated that language. I am not ascribing to the 45p rate any special status. Like all tax rates and allowances, we will keep it under review.

Q341 Michael Fallon: Given the need to make us more internationally competitive, wouldn't it be simpler if we eventually simply moved to two rates?

Mr Osborne: Well, as I say, we keep all tax rates under review.

Q342 Michael Fallon: You said it would cost £100 million to reduce the top rate to 45p, and the OBR looked at that. How certain of that figure are you?

Mr Osborne: The OBR described it as a reasonable and central estimate. First, this was work done by the HMRC, and the OBR looked at it and came up with this being the central and reasonable estimate, which is what you would ascribe to any of the costings in this document. There is no special status ascribed to the costing of the 50p measure compared with any other measure in the Budget.

Q343 Mr Ruffley: Chancellor, on 50p, the HMRC study says, "The longer the additional rate remains in place the more people are likely to consider it a permanent feature of the UK tax system and the more damaging it would be for competitiveness. This suggests the negative impact on GDP may increase over time, and therefore the direct yield…might fall over time toward or beyond zero." For those of us who applauded your reduction of 50p, if it fell to zero, would you abolish it?

Mr Osborne: Mr Ruffley, you and I, and perhaps others on the Committee, are people who want to have lower taxation. I want to do it in a way that is sustainable and that the public finances can support, but I am not going to be drawn on the future status of the 45p rate. Like other tax rates, it is under review.

I would say this, also; I think there was something particularly damaging about having a 50p rate of tax. I do not think that applies to a 45p rate of tax. I think we now have a competitive top rate of tax if you look at how it compares with France, Germany or Italy. I do not think it is sustainable for this country to have a higher top rate of tax than France. Indeed, the President of the French Republic was making a joke about how high the British personal tax rate was just a few months ago, so it was certainly noticed on the continent. We now have a pretty competitive top rate of tax vis-à-vis our continental neighbours. The top rate of tax in the United States, depending on which state you live in, is lower. But as I say, I am not going to be drawn on, "Could we cut this in the future, or could we cut that?" I would like overall levels of taxation to be low.

Q344 Mr Ruffley: Finally on this, HMRC said that it could go beyond zero—in other words, it would actually have a negative effect. At that point, is it not almost true by definition that a Chancellor would not keep a tax that was costing the economy dear?

Mr Osborne: I think what the Revenue was specifically looking at in this regard, when it came to the costing, was the cost of cutting to 45p. It scored that as the direct cost of that to the Exchequer of £100 million. In this document, it then says that the indirect cost, in VAT receipts, is of up to £130 million that were forgone as a result of the 50p rate. That is why you can come up with a less-than-zero costing. We just had the direct static cost, in this Red Book, of £100 million. As I said in the Budget speech, no Chancellor of the Exchequer can justify a deeply uncompetitive top rate of tax that is raising next to nothing.

Q345 Mr Ruffley: Sure. On age-related allowances, you raised £360 million in the first year, £670 million in year 2 and £1 billion in year 3. In the great scheme of things, those are not huge numbers. Yet there was a staggeringly negative response. Were you surprised by that response?

Mr Osborne: Well, I guess my responsibility is not to write the newspaper headlines the next day, but to try to come up with a Budget that I think is the right one for the country and, particularly at a time like this, makes us more competitive and balances the books. As I made clear in the Budget speech, there were savings involved in this policy and, in the interviews afterwards, I also drew people's attention to the £5.30 increase in the basic state pension that is coming next month. Of course no one likes it when their allowances are frozen. We have frozen child benefit and we have frozen some of the tax credit rates, and these are all difficult decisions.

Q346 Mr Ruffley: But if you had your time over again, do you think it was worth the row for, in year 1, £360 million?

Mr Osborne: Well, you read out the figures. It increases to about £1.2 billion by the end of the score card. That is a significant saving. We are doing this in a way that will simplify the tax system. The National Audit Office and the Office for Tax Simplification both pointed to the complexity of the system. We are doing it in a way in which there are no cash losers—people have their allowances frozen—and we are also not handing out new allowances next year. But we are also doing it at a time, and this was very much part of our thinking, when we are rapidly increasing the personal allowance so that, in a few years, everyone can be on a single personal allowance. When you have a bit of the tax system that is identified as complex and there is an approach that you can take that deals with that, it is worth looking at.

Q347 Mr Ruffley: What about the argument from many pensioners that they feel they are taxed twice—they are taxed on their earned income and then, if they are over a certain threshold, they are taxed again on their retirement income. Why is that something you did not take cognisance of?

Mr Osborne: As I say, I would not say that I am fundamentally changing the basis for the taxation of savings. There is an age-related allowance, which was identified as a complex part of the tax system. We have frozen the rate; we have not, for existing holders of age-related allowances, abolished it. The rapid increase in the personal allowance has afforded us a moment to do this.

Q348 Mr Ruffley: On philanthropy, I hope that we all, on this Committee, can agree on one thing—that philanthropic giving and charitable giving is a good thing and, indeed, part of the big society. Have you made an estimate of what will happen to charitable giving in total as a result of capping income tax allowances, as you have chosen to do?

Mr Osborne: First, as I identify in the Red Book, there is a potential issue around large donations to nationally important cultural institutions and the like. We are going to look at this and consult on it. *[Interruption.]* We are looking at the big-end philanthropy. Let me remind you that under our proposals—we are consulting on them this year—if you have an income of £4 million, you can give £1 million to charity. Of course, you can give as much as you want to charity, but you can give £1 million with tax relief.

I suspected that this might come up, so I asked the Inland Revenue to give me stylised examples of the tax affairs of some very wealthy people. They are stylised examples; they are not individuals. I, like any previous Chancellor, am not allowed to know the tax affairs of any individuals. Here are illustrative examples that I have received from the Inland Revenue of some of the kinds of things it sees. An individual—a stylised individual—can have an income of £10 million. Under the tax system that I inherited, they could claim loss relief for £5 million, charitable relief for £4 million and qualifying loan interest of £1 million. Their average income tax for the year is 0%, so they pay no income tax whatsoever. I have another example to give the Committee. Again, these are examples based on analysis of some of the top 20 claimers of income tax reliefs, but they do not involve actual taxpayer details. We have a stylised example of someone who, with an income of £10 million, could claim loss relief of £5 million and charitable relief of £5 million—tax due: zero; average income tax rate: zero.

That is the tax system that we have at the moment. I think it is very difficult to justify people having 0% tax rates when they have very high incomes. I am not setting a minimum tax rate. I looked at that, but it would be extremely difficult to enforce. Of course, people can save into a pension. We want to encourage people to save into various venture capital and enterprise management schemes. All I am doing is capping currently uncapped reliefs, like loss relief and charitable giving relief. That will mean that people on incomes of, say, £10 million will not be able to reduce their income tax bill to 0%.

I think that was a fair change to make, particularly at a time when I was taking a decision to cut the top rate of income tax from 50p to 45p, even though it raised no money—or close to no money, depending on which view you take. It is an important change. I will look specifically at large philanthropic donations to charitable institutions. I should also say that if you make a one-off donation, you can use the allowance for several years on it. I just think it is difficult to justify 0% rates of income tax for some of the wealthiest people in this country.

Mr Ruffley: That is very helpful. Thank you.

Q349 Stewart Hosie: Chancellor, on the 50p, generally, before any detail, given that people who are earning very modest wages may lose tax credits and have been subjected to wage freezes, and that middle-class families who are losing child benefit have been and will be drawn into paying a 40p tax rate when they were not previously, do you understand why people in general are angry and confused that you are seeking to remove the 50p tax rate at this time?

Mr Osborne: I thought it was very important to demonstrate that we were asking for more money from wealthy people. You can introduce a 50p tax rate, as the previous Government did, and you can live with a system in which people are paying 0% income tax on very high incomes, but is that a fair system? Isn't it better to try to give yourself a more competitive tax rate, so that you do not have a higher tax rate than France or Italy, but you do have people on incomes of £10 million or £20 million paying some income tax? I thought that was the fair and right thing to do. In the end, my responsibility is not to write tomorrow's headlines, but to try to come up with Budget policies that give this country a fighting chance in a very, very competitive global economy for the coming decades, and I think that I have done that.

Q350 Stewart Hosie: Let us look at some of the detail on that. The Revenue report on the 50p rate did identify substantial forestalling. It did identify significant yield reduction on the basis of an assessment of self-assessment returns. But, given if there were to be forestalling on a high rate of tax, it would be done in the early year or years anyway, and given that self-assessment returns are likely to show a lower yield because of the downturn anyway and that this was a temporary measure accepted by all of us, why did you not allow the 50p rate to run on for some time to see its forestalling unwind and the yields increase as the economy recovered?

Mr Osborne: As the document makes clear, it is by no means certain—far from it—that you get all the forestalled income back. People make permanent changes to their tax arrangements. They shift their income into capital gains. You do not need reminding, Mr Hosie, but I inherited an 18% rate of capital gains tax so people who were living off capital gains were paying lower tax rates than the people who cleaned for them. That was headlines in the papers. We have changed that.

You can shift your income into other forms of income, like capital gains. There were examples of people leaving the country and, when it came to the self-assessment returns, if you looked across the board at different taxes—corporation tax receipts, VAT receipts and so on—they were not below forecast. What really stuck out was that the self-assessment returns were below forecast, so you would have expected a general-economy effect on tax rates to follow your logic. We didn't see that.

An important part of the work of the HMRC is to look at some of the academic evidence. It discovered that the Labour Government, when they were costing this policy—ultimately, it was a ministerial decision—used a taxable income elasticity of 0.35, which is right at one end of the academic evidence. There is evidence that it can be 0.7 if you go to the United States. We have plumped for, and the HMRC has recommended, an absolutely standard rate of 0.45, just below the Mirrlees review by the IFS. By the way, if I had gone with the Mirrlees review of the IFS, I think I could have reduced the costing to zero in the Red Book, but we thought it was sensible to go with 0.45 and Robert Chote thought that was a central and reasonable estimate.

Q351 Stewart Hosie: Let us ask you about the costing. The Red Book says costs of £100 million, but the Revenue says yield of £1 billion or less, implying a range of lost revenue between £100 million and £1 billion.

Mr Osborne: That is the cost of 50p—sorry, that was the revenues raised from raising the tax rate from 40p to 50p. That is not the—I have reduced the rate from 50p to 45p. Even the previous Government conceded that, on their estimates, two thirds of the revenue would have gone in a sort of static costing and, taking into account no other factors, would have been lost by raising the tax rate from 45p to 50p.

Q352 Stewart Hosie: Even if we accept that argument about the cost of £100 million, I am slightly at a loss to determine why in the current circumstances you would have implemented a policy that loses you £100 million of revenue yield.

Mr Osborne: If you are going with £100 million, you also have to go with the evidence in the report that the lost VAT receipts as a result of the policy were £130 million for the Exchequer—a minus £30 million impact. As I said, you can take measures that raise around £500 million in the Red Book, again independently audited. It is not entirely my decision. Robert Chote checks the numbers and sees whether they are central and reasonable estimates. He did not take measures that stop some people on very high incomes having 0% income tax rates. Surely, that is sensible tax reform.

Q353 Stewart Hosie: You keep arguing that there are these very wealthy people who have managed to avoid paying tax at all. If it were worth their spending a lot of money on lawyers and accountants to avoid paying tax of 50p and end up paying zero, presumably it is equally worth their while avoiding paying tax of 45p and ending up paying zero. I do not understand how you can have an implied tax yield for those very wealthy people that goes from zero to something higher, when they are managing to avoid it entirely at the moment.

Mr Osborne: I am introducing caps on the currently uncapped reliefs in income tax in order to deal with that issue. The truth is that, when the previous Government raised the tax, he initially said that it would have a 45p rate. Before it even came in, they raised it from 45p to 50p. There was something material about a 50p rate that sent a negative signal around the world. You can pick that up in any international survey of international competitiveness or any commentary on the British economy over the past year. We have got to a situation where we can have a competitive rate of tax of 45p and we can raise more money from wealthy people. Surely that is what you want at a time like this: you want a competitive economy, where everyone is paying their fair share. I have increased the amount of money coming from wealthy people and I have given us a more competitive economy.

Q354 Stewart Hosie: I understand the issue of competitiveness; everyone should pay their fair share. Looking at these numbers, however, the raw numbers show that there is a cost to reducing the 50p rate of £100 million. Let me ask you this: if the vote last night—it was No. 5 or 6—had gone against you, would you have found another way to lose £100 million?

Mr Osborne: Well, I was fairly confident that we were going to carry the vote, because of all that discussion in the coalition, which we talked about near the beginning. It was definitively helped by the fact that the Labour party chose not to vote. The shadow Chancellor told the House of Commons last week that there would be a vote this week and that the Labour party would vote against it. I have the resolution that was on the Order Paper. The SNP, Plaid and some others voted against, but the Labour party went home.

Q355 Teresa Pearce: On the 50p tax rate, we have just had a discussion of its costs, which is offset by what is accepted to be behavioural change. What I gather from what you have said, Chancellor, is that the figures in this book are HMRC's figures, which have been audited by Robert Chote. In that case, Sir Nicholas, could you explain to me what it means in a booklet like this when it talks about the Government's view?

Mr Osborne: Can I just say that this document is produced by HMRC? We used this document to get the £100 million costing that we use in the Red Book.

Q356 Teresa Pearce: So this is the first document.

Mr Osborne: This was an HMRC document, which we showed to the OBR. The £100 million costing in the score card—the static, direct costing—is what the OBR have decided is central and reasonable. It has not audited this document; it has audited the number that we use this document to derive.

Q357 Teresa Pearce: So, Sir Nicholas, what does it mean when it talks about the Government's view?

Sir Nicholas Macpherson: It means precisely what it says.

Q358 Teresa Pearce: Does that mean that it is not HMRC's view? It is Ministers' view that this is the assumption on behavioural change and income elasticity.

Sir Nicholas Macpherson: I think that it is fair to say that the convention in these things is that the Government are indivisible.

Q359 Teresa Pearce: Is that right?

Sir Nicholas Macpherson: You don't publish documents that say, officials think this and the Government decides that.

Q360 Teresa Pearce: No, but you would say "we" or "there is".

Sir Nicholas Macpherson: Let us be totally clear, because having been here for this costing and having been in charge of the official Treasury in 2008 and 2009, this costing is a best estimate of Her Majesty's Revenue and Customs and does not reflect political interference any more than the costing last time round reflected political interference from Alistair Darling.

Q361 Teresa Pearce: So we have actual costing, which is what you can actually estimate, and then we have the presumption of behavioural change.

Sir Nicholas Macpherson: I think this is a reflection of how both Her Majesty's Revenue and Customs and the Treasury have improved their approach to costings. If you go back to Dennis Healey, the last time that we put up income tax was in 1975. If you went back to the Red Book of the day, there would be no attempt to build in behavioural responses. My recollection—I may be wrong—is that there was no attempt in 1979 or 1988. The costing in 2008 was recorded by the then Chancellor, Alistair Darling, as being cautious. With the benefit of hindsight—we weren't to know—it turned out not to be cautious enough. We assumed that two thirds of the revenue would disappear through tax planning. As the document sets out—we now have real evidence—something like 83% or 85% disappears through behavioural responses.

Mr Osborne: Mr Bowler wants to say something, because he is the director of the Budget and this is the first time that he has been before a Select Committee.

Chair: He ought to be given a go.

James Bowler: I think I can answer your question. The document, up to page 48, is HMRC's analysis of the yield that is received from the increase to 50p. Having got that analysis, we then have to take a decision as to what we want to do in this Budget, which is to reduce 50p to 45p. Annexe A, from page 48 onwards, sets out what the Government intend to do. I am hoping that that is the answer to your question.

Q362 Teresa Pearce: Thank you. I have listened very carefully to what the Chancellor has had to say in the Chamber and here today, and it appears that you set great store by the fact that these figures have been ratified by bodies other than yourselves and by Robert Chote. Yesterday, however, when I asked him when he got the analysis from HMRC, he said that they had been discussing them for some weeks before we knew what the Government were going to assume. That leads me to think that this assumption about behavioural change is actually yours and not HMRC's and not the OBR's.

Mr Osborne: The way the system works is that the costing that the Treasury wants to put on something is ultimately a ministerial decision. Ultimately, the decision of what number appears here is a ministerial decision. Now, I base that on advice that I get from officials and this work done by HMRC. The crucial difference between myself and my predecessor is that if Robert Chote does not think that is a reasonably and central estimate, he tells us and does not accept the costing. I think the legislation gives me the power to override him and proceed with it anyway, but—by golly—you would know, because all the controversy over the last week would have been that Robert Chote does not think it is a reasonable and central estimate. The big difference therefore in this aspect of Budget making is that I still have to produce the costings, and that is what the annexe does, but—

Q363 Teresa Pearce: So the figure for behavioural change is yours.

Mr Osborne: Well, I have used the evidence from HMRC about the self-assessment forms. I have used the official estimate provided to me within the Treasury, and I looked at that. We have put that forward to the OBR. They think that is a reasonable and central estimate, having also studied all this to see whether they thought it was a reasonable and central estimate and having made their own judgments. That is very, very different from the costing—I do not want to put Sir Nicholas in any kind of position—done when the tax rate was increased, which was a ministerial decision not audited by anyone. There is a difference.

Teresa Pearce: I can see that there is a difference, Chancellor.

Mr Osborne: There is one other thing. What the OBR decides entirely by itself—it is not a bit of the document that people tend to read—is what they think the receipts are from different taxes. That is their estimate.

Q364 Teresa Pearce: But they were wrong in that last November.

Mr Osborne: Well, they did not have any evidence to change what they had inherited, because the self-assessment tax receipts had not come in. They only came in this January for the first year of operations.

Q365 Teresa Pearce: And they were surprised by those receipts.

Mr Osborne: And they were very surprised by them. They were surprised and they looked into the costing done by the previous Government and made their own judgments. There is an independent element to it in terms of the fiscal forecast. There is an independent element in terms of the auditing of the number that I submit to the OBR. This is how Budget making should be. You can examine the process as much as you like, but the truth is that this was a tax rate that was introduced to put a good headline on a press release. It raised next to no money at all. It allowed a tax regime to continue where people earning £10 million or £15 million were paying 0% income tax, and I have changed that in this Budget.

Q366 Teresa Pearce: Thank you, Chancellor, but that was not the question I asked you. The question I was asking you was, is the assumption about the behavioural change your assumption, or that of the HMRC or the OBR? I can see that we are not going to get anywhere with that.

Can I ask you another question—

Mr Osborne: Well, it is drawn from the HMRC report.

Teresa Pearce: Which includes your figure.

Mr Osborne: The HMRC report is the HMRC's report, and Annexe A is the Treasury's—not the HMRC's—costing. I did not ask the HMRC to tell me what the cost of cutting is. The report is not about the cost of cutting from 50p to 45p. This is the Exchequer effect of the 50% additional rate of income tax. From this work, I then derived a costing of a Budget policy measure, which was to cut from 50p to 45p, and then I asked Robert Chote whether that was a central—

Teresa Pearce: Okay. Can we move on to my next question—

Mr Osborne: I asked Robert Chote what he thought, and he told us he thought that it was a central and reasonable estimate.

Q367 Chair: Before we move on from that point, may I just chip in to clarify the point that I think Teresa was trying to get at? Was there ministerial supervision of the construction of Annexe A? By that I mean Annexe A of what you have described as the HMRC document. For example, was chart A1 constructed after a ministerial view had been obtained as to what it should present? That is three different Laffer curves, the central one being the one that you chose as the basis for your assumption.

Mr Osborne: To the best of my knowledge—I can write back if it is different—these numbers on static Exchequer impact and the like were produced by the HMRC and were not changed by Ministers. That is confirmed by my officials, I think.

***Sir Nicholas Macpherson** indicated assent.*

Mr Osborne: Ultimately, the judgment on the costing we were going to ascribe in this report was a ministerial judgment, as it has always been in Budget-making. But crucially, this was a judgment that Robert Chote had to, in effect, sign off on. He thought that it was central and reasonable. So the constitutional process is that ultimately, the Chancellor of the Exchequer is responsible for everything in this document, which of course I accept, but the big constitutional change is that we now get very independent people—Robert Chote, Steve Nickell and Graham Parker—to check on it.

Q368 Teresa Pearce: According to this booklet, 300,000 people will be affected by the reduction from 50p to 45p. Given that there is an assumption that a number of people have avoided the 50p tax by either moving offshore, reducing their income, tax avoidance or even, as it says in the report, tax evasion, how many people do you think will in future be paying the 45p who would have been paying the 50p had they been included, if you see what I mean?

Mr Osborne: I do not have that number in front of me, and I do not know whether that number exists, but I will certainly write to the Committee with that.

Q369 Teresa Pearce: But if there are 300,000 people now, and you expect behavioural change—

Mr Osborne: Well, they are making all sorts of assumptions about—

Q370 Teresa Pearce: How can you have assumed—

Mr Osborne: Well, because they are not assuming—

Q371 Teresa Pearce: Could you let me finish my question, please, Chancellor? If there are 300,000 people now, and you expect a behavioural change that will reduce the amount that this measure is going to cost, you must have a figure in mind of how many extra people that is; otherwise, you cannot come up with a number.

Mr Osborne: No, because the assumption is more complicated than that. People can put £50,000 into a pension, and we have to make an assumption about how many people are doing that, so that reduces the income—

Q372 Teresa Pearce: But this must be—

Mr Osborne: By the way, it was £255,000 a year into a pension, until I became Chancellor and changed that. They can now put £50,000 into a pension.

Q373 Teresa Pearce: They could put double into an EMI.

Mr Osborne: They can put some money into the enterprise management incentive scheme and, of course, we have also now made changes to cap these current uncapped income tax reliefs, such as loss relief. In other words, there is a whole set of assumptions that go into the costing; it is not a straightforward calculation. That is what the HMRC and Treasury officials do in the preparation of the Budget.

As I say, you can see the evidence we have used to come to our calculation of how much revenue the 50p rate was actually raising, and Robert Chote pores over all these numbers and comes up with a reasonable and central estimate.

Q374 Teresa Pearce: Can we move on to a different issue? We have heard that 500,000 people will have to fill out self-assessment forms because of the change to child benefit. We have also got figures that show that over five years it will cost between £8 million and £13 million for IT, £100 million for staff resources and £5 million for customer information. So could you let me know how much you are increasing

HMRC's budget by so that they can recruit extra staff to deal with these extra self-assessment forms, not only for child benefit but for the 230,000 people who are brought into tax? There is the age allowance; there are the extra people who because of the behavioural change are now going to start paying tax. Can you tell me how much you will increase HMRC's staff budget by?

Mr Osborne: Well, we are confident that HMRC can handle this work. I might point out that it raises around £2 billion a year. Exactly the people I have just had questions on from the last few questioners are the people who would receive child benefit if I had not removed it. But I have had many discussions with HMRC. I am confident that they can handle this additional work and of course, when their settlement was determined for the spending review, they knew they would have to handle the removal of child benefit because it was all part of the same spending review. So the HMRC settlement included the assumption that they would remove child benefit. My understanding is that the bulk of that cost in terms of administering it was the cost of removing child benefit. As I say, they are well able to cope with this.

Q375Teresa Pearce: So why is there a figure of £100 million for staff resources in HMRC's own figures if it does not involve extra staff?

Mr Osborne: As I say, it was part of their settlement when we were determining in the autumn of 2010 how much money they would need to operate and how much staff they would need for different functions. Where we have really increased resources in the HMRC is the number of people put on tax points and tax evasion. We are raising £2 billion a year near enough from this measure. Again, it is all very well for some members of this Committee to say that we should not be doing this and then to complain that I am taking measures to reduce the cost of tax credits and the like, but I have yet to hear a constructive suggestion of where we are supposed to get this money. This is money coming from the top 10% of families. I can't believe you came into Parliament—

Q376 Teresa Pearce: Only families with children.

Mr Osborne: The top 10% of families with children, in terms of income bracket. I know it is controversial, but if we had not taken this measure the better-off end of the income spectrum would not have contributed to the spending element of the deficit reduction plan. That would have been very difficult to justify. You would perfectly reasonably have asked me questions saying, "Why are you still paying welfare payments or child benefit payments?"

Q377 Teresa Pearce: I would not have asked that question, Chancellor.

Mr Osborne: Would you not?

Q378 Teresa Pearce: No. One last thing: you said earlier about the tax credit bill being extremely high. You said to give you another way of cutting it. Have you modelled increasing the minimum wage to the living wage, so that you would cut the tax credit bill?

Mr Osborne: On the minimum wage, we just follow the procedures put in place by the previous Government, which means we have the Low Pay Commission. I am happy to stand corrected, but I think this Government have implemented every single recommendation they have received from the Low Pay Commission.

Q379 Teresa Pearce: So you haven't done any modelling on increasing the minimum wage?

Mr Osborne: We have left untouched the arrangement we inherited: the Low Pay Commission makes recommendations on the minimum wage and we implement them.

Teresa Pearce: Okay. You asked to be given another way, so I was just being helpful. Thank you.

Q380 Mr Love: Let us return to the vexed question of 50p and 45p, based, as I understand it, on tax income elasticity, where HMRC referred to work being done by the Institute for Fiscal Studies. We asked the IFS representatives this morning. They confirmed to us that the framework of reliefs and allowances will affect the tax income elasticity. The question I want to ask is whether you asked the HMRC to look at reliefs and allowances to see whether they could come up with a regime that would raise more money from the 50p before you decided to reduce it to 45p.

Mr Osborne: I was keen on a regime that would raise more income tax from wealthy people, and I think we have produced that.

Q381 John Thurso: Chancellor, there is obviously a great welcome in the far North for the contractual stability for offshore operations that you announced.

Mr Osborne: As reported by *The Herald*.

Q382 John Thurso: I wasn't listening to that. What work is going on in the Treasury to look at the security of energy supply?

Mr Osborne: There's a tremendous amount of work done in the Treasury on energy policy and the security of energy supply. Something giving us a particular cause for concern at the moment is the proposed strike by the tanker drivers, which could disrupt supplies of fuel. We certainly would not want to see that strike proceed.

Q383 John Thurso: But we had some interesting evidence from Professor Helm this morning on that question, particularly on the projections that indicate the date at which our generating capacity and our consumption go in parallel, which is about four or five years away. He suggested that there was a need for serious investment but nobody will invest in the current regime. Is that something that the Treasury are now actively looking at?

Mr Osborne: Well, part of the Budget was a commitment to produce by the autumn a gas strategy on the understanding that gas-generated electricity is going to be the major source of electricity generation for many years to come. The plethora of environmental policies that were put in place by the previous Government and that exist under this Government do not, we think, provide adequate support for investment in the gas industry.

The Energy Secretary is going to produce that strategy, and the key thing is that it is going to provide some grandfathering for the emission permits. In other words, it will allow people to build a gas power station with some certainty that we are not suddenly going to change in five, 10 or 15 years' time the emission requirements of that station. That was deterring investment.

Chair: Chancellor, thank you very much for coming before us this afternoon, which has been fairly long. There has been a heap of stuff on 45p and 50p, and there was a bit on the leaks at the beginning. I think it has been worth while, but we do not yet know whether this is going to be one of those Budgets that quietly sinks without trace or one of those Budgets, such as 1981, that is perhaps not so well supported at the start but much later on is considered one of the great reforming Budgets of a Chancellor's period.

Written evidence

Written evidence submitted by the Chartered Institute of Taxation

1 These notes by the Chartered Institute of Taxation (CIOT), with input from our Low Incomes Tax Reform Group (LITRG), are intended to assist the Treasury Committee with their inquiry into Budget 2012. They cover a range of taxation matters but are not a complete analysis of the announcements, press releases and related documents contained in the Budget.

Individual Taxation

2 **Personal allowances:** the level is a judgment for the Chancellor; we simply note two points:

- Those low-income taxpayers who are in receipt of means-tested benefits calculated on net, after-tax income (eg housing benefit and council tax benefit) will not see the full benefit of the increased allowances.
- The National Insurance Contribution (NIC) primary earnings threshold is becoming ever more detached from the personal allowance level, making integration more difficult.

3 **Age allowances:** freezing and eventual abolition is a logical way to proceed at a time when the personal allowance is rapidly catching up. It offers real simplification and administrative savings, though there is clearly an argument for a more gradual withdrawal. The cut off at April 2013 does introduce additional complexity that may be with us for some years.

4 **Child Benefit:** raising the threshold for removal and introducing a tapered withdrawal, rather than a cliff edge, are sensible moves. Tapering makes the withdrawal fairer, though not simpler. Whilst some of the CIOT's and LITRG's concerns[1] have been addressed, others remain.

- The mechanics of receipt of benefit by one partner and (usually) withdrawal by taxation on the other partner will need a lot of explanation and assistance: good communication will be essential.
- Recipients need to appreciate that the child benefit recipient has a "passport" into, eg NI credits. Those on high incomes, or whose partners are on high incomes and are facing the tax charge, may wish to give up their payments—but need to keep their claim in place to preserve their rights (and also guard against sudden loss of income).
- Defining and monitoring partners/households, especially when a relationship forms or breaks, will cause difficulties.
- Losing a job may mean a need for a late claim; an unexpected bonus (or gaining a better job) may mean a subsequent, possibly unexpected, tax bill to clawback child benefit.
- The penalty on single-earner couples remains.

5 Overall, this change will mean a considerable additional administrative burden, including presumably a good number of people being drawn into self-assessment. These numbers could be significant and the burdens should not be underestimated. We do still wonder if integration with tax credits has been considered as an alternative route.

Small Business[2]

6 **Default cash basis:** we think the consultation on introducing this for the smallest businesses is a good move; the tie in with the VAT threshold is sensible. This recognises what many businesses do already. Simpler record keeping will also reduce the need for business record checks, an issue that has caused us concern over the last few months. The key is to keep it simple—the professional bodies need to be involved in discussions on "standard" and "transitional" rules.

7 **Small business administration:** we think the HMRC paper "Making tax easier, quicker and simpler for small businesses", which picks up many OTS recommendations, offers real scope for making life easier for small businesses. However, the Online Business Tax Dashboard needs to be available to tax agents who assist the vast majority of small businesses. One of the best ways to help businesses who choose to use agents is to help those agents to do their job. We also support the OTS proposals for a targeted Disincorporation relief to assist companies at the end of their lives.

8 **Real Time Information** (RTI): we must sound our continuing major concerns about RTI (see "Improving PAYE for small business"); this will not just have benefits but will bring additional costs. It is not just clicking an extra button when doing the payroll. Similarly, Digital by default must have regard to the difficulties many small businesses (and not just in rural areas) will have with digital submission. There need to be a range of practical alternatives.

---

[1] See LITRG paper at http://www.litrg.org.uk/News/2012/child-ben-tax

[2] John Whiting's dual role as the CIOT's Tax Policy Director and as Tax Director of the Office of Tax Simplification, is recognised through a standing 'declaration of interest' at the CIOT; he has no involvement in the framing of any CIOT comments on proposals emanating from OTS recommendations.

Anti-Avoidance Measures

9 **GAAR:** the proposed GAAR is a very important move and we think the government is right to press ahead with a narrowly-targeted GAAR aimed at truly artificial schemes. We welcome the recognition in the announcement that a key need, as we have always said, is for the rule to be practical and certain for taxpayers and HMRC.[3]

10 It is also critical to maintain the safeguards for taxpayers set out in the Aaronson report. This needs to be a balanced package, carefully designed to balance the needs of business and individuals for certainty against the Exchequer's targeting of what the Chancellor described as "morally repugnant" avoidance. Should the proposed GAAR turn out to have a broader scope, it will add to business uncertainty. In our view, the GAAR must remain targeted only at situations where tax avoidance is the sole (or substantial) purpose of the transactions. We do, though, note that a GAAR will not affect some of the most high-profile tax situations that may be in the public's mind: that may be a cause for concern if expectations are exaggerated and should not be overlooked.

11 **Reliefs capping:** We can understand the desire to tackle what is seen as excessive reliefs offsetting. We do think the route chosen is the wrong one. If, as we understand it, the mischief being targeted revolves around "sideways loss relief" (loss relief from business investments), it would be better to adjust the already manifold controls on loss offsets. Although that would add more complexity to an already involved area, it is likely that the new rules will be complex anyway. More significantly, the proposed restrictions seem to send a confused message around such things as giving to charity and investing in risky areas such as enterprise zones.

12 There is real concern in the charitable sector about wealthy philanthropists being put off giving because of the reliefs capping. The new **inheritance tax relief** (a 10% reduction in IHT for 10% of an estate left to charity) also contains an incentive to delay lifetime gifts and instead leave legacies.

13 **VAT anomalies:** the proposals to tackle a number of apparent anomalies are in many ways sensible. We do, though, object to these changes being generally branded as tackling avoidance. Some (eg hairdressers' chair rental) may be; far more (eg sports drinks/supplements and self-storage) are the result of the VAT legislation not keeping up with developments in the marketplace; and some (eg hot food) are simply the result of loose legislative wording. The lesson to be learnt here is that there must be a commitment to keep VAT boundary issues under review, with a concomitant commitment to helping producers and traders with rulings on new products and services.

14 **SDLT measures:** in some ways, the only surprise about this is that it has taken so long to move against SDLT avoidance. The combination of the annual charge to be consulted on and CGT on non natural persons may have wider effects: we trust that REITs will not be affected by the measures and wonder about the policy impact on overseas investors. Definitions, enforcement and collection will all need careful design but we are very willing to participate in consultations to ensure the provisions are focussed and workable.

15 **Retrospection:** finally in this section we must include some comments on retrospection. We have a specifically retrospective measure in the package of measures with the debt buy-back change announced before the Budget. The speech also contained an explicit warning about retrospective action against schemes that might seek to sidestep the SDLT changes. However understandable, these moves do concern us as a matter of principle. We accept that no government would ever rule out completely the use of retrospective action but any retrospection damages the image of stability and certainty that is so important to the reputation of the UK's tax system. We have called in the past for an open and measured debate on when retrospection might be used,[4] ideally with some very narrow guidelines being laid down.[5]

Measures to Welcome (Albeit With Some Caveats)

16 There are many measures to welcome in this Budget, not least the fact that many are the result of consultation over the last year. The Tax Policy Making process is working, though not completely (eg the lack of debate about the policy issues around the IHT 10% relief and indeed child benefit withdrawal). In no particular order we would welcome:

- **Statutory residence test (SRT)**: we are pleased to see the commitment to take the SRT forward and scrap ordinary residence whilst preserving overseas workday relief.
- **Non-resident sportsmen**: the proposed changes around including training days may be a sensible compromise and reduce the tax deterrent to competing in the UK. It remains mystifying, though, why the UK needs to introduce specific reliefs for every major sporting event but does not have an internationally acceptable framework for sports taxation.

[3] Our response to the GAAR report, submitted to HMRC in January, is at http://www.tax.org.uk/tax-policy/public-submissions/2012/GAAR_CIOT_ATT

[4] See our discussion paper developed as part of our contribution to the consultation on 'Tax Policy Making—a new approach' in November 2010 and published at http://www.tax.org.uk/tax-policy/public-submissions/2010/RetrospectiveTaxationACIOTdiscussionpaper

[5] The remarks by the Exchequer Secretary to the recent Oxford Centre for Business Taxation conference on Tax Policy Making could be a good starting point.

— **Incapacitated persons:** modernising the definition has been a long-running LITRG campaign and it is pleasing to see it finally come to fruition.

— **Small pension pots**: we very much welcome the extension of relief for commuting small (£2,000 or less) pension pots from occupational schemes to personal schemes, but regret the restriction to two personal pension schemes. Ideally, the limit should be more like £5,000 as pension pots up to that level can easily be stranded, with providers unwilling to pay out annuities and contributors unable to draw them down.

— **National insurance & income tax integration**: the Government's commitment to move ahead on this is excellent news and we are pleased to see that the position of the self employed is also to be on the agenda.

— **Seed investment scheme**: although the monetary amounts remain low, we welcome changes as a result of consultation such as allowing subsidiaries.

— **Enterprise management incentive and Enterprise investment scheme**: there is a range of useful changes to these schemes, though scope for more improvements.

— **Research and development**: the "above the line" relief (ie a taxable grant, instead of a tax credit) is welcome.

— **Controlled Foreign Companies (CFCs):** good progress through consultation.

— **Patent box**: again this seems to have evolved well through consultation; it remains a measure that focuses on particular sectors rather than business generally but is welcome.

— **Dishonest conduct**: we will always support, indeed encourage, moves to tackle dishonest agents, though we feel HMRC should use their existing powers rather than seek new ones. The acceptance of our point about the possible impact on third parties (eg a former employer of a dishonest agent) is sensible.

And Finally…

17 One point we mention regularly is the difficulty of finding all the Budget releases and papers. Although HMT and HMRC have improved matters markedly in recent years, it would be enormously helpful to all if there were a single index page listing all Budget-related papers. That might be updated as new papers are published in the wake of the Budget. We understand the difficulties that last minute decisions mean but this is surely a modest move that would help considerably.

26 March 2012

Written evidence submitted by the CBI

CBI Overall Assessment of the 2012 Budget Report

The CBI views Budget 2012 as a budget for growth. The UK currently faces the twin challenges of a large budget deficit coupled with a weak short-term macroeconomic outlook. Overall this budget has struck to the course outlined in the government's fiscal consolidation plan. Within an overall fiscally neutral budget, this budget provides short term support for the economy through announced increases in the personal allowance which will support consumer confidence and demand. Medium term incentives are enhanced through a reduction in Corporation Tax and the top rate of personal income tax, these measures will support the UK economy's supply side in the medium term.

If businesses were looking for more, it was in the area of deregulation. For smaller businesses, things may not feel very different on the ground. The CBI is disappointed that the Chancellor has not taken the opportunity to replace the currently unworkable Carbon Reduction Commitment.

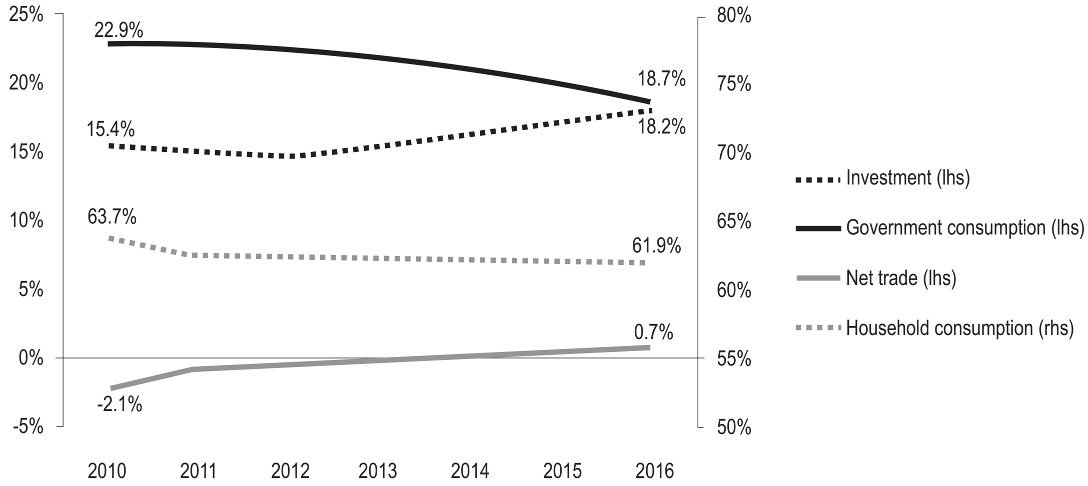
Economic Outlook

The CBI expects the economy to grow by 0.9% in 2012 with growth further accelerating to 2.0% in 2013. This is broadly consistent with the OBR's forecast of 0.8% this year followed by 2.0% next year. Overall, economic risks remained skewed to the downside with threats to the UK economy from higher oil prices and a re-intensification of the Eurozone crisis.

Rebalancing the economy

Budget 2012 supports the rebalancing of the economy through further increasing incentives for business to invest. During the NICE decade, the UK economy became dominated by debt-driven household and government consumption, which together accounted for 89% of GDP in 2009—more than in France, Germany or the US. The CBI report *A Vision for Rebalancing the Economy* highlights the need to move to a more sustainable model of economic growth, driven by growth in business investment and exports. The OBR forecast shows significant rebalancing over the forecast period, with investment increasing from 14.9% this year to 18.2% in 2016. The UK's trade position is also forecast to improve steadily from a -2.1% deficit in 2010 to a trade surplus of 0.7% in 2016 as a result of strong export growth—again, in line with CBI expectations for rebalancing. The OBR estimates that each 1% reduction in the Corporation Tax rate will increase the level of business investment by 1% over the forecast period. Furthermore, a low CT rate, by encouraging multinational firms to invest in and set up headquarters functions in the UK, increases exports from the UK, helping drive improvements in the UK's trade position.

OBR FORECASTS MODEST REBALANCING ACROSS THE COMPONENTS OF GDP, 2010–2016 (OBR)



Source: Economic and Fiscal Outlook—March 2012—Office for Budgetary Responsibility

Business Investment

The OBR now forecasts that business investment will grow by 0.7% in 2012, significantly lower than its forecast of 7.7% in November. While this appears to be a sharp downgrade, the OBR states that the majority of this downward revision is attributable to the surprising weakness of the outturn in the fourth quarter of 2011, when according to the ONS provisional estimate, business investment fell by 5.6% q/q—the OBR had been expecting a small rise. Business investment data tends to be volatile and as the OBR notes, there is a tendency for initial estimates to be revised higher.

It is also important to note that the economic climate deteriorated markedly during the fourth quarter. In particular, tensions in the euro area intensified further, and this is likely to have contributed to a fall in business investment. Indeed, CBI surveys show that over that period, business optimism fell across the board, and investment intensions weakened, partly driven by rising concern about demand and business prospects. However, activity seems to have recovered somewhat through the turn of the year, with output expectations in the latest CBI industrial trends survey at their highest for a year. It is therefore plausible that a large share of the fall in the fourth quarter represents merely a postponement of activity, rather than a permanent loss. Indeed, with some of the most serious risks around the situation in the euro area having dissipated somewhat, and the pre-Christmas gloom having lifted, we think there is scope for growth in business investment to be a little stronger through 2012 than the OBR expects.

Fiscal Position

The government remains on course to meet its fiscal targets

We welcome the Chancellor's decision to deliver a fiscally neutral budget and to stick to the government's deficit reduction plan. The OBR confirmed that government is on course to meet its deficit and debt targets, reporting small improvement in the public debt to GDP ratio relative to its previous forecast. In 2016–17—the relevant year for fiscal mandate, the OBR estimates the cyclically adjusted current budget to be in a surplus equal to 0.5% of GDP, unchanged from its Autumn Statement forecast.

Recently both Moody's investor service and Fitch Ratings have issued a negative outlook on UK sovereign debt citing the reduced ability of the UK government to meet its fiscal targets in the event of further negative economic growth shocks. This highlights the necessity of using any positive fiscal surprises to pay down the debt, to maintain the credibility of the government's deficit reduction strategy.

The impact of the recession and financial crisis on the public finances

The CBI judges that the OBR may be erring on the side of caution in its assessment of the permanent impact of the financial crisis on potential growth, and, therefore the public finances. The permanent impact of the financial crisis on the potential size of the UK economy is important because it determines the extent to which the economic recovery can be expected to restore tax revenues to their previous trend. The larger the permanent impact on the economy and therefore tax revenue, the larger the required fiscal consolidation.

The OBR has further increased its estimate of the long term economic impact of the last recession and financial crisis. The OBR downgraded its estimate for potential growth in 2012 by 0.5%, to 0.8%. A 0.5% reduction in the potential size of the economy will increase the structural deficit by around 0.3%. The OBR now estimates that the potential size of the UK economy has been permanently reduced by 11.2% as a result of the financial crisis. On balance, this may be a somewhat pessimistic estimate—for example the IMF estimates that the average impact of a financial crisis is a 10% permanent reduction in GDP. Furthermore, analysis immediately after financial crises tends to exaggerate the effect on potential output. For example in the early 1990s it was estimated that Sweden and Finland suffered a large permanent loss of output from the Scandinavian financial crisis, but more recently, analysis by the European Commission concluded a significant proportion of output loss was actually temporary and recovered later in the economic cycle.

Demographics, trend growth and the implications for the public finances

While the CBI is slightly more optimistic than the OBR about the effect of the financial crisis and recession on the current potential size of the economy, demographic and migration changes are likely to lead to significantly slower trend growth in the longer run.

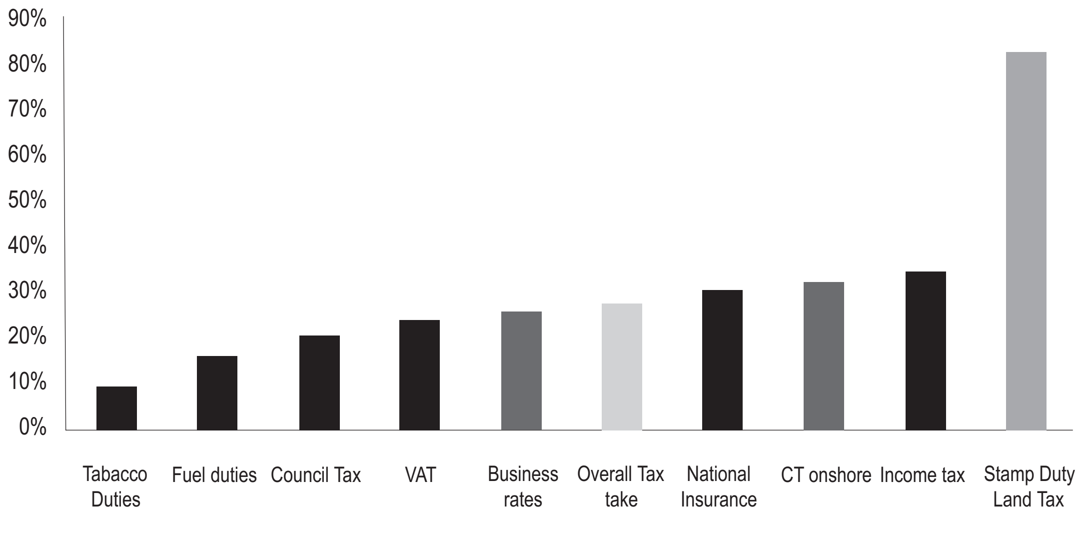
Between 2002 and 2012 the prime working age population (aged between 15 and 50 years) increased by 0.7% per year. Between 2012 and 2022 the Government Actuary's Department (GAD) expects this prime working age population to grow by just 0.2% per year. But while the GAD assumes net immigration of 200,000 per year, if the government achieves its target of reducing net migration to below 100,000 per year, growth in the working age population would fall to 0%. Therefore, assuming pre-crisis productivity per head growth of 1.7% resumes, changes in working age population will be sufficient to reduce UK trend growth from 2.75% pre-recession to 2.05% between 2012 and 2022.

Over the five year forecast period, the two effects (CBI optimism about the effect of the financial crisis, but lower expectations of trend growth) largely cancel each other out, leaving a similar five year cyclically-adjusted deficit to that forecast by the OBR. However, beyond the OBR's forecast period (from 2016–17), the longer term implication is that spending growth will have to match lower economic and tax revenue growth.

Tax revenue forecast

Business continues to make a consistent and significant contribution to the UK's public finances. The OBR forecasts that tax revenue as a proportion of GDP will be stable during the forecast period, with national accounts taxes accounting for between 36.0% and 36.2% of GDP between 2012–13 and 2016–17. Within its overall tax forecast, the OBR shows the business contribution to tax revenue (excluding the oil and gas sector) remains broadly unchanged.

REVENUE GROWTH FOR TAXES YIELDING IN EXCESS OF £10 BILLION, 2011–12 TO 2016–17



Source: Economic and Fiscal Outlook—March 2012—OBR, CBI Analysis

Despite the announced acceleration in the reduction of the headline rate of corporation tax, onshore CT receipts grow by 32% between 2011–12 and 2016–17, ahead of growth in the overall tax take of 28%. Corporation tax has been cut from 52% in the 1970s to 26% in the financial year about to end. However, the CT take as a proportion of GDP is higher now than in the 1970s—historically, reductions in CT have generated enough additional economic activity to more than offset the lost revenue from rate cuts.

Stamp duty land tax

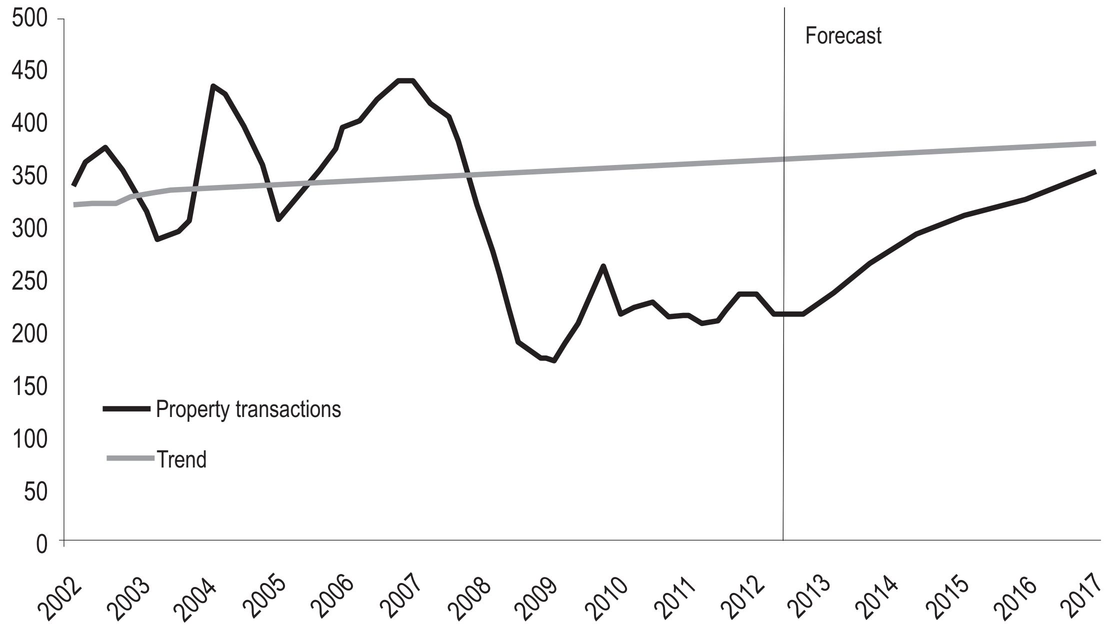
Stamp duty land tax (SDLT) is expected to yield 82% more in 2016–17 than 2011–12, compared with growth of overall current tax receipts of 28%. The OBRs basis for this forecast is a revision to the mean for property transactions. Assuming a revision to the mean for residential property may be optimistic for three reasons:

— **Stamp duty land tax rates:** Until 1997 the maximum rate of stamp duty applicable to property of any value was 1%. Since March 2000, property over £250,000 has been subject to a 3% SDLT. In a property price boom higher SDLT may have been disregarded by property buyers. However, in an environment of stable property prices, higher transaction tax may discourage transactions, creating a new lower trend in residential housing transactions.

— **Mortgage availability:** In the short run, continued bank deleveraging will reduce the availability of mortgage finance to purchase property. In the longer run stricter Financial Services Authority (FSA) regulations on mortgage lending may limit the provision of mortgage finance.

— **Property prices:** The ratio of house prices to income is near a record high level. High property prices combined with FSA rules preventing self-certification of income for mortgages, may price some potential buyers out of the housing market

PROPERTY TRANSACTIONS SET TO REBOUND (THOUSANDS, OBR)



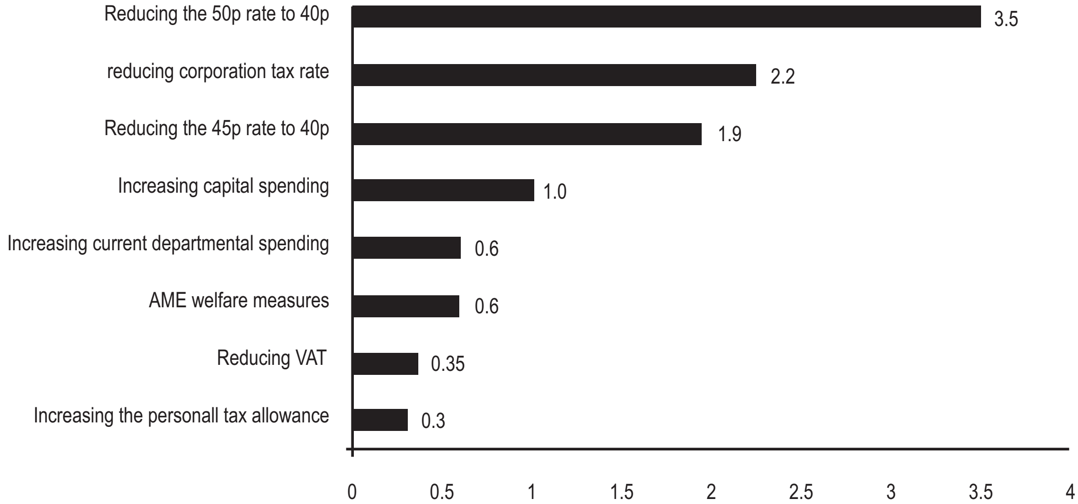
Source: Economic and Fiscal Outlook—March 2012—Office for Budgetary Responsibility

A budget for growth

This budget can be expected to be growth-enhancing over the medium to long run. Budget 2012 announced a reduction in the corporate tax rate, a reduction in the top rate of income tax and an increase in the basic personal income tax allowance. Revenue was then raised through expanding the consumption tax base and through a higher property tax. The OECD paper "Tax and Economic Growth[6] "studied the effects of various types of taxes on the economic growth of developed nations within the OECD and found that corporate taxes are found to be most harmful to growth, followed by personal income taxes and then consumption taxes—recurring taxes on immovable property are the least harmful for growth. Analysis of fiscal multipliers for individual UK taxes using evidence from the OBR and HMRC finds that reducing corporation tax and the top rate of income tax have higher fiscal multipliers than alternative methods of stimulating the economy, for example increasing departmental spending or cutting VAT.

6 Economics Department Working Paper No. 620, July 11, 2008. Organisation for Economic Cooperation and Development.

REDUCING THE 50P RATE AND CUTTING CORPORATION TAX HAVE THE HIGHEST FISCAL MULTIPLIERS (OBR, CBI ANALYSIS)



Source: Source: Economic and Fiscal Outlook—March 2012—Office for Budgetary Responsibility, CBI Analysis[7]

Corporation Tax

Reduced headline rate (24%)

The Chancellor has taken the opportunity to ensure that the UK's corporate tax system is more internationally competitive, sending a powerful signal to companies to invest, do business and create jobs in the UK. An extra 1% off corporation tax this year, beyond the planned cut of 1% point could make a big difference to investment intentions. The government's previously planned reduction to 23% has been revised in turn, so that the rate will continue to fall by 1% each April until it reaches 22% in April 2014. The changes mean that a rate of 20% is now within reach, though the CBI's ambition remains for the headline rate to fall to 18%.

In 2014 the UKs headline rate of corporation tax will be the 4th lowest in the G20. However in terms of effective marginal tax rate (EMTR) which determines the attractiveness of additional project investment for firms already operating in a given country, there remains further room for improvement. In 2014 the UK'S EMTR will be 12th in the G20 and still have a higher EMTR that our major European competitors including Italy, France and Germany.

The OBR estimates that a 1% point reduction in corporation tax will lead to business investment in 2016–17 that is 1% higher than it would have otherwise been.[8] This results in a level effect of £2.06 billion in GDP in 2016–17 at a cost of £920 million in foregone tax revenue, generating an economic multiplier of £2.24. Pound-for-pound, the economic effect of reducing corporation tax far exceeds effects from increasing personal allowances, cutting VAT or increasing government spending.

Corporate balance sheets grew by £62 billion in 2010 alone, adding to a significant cash surplus that has been building since 2002. Corporations are in financial surplus unlike households and government, which have significant deficits. Unlocking business investment through cutting corporation tax will increase the proportion of corporate cash surplus that is invested in the UK rather than overseas. Furthermore, unlike stimulating household consumption through a VAT cut or increasing government spending which will increase imbalances in the UK economy, encouraging business investment will help correct imbalances between the large surplus and deficit parts of the economy.

Controlled Foreign Companies (CFC) reform

Over the years, and particularly since the CBI Tax Task Force report published in 2008, the CBI has been very supportive of this (and the last) government's efforts to reform the CFC rules and thereby help to create a more competitive UK tax regime. Officials have been working closely with the business community to produce a structure that benefits both the government and business. Following our concerns about the initial draft legislation, the revised CFC legislation is designed to meet its stated objectives of simplification and greater competitiveness. The proposed new "Gateway" to the CFC regime will greatly simplify what has been a hugely complex system by making clear which companies are impacted by the legislation.

[7] The multiplier for Corporation Tax is calculated by dividing the additional business investment in 201617 from a 1% reduction in CT by the cost of revenue foregone in 201617 as a result of a 1% CT reduction. The CT multiplier is lower in earlier years of the forecast period. However, by 201617 only two-thirds of the steady state business investment effect is realised, therefore in years subsequent to 201617 the CT multiplier will exceed the figure estimated in the above graph.

[8] OBR Economic and Fiscal Outlook March 2012, page 46, Box 3.1

General Anti-Abuse Rule (GAAR)

We welcome the consultation on the proposed General Anti-Abuse Rule (GAAR). The legislation needs to balance the need to stamp out truly abusive avoidance schemes with the need for clarity and certainty around legitimate tax management.

The CBI has acknowledged, and will make still clearer in the future, that it considers highly abusive but still "legal" tax planning unacceptable, and to the detriment of not just the exchequer but also responsible taxpayers. The proposals contain very important taxpayer safeguards for normal tax management, which should restrict the potential for uncertainty—a GAAR that resulted in increased uncertainty would damage the competitiveness of the UK system.

Bank Levy

The government has increased the full rate of the bank levy to 0.105% from 1 January 2013, which is designed to offset any gain from the additional reductions in corporation tax. Like all businesses, banks want stability in the tax system, so yet more tinkering to the bank levy is unhelpful, but leaves the levy at £2.5 billion per year—the level previously targeted.

Income Tax—Higher Rate Reduction to 45%

The CBI welcomes the reduction of the higher rate of income tax to 45% from April 2013, which will send a clear signal that the UK is open for business. The CBI has stressed that the personal tax regime must encourage top talent to live, work and create wealth in the UK. The Chancellor however, left unanswered the question of any return to a 40p rate.

HMRC estimated that the 50p rate of tax increased income tax revenue by £1 billion. The effect from behavioural change (working less) leading to a genuine reduction in income—and as a result GDP—was estimated at £2.9 billion to £4.4 billion.[9] A reduction of the 50p additional rate to 45p was estimated to have an exchequer cost of £100 million. If approximately half the behavioural change is reversed as a result of reducing the top rate of tax, £1.75 billion of additional GDP will be generated at an exchequer cost of just £100 million.

In addition to being economically inefficient, the HMRC study concluded that the introduction of the 50p rate was highly distortive. Significant income was converted into capital following the introduction of the new rate of personal tax and an estimated £16 billion of forestalling occurred, where income was taken early to avoid the introduction of the higher tax rate.

Further reduction to 40p would have significant economic benefit

A further reduction in the top rate of tax to 40p is estimated by HMRC to result in a £900 million reduction in income tax revenue. A 40p top rate of tax will fully reverse the behavioural effect of introducing a 50p rate, generating a further £1.75 billion of GDP beyond the announced reduction to 45p, at an exchequer cost of £900 million, resulting in an economic multiplier of £1.94. Evidence from the HMRC study suggests that cutting the top rate of tax is a more effective way of stimulating the economy than reducing VAT or increasing government spending. Furthermore this analysis takes only income tax effects into account: if a 40p rate results in £1.75 billion additional income, at least a proportion of this will be spent, generating additional VAT. A total tax analysis would, therefore result in even higher economic multipliers and may well conclude that a 40p rate is superior to higher rates in terms of both economic output and tax revenue.

Industrial Policy

The CBI has already launched a major project on industrial policy and we are pleased to see the Chancellor follow suit with the announcement of an independent review led by Lord Heseltine. We have called for a new approach to industrial policy that will place it at the heart of our plans for growth. Our project has started analysis of industrial policies overseas and it is no surprise that Lord Heseltine's review will now also include an international benchmarking exercise.

The forthcoming review has a clear link to public procurement, which we have consistently lobbied should be a driver for growth and business investment. There is also an indication the review starts from the premise that an effective policy must be cross-government, not simply isolated in BIS, and that is very welcome. Details of the CBI's industrial policy project can be found here: http://tinyurl.com/7qxxzf8

The new Enterprise Zones announced today will help support greater economic activity right across the UK. These new zones will encourage investment and give business a strong incentive to expand activity, creating jobs in parts of the country that need them most.

[9] The Exchequer effect of the 50 per cent additional rate of income tax, March 2012, p. 44

Access to Finance and Encouraging the UK's High Growth Export Champions

The Chancellor reaffirmed the government's commitment to two of the CBI's key strategies for growth: nurturing medium-sized businesses and increasing the UK's export capabilities, with a clear statement on the need for diversified access to finance for small and medium-sized business in particular.

Business Finance Partnership

The CBI welcomes the commitment of an additional £200 million of investment to the BFP, with £100 million of this to be invested through non-traditional lending channels that can reach smaller businesses. As the Breedon Review Taskforce reported last week, anticipated growth in demand for finance and the expected constraint on availability from banks and other sources, could leave a finance gap of between c£84 billion and £191 billion over the next five years. Alongside its commitment to take forward the broader recommendations of the Breedon Review in 2012, this measure is encouraging for the UK's future champions who will rely on a diversified supply of finance options to create the up to £20 billion of growth by 2020 that they are capable of delivering.

Further extension of Enterprise Finance Guarantee

The EFG will be further extended by raising the level of lenders' EFG portfolios to which the Government guarantee applies from 13% to 20% for 2012–13. This is welcome and will encourage further take-up of this scheme by lenders and further help to open up access to finance for small and medium sized businesses.

Increasing exports

Government has set a new ambition to more than double annual UK exports to £1 trillion by 2020 and the Chancellor reconfirmed the responsibility of UK Export Finance to support UK businesses selling overseas. With the UK's share of global exports in sharp decline over the last decade—from 5.3% in 2000 to 4.1% in 2010—it will be particularly important for UKTI to continue to raise its game in marketing its services to medium-sized businesses. While the new ambition is a welcome statement of intent, the Budget did not change any of the initiatives already in place to help boost our export performance.

Measures to support the UK's creative industries

The new tax credits for TV drama, animation and computer game firms will be a welcome boost for the UK's creative industries. These highly mobile companies operate on a global stage, and their exports generate much-needed wealth and jobs. With other countries already offering attractive tax incentives it is important that the UK can continue to compete.

Employment—Pensions, Pay and Regulation

Pensions tax relief and state pension reform

There was much speculation about further changes to pensions tax relief for higher earners, just a year after the government's cut to the annual allowance hit many high earners. We were pleased by the Chancellor's decision to leave last year's settlement in place—another change would have lumped significant costs on business by forcing them to change scheme rules and revisit complex administration changes they made only last year, in response to the government's most recent restriction.

The Chancellor also confirmed that future pensioners will benefit from a single-tier state pension to replace the two-tier system we have now. This is a big, complex reform which will take many years to come into effect, but one immediate impact is the abolition of contracting-out for those offering defined benefit schemes. Abolishing this will have a big impact on affected employers and scheme members unless government allows companies to offset the costs of losing the contracting-out rebate, which could run to billions of pounds each year. The state pension age will also increase to reflect the fact that we are living longer, healthier lives via a new fixed system—a measure that the CBI has long supported.

Localising public sector pay

Moving to localised pay setting in the public sector will help align pay with local labour markets and living costs. This will remove the in-built public sector advantage in hiring in lower-cost areas, and free spending to resource public services in some higher-cost areas. Overall, it should lead to more efficient public services, with fewer human resource gaps due to underfunding, and better people management in the sector. The risk is that regions are set so large as to lead to "pattern bargaining", where unions use settlements in one region to drive other settlements up. To address this risk, government should look to set pay at a local, rather than regional level, ensuring decisions on pay are taken as close to the ground as possible.

Deregulation

The Budget contained details of the government's deregulatory initiatives to date, including the extension of the qualifying period for unfair dismissal, a bundle of health and safety initiatives and plans for sectoral reviews of regulators. However, it did not contain any new initiatives or regulations that will be simplified or removed. While the government has talked a good game so far, it has failed as yet to deliver a significant shot in the arm through regulatory reform. The lack of vigour shown so far is acting as a brake on growth, and that action—rather than perpetual consultation—is needed as a priority.

Energy and Climate Change

The new oil and gas measures are welcome, as is more positive language on the benefits of clean energy. But the announcements on carbon taxation, the CRC and CFP in particular, take the UK no further towards the strategic approach necessary to make low-carbon a growth driver across the economy. This means that we will continue to look to Government to build investor confidence, reduce bureaucracy, and support low-carbon growth in every industry.

Further consultation on the Carbon Reduction Commitment (CRC)

The CBI has strongly argued that the CRC should be scrapped and replaced with less complicated ways of measuring and taxing carbon emissions. Responding to this call, the Budget put a new deadline in place: if by this Autumn DECC's existing simplification process has not sufficiently improved the CRC, the Government will bring forward proposals to replace it with a simpler instrument. The CBI will take up the Chancellor's invitation to discuss detailed proposals, but we still expect a workable solution to include the removal of the burdensome CRC, while preserving its revenue stream.

An expected rise in the Carbon Price Support Tax

The carbon price support tax rate for 2014–15 has been raised by roughly a third to £9.55 per tonne of carbon dioxide (and indicative rises set out for 2015–16 and 2016–17). This change was expected, to top up the lower-than-expected European carbon price to reach the UK carbon price floor. But it will further widen the UK-EU competitiveness gap for energy-intensive businesses, underlining the need for a more coherent strategy to unlock low-carbon industrial growth and immediate financial support for those most at risk. The commitment to reduce the carbon price support tax burden on Combined Heat and Power is welcome, but this alone may not make the technology economic relative to less carbon-efficient approaches.

Changes to the oil and gas taxation regime

A number of measures have been announced to encourage investment in North Sea oil and gas extraction, including a plan for the Government to sign contracts providing assurance of tax relief on decommissioning, and new targeted tax allowances for certain types and locations of fields. These welcome measures will help to restore investor confidence following the sudden changes to the taxation regime in the previous Budget. It remains to be seen how the new gas generation strategy will link to the Government's work on Electricity Market Reform.

Infrastructure

On infrastructure, the Chancellor gave encouraging pro-growth signals and talked up the need for investment. However, this is only part of the picture, with many important announcements yet to be revealed—the NPPF and aviation capacity for example. It is disappointing that there was no sign of taking up the CBI's calls for changes to the capital allowance structure to incentivise investment in infrastructure—state aid rules were considered too difficult to clear.

A new capital allowance for infrastructure

Ahead of the Budget the CBI proposed a new capital allowance (or "fallback depreciation") to cover infrastructure assets that do not currently qualify under the capital allowances regime. This would help to incentivise new infrastructure investment—£200 billion is needed over the next five years, of which 70% must come from the private sector. A new capital allowance would also equalise the tax treatment of different types of investment, removing the current distortion in favour of certain assets, and would restore the attractiveness of the UK as a place to invest in infrastructure.

However, the Budget gave no sign of progress on this measure and discussions thus far have centred on the potential difficulty of securing State aid clearance for a new allowance. We have argued that the benefits of infrastructure investment can accrue to all businesses and that there may be precedents in other countries where similar measures have been implemented with the express consent of the European Commission under State aid rules. We feel that this may be worth pursuing further, for example through further Treasury engagement with the European Commission.

Planning

The Chancellor made encouraging remarks about next week's publication of the NPPF, talking up the need for a pro-growth planning system. Most importantly, the Budget document talks of a "powerful" presumption in favour of sustainable development that should give confidence to businesses. Of particular note is the absence of a transition period, with the Budget document stating that the framework will come into force for plan-making and decisions from the end of March 2012.

We were pleased to see commitments in the Budget to bring forward legislation to adjust the scope of Special Parliamentary Procedure. The current use of SPP means there is an open-ended timeframe at the end of the planning process, which increases uncertainty and damages investor confidence. Furthermore, we welcomed the Government's pledge to publish revised guidance and remove duplication in the consenting regime to clarify and improve the system.

Pension fund investment

The establishment of the Pension Infrastructure Platform, which will begin to invest £2 billion in UK projects in early 2013, is welcome. Pension funds can provide a much needed cash injection to infrastructure investment, while the assets will provide them with the stable, long-term returns they seek—we hope the PIP becomes a key player in the infrastructure market in the next few years. The CBI is currently working on further models needed to incentivise pension fund investment in infrastructure and will be publishing a report in the Spring.

Digital

The government's commitment to supporting the private sector to deliver world-leading superfast broadband is an important part of ensuring the UK's competitiveness. The confirmation of the ten "super-connected cities"—Belfast, Birmingham, Bradford, Bristol, Cardiff, Edinburgh, Leeds, London, Manchester and Newcastle—and further roll-out of £50 million of public money to support a second wave of smaller cities to fulfil digital aspirations is a positive move. The lynchpin will be the role of the private sector in delivering this roll-out.

Tax Incremental Finance

Government's decision to commit an additional £150 million for Tax Increment Financing projects from 2013–14 is a welcome development. With some £200 billion needed to upgrade our infrastructure over the course of this parliament, it is essential that we get TIF schemes up and running quickly to help leverage this investment from the private sector.

Transport

While the Chancellors remarks on aviation capacity were positive, industry was hit by a double increase of APD (including last year's deferment). With little spending available, the focus must remain on unlocking private investment.

Aviation capacity

The Chancellor's commitment to confront the impact of constraints on our aviation capacity is very welcome. Constrictions at the UK's hub airport are hurting the wider economy—weakening trade links, hindering exports and threatening future investment in the UK. We need the government to make some tough choices to remove a key impediment to growth. However the timing of the government's consultation on aviation strategy—originally scheduled for the end of the month—is still unclear, with the Chancellor mentioning further announcements over the summer.

Air Passenger Duty

The Chancellor did not respond to the CBI's call to set aside the 2011 inflation increase (of 3%), deferred in last year's Budget. This means that we see an above-inflation increase of 8% this April—harming the industry at a time of record oil prices and adjustment to the costs of the EU ETS. The UK's APD rate remains the highest air passenger tax in the EU and has seen significant increases in recent years.

Roads

The Budget document states the government's welcome commitment to take forward many of the Cook review recommendations, including developing a national roads strategy and setting a renewed focus on the level of performance expected from the Highways Agency. In addition to publishing further details of the feasibility study into new ownership and funding models for the road network, the Budget document announced that a package of measures to enhance capacity and performance of the A14 will be finalised by July 2012—a high priority for the CBI.

Rail improvements

The Chancellor's announcement to support Network Rail to invest a further £130 million in the Northern Hub rail scheme will help to ease capacity constraints. Furthermore the electrification of the Welsh Valley lines will be welcomed by business and we look forward to the High Level Output Statement for rail this summer where detail on funding will be confirmed.

RESEARCH AND INNOVATION

Science and research

The government has committed £60 million to set up a new Aerodynamics Centre in 2012–13 which will support innovation in aerospace technology—commercialising new ideas and seeking to spin off applications into other sectors. This is a very welcome announcement supporting competitiveness and future capability development in the UK's world-leading aerospace sector.

A further £100 million capital investment fund for universities has been allocated to HEFCE to manage. The move firmly puts the emphasis on the importance of business-university collaboration for growth, although details of the funding model are not yet available.

R&D tax credit

We strongly support the government's continued commitment to introduce an above-the-line R&D tax credit in 2013, which will allow loss-making companies to claim a payable credit for the first time. This payable credit has only been available for smaller companies. The proposed changes will have a significant impact on the attractiveness of the UK as a place to do R&D by providing certainty for businesses over the whole course of a project cycle, allowing them to factor the credit into planning, while also boosting the visibility of the credit to international investment managers. Announcing that the above-the-line credit will be worth a minimum of 9.1% before tax means the credit will not drop below the value it would be worth under the current system, once corporation tax drops to 22% in 2014.

Enterprise Management Incentive (EMI)

Doubling the incentive under the Enterprise Management Incentive (EMI) scheme will enable entrepreneurial, high risk companies to better motivate their staff. EMIs are tax advantaged share options, designed to help small, higher risk companies recruit and retain employees with valued skills. They are also a way of rewarding employees for taking a risk by investing their time and skills to help small companies achieve their potential. The extension of Entrepreneurs' Relief to shares acquired through EMI will eliminate a major anomaly and is a welcome improvement.

HOUSING

Following CBI calls for a mortgage indemnity scheme to boost the housing market, the Chancellor confirmed the £150 million additional funding for the Get Britain Building fund to support firms in need of development finance. This fund should support the delivery of up to 16,000 new homes and over 30,000 construction jobs and more in supply chains. The CBI welcomes these moves—we've been calling for a boost for activity in the housing market and construction sector as a game-changer for growth.

27 March 2012

Supplementary written evidence submitted by the Institute for Fiscal Studies

1. *Maximum first-year loss from Budget reforms to age-related tax allowances*

The biggest cash losers when this policy is implemented in 2013–14 will be those who turn 65 during 2013–14 with an annual taxable income between £10,820 and £26,200. (£10,820 is what the allowance for those aged 65 to 74 would have been in 2013–14 without any policy change, given default indexation and the OBR's inflation forecasts. £26,200 is the amount above which the age related allowance will be tapered away in 2013–14 until it is no higher than the allowance for under 65s, given default indexation and the OBR's inflation forecasts.)

Without the policy change, these people would have benefitted in full from the tax allowance for those aged 65 to 74. Instead, their allowance will be the same as that for those aged under 65, which is currently planned to be £9,205 in 2013–14. The extra tax they will pay as a result of these changes in 2013–14 is therefore 20% of (£10,820—£9,205), which is £323.

2. *Maximum first-year loss if the changes to age-related tax allowances were moved back one year to 2014–15 and the personal allowance were £10,000 in 2014–15*

The committee expressed an interest in how the above would change if the reforms were delayed one year until 2014–15, and if the coalition subsequently announced that it would reach its goal of a £10,000 personal allowance for those aged under 65 in 2014–15.

In this case, the maximum loss in 2014–15 would be among those turning 65 in 2014–15 with a taxable income between £11,070 and £26,900. (Again, these are the nominal values of the tax allowance for those aged between 65 and 74 and the point above which the age-related allowance gets tapered away respectively, in 2014–15, given default indexation and the OBR's inflation forecasts.)

The additional tax paid in 2014–15 by these individuals as a result of the change to age-related tax allowances would therefore be 20% of (£11,070—£10,000), which is £214.

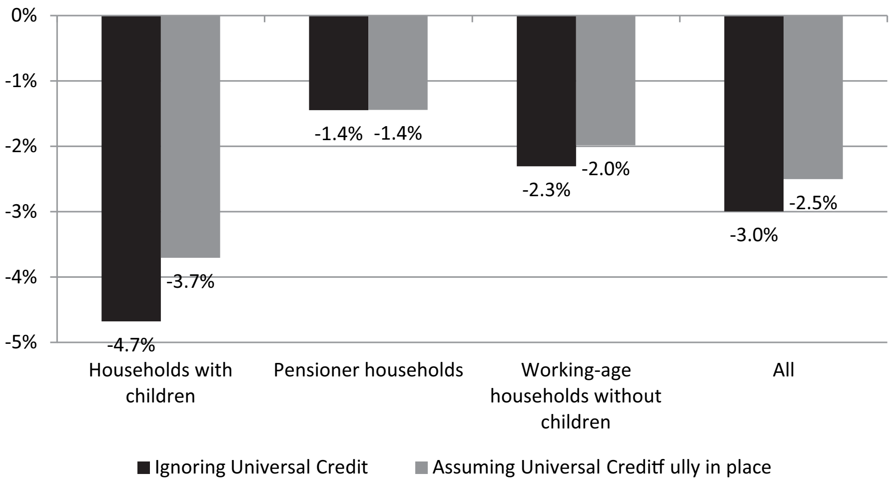
In other words, this approach would reduce the maximum first-year cash loss from the reforms to age-related allowances by about one third relative to the current policy. It would also give individuals one more year to plan changes to their behaviour in the light of this reform (for example, they might decide to retire slightly later).

3. *Longer term context for trends in pensioner incomes and the effects of reforms to taxes and benefits on the incomes of pensioner households*

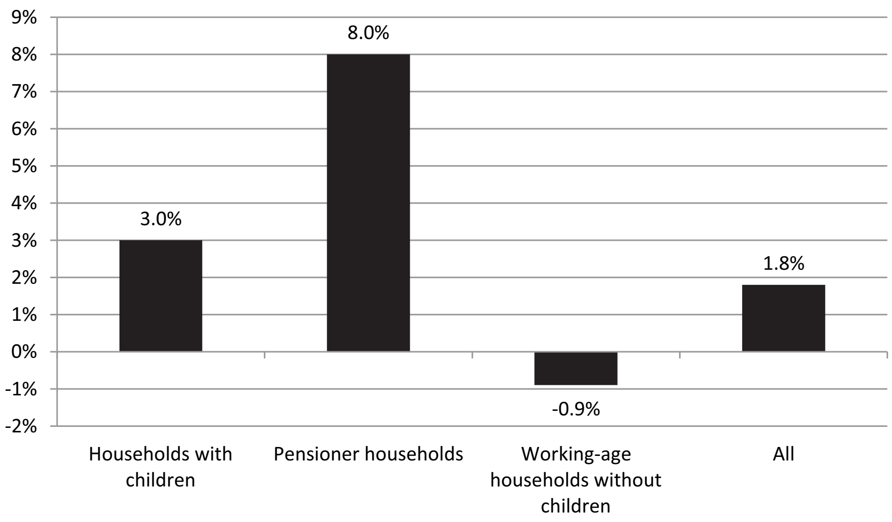
The committee asked for some longer term context behind the point made by IFS researchers that, on average, pensioner households have been affected less than other major demographic groups by tax and benefit reforms under the current government (Figure 1 reproduces the IFS' post-budget analysis which made this point).

Figure 2 shows the estimated impacts of tax and benefit reforms under the previous Labour government, by household type. It shows that pensioner households were the major demographic group who benefitted the most from tax and benefit reforms over that period, with a 8% net income gain on average from those reforms (this compares to a 1.8% net income gain on average for the population as a whole). Key measures responsible for this are the introduction of Winter Fuel Payments and increases in the generosity of means-tested benefits for pensioners (particularly the introduction of the Minimum Income Guarantee in 1999).

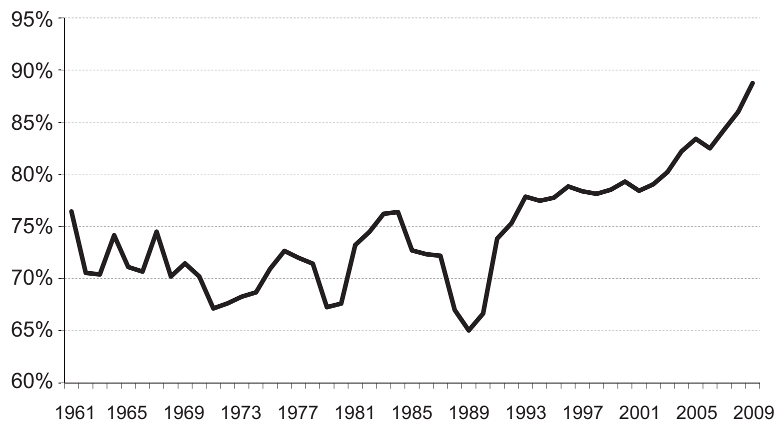
Figure 3 shows how median household income among pensioners has evolved relative to median income among the population as a whole, since 1961. Income at the median among pensioners has increased more quickly over this period than income at the median among the whole population, and this is particularly so since the early 1990s.



Notes: Income measured at household level before housing costs have been deducted.
Source: Presentation at IFS post-Budget briefing
(http://www.ifs.org.uk/budgets/budget2012/budget2012robjoyce.pdf).



Notes: Income measured at household level before housing costs have been deducted.
Source: J. Browne and D. Phillips, 'Tax and benefit reforms under Labour', IFS Briefing Note 88 (http://www.ifs.org.uk/publications/4807).



Notes: Income measured at household level before housing costs have been deducted, adjusted for household size using modified-OECD equivalence scale. Years are calendar years until 1993 and financial years thereafter.
Source: Family Expenditure Survey and Family Resources Survey, various years.

27 March 2012

Supplementary written evidence submitted by the British Chambers of Commerce

When a carbon floor price was first proposed we were concerned about its potential impact on the competiveness of UK based firms and skeptical about its alleged environmental benefits. Recent independent analysis has reinforced those views and we now believe that the policy should not be introduced. As the House of Commons Energy and Climate Change Select Committee warned in January, UK industry faces a "devastating effect" from the government's decision to set a unilateral price for carbon.

It is our view that an adequate price level for carbon is best is achieved by action at the EU level through reform of the EU Emissions Trading System. As the second biggest player in the EU carbon market the UK will well positioned to lead this reform. It is also our view that incentivising investment in low carbon forms of energy in the UK does not require the introduction of a carbon floor price. The proposed feed-in tariff with contracts for difference that has been included in the Electricity Market Reform package is also targeted at securing new investment in low carbon projects, and this policy would not have the same negative impact on businesses.

However, it appears that the Chancellor is determined to persist with the policy. Therefore, the Government must introduce further compensatory policies for sectors that will be competitively disadvantaged by a floor price. Unfortunately the changes announced in Budget 2012 only serve to emphasises the need for an alternative approach. The rise from £4.94 per tonne of carbon dioxide in 2013–14 to about £9.55 per tonne in 2014–15 will increase electricity prices and will hurt competiveness.

28 March 2012

Supplementary written evidence submitted by John Whiting OBE, Tax Policy Director, Chartered Institute of Taxation

Response to Q227

I was asked by the Chairman to consider the administrative costs that will arise through the child benefit withdrawal proposals. I have looked again at the HMRC estimates, contained in the Tax Information & Impact Notes.

I note the figures quoted, in particular the estimate of a further 0.5 million people being drawn into the self assessment system. This is a 5% increase in the numbers in SA—quite significant.

I am not in a position to question the IT costs figure, merely to note that there are some system changes required. I assume this figure includes work on forms design aspects—something that needs to bear in mind that most of those additional people being drawn into SA by child benefit have simple tax affairs (otherwise they would already be in SA) and so should be completing simple forms.

On the figure of additional HMRC staff costs of around £1,000 million over the first five years, that does sounds a reasonable number for additional helpline staff, which I assume is the main impact for additional resources. I would, though, have expected a considerably greater figure in the first year or two, tapering away somewhat. It may be that the net result is £100 million over five years; but surely this is something that needs to be staffed up for at the start on a "front end loaded" basis and anticipated to be brought into "routine business", rather than viewed as a "steady state"?

Monitoring SA returns for child benefit issues is perhaps simply part of overall SA monitoring. I am not sure whether that creates extra costs or it is part of the £100 million staff costs. It would have been useful if these two separate issues were costed separately in the estimate of additional HMRC staff costs.

I do have concerns about the amount of £5 million for "customer information". Surely writing to all £50,000 taxpayers will absorb most of that in one go? It implies there will be little left for follow ups, for second year campaigns, for information leaflets to be made available, for material to be generated for voluntary organisations (and employers...and MPs?) who will no doubt have to field many questions from taxpayers. I am very ready to be told that these things are allowed for in the sums set aside but I remain to be convinced. This is an exercise that will be all about good quality communication.

Finally, I do wonder about the costs for the affected taxpayers. There will be an additional compliance burden on some people who previously have had little contact with the tax authority. There will no doubt be some impact on employers who as usual will have to field questions about tax from a few employees and no doubt process more tax code changes. Hopefully these impacts will be minimal though they are not nil.

I should stress that in the time available I have not been able to do any research on this issue. My comments are therefore simply my own views, informed by brief discussion with a couple of colleagues and should be taken as such. I hope they are nonetheless of use to the Committee.

John Whiting

28 March 2012

Written evidence submitted by Francis Clark LLP

The Concern in Context

In Cornwall and around the country pasties are sold from bakeries. Typically these will be small shops where the pasties and made and baked or will be baked having been brought in frozen. Bakery chains may have their own centralised bakery where pasties are made and then supplied to the bakery shops.

The cooked pasties will then be placed on trays on display. These may be trolleys in front of the ovens, heated display units or unheated display units. Pasties will then be sold as requested by customers. They may therefore be sold hot from the oven, lukewarm or cold, depending on when they sold in relation to when they were baked.

Bakeries may have a seating area, either inside or out, but most will have no facilities for food to be eaten on the premises. Hence, they may or may not have the appearance of a hot food takeaway.

The "Budget 2012 Policy costings" document (on page 37) is unclear as to whether or not bakeries were included in the tax base figure of £700 million. I have tried to clarify this with the Office of Budget Responsibility but so far without success. There are a large number of such bakery shops on high streets in the South West and throughout the UK.

The Current VAT Position

The current VAT position is based on legislation, H M Revenue & Customs (HMRC) interpretation and case law.

Legislation

The legislation concerned is in the Value Added Tax Act 1994. Schedule 8 which sets out the detail on zero rated items and the relevant extracts are reproduced at Appendix 1.

HMRC Notice 709/1 Catering and takeaway food

This notice sets out HMRC's interpretation of the rules and Section 4 deals with hot takeaway food. Sections 4.3 to 4.5 are particularly relevant and are reproduced at Appendix 2.

Case Law

The leading case in this area is *John Pimblett and Sons Ltd v Customs and Excise Commissioners [1988] STC 358*. The case report is set out at Appendix 3.

There has recently been a European Case *Manfred Bog and Others (C-479/09)* concerning takeaway food. This case is unlikely to have any affect in the UK because the UK has a specific derogation in respect of zero rated items and HMRC have stated that they consider that this case has no implications for the UK treatment of hot takeaway food. However, HMRC may be concerned that it will still lead to litigation. There was also a further case in February 2011 (Deliverance Limited) which concerned delivery of food but this is not directly relevant to pasties. However, it again may have been a factor in the Budget announcement.

I suspect that pasties were not being directly considered as part of the Budget announcement and indeed the press release referred to hot takeaway chicken from a supermarket.

Analysis

Pasties sold direct from the oven without further heating and without a seating area are currently zero rated (see Pimblett case below). This is because they are food. They are not considered to fall under the definition of "a supply in the course of catering" under Schedule 8 Group 1 (a) and Note 3(b) as they are not "heated for the purposes of enabling it to be consumed at a temperature above the ambient air temperature."

Turning to HMRC's guidance in notice 709/1 in respect of freshly cooked products, you will see that HMRC consider that where products are not sold with the intention that they are consumed whilst still hot, these are zero rated supplies.

This treatment stems from case law and in particular *John Pimblett and Sons Ltd v Customs and Excise Commissioners*. This case concerned pies which were baked in a bakery and then sold from trays without reheating. The Court of Appeal held that the intention of the baker was not to sell them as hot, rather that they were hot because they were in the process of cooling down. This also provided a pleasant smell and atmosphere for customers and demonstrated that the pies were freshly cooked.

Standard rating would apply where the main aim of the supplier in heating the food was to enable it to be consumed hot. The customer's intention, place of consumption and whether the food was collected or delivered does not affect the VAT treatment.

You will see therefore that this type of food can only be zero rated if the main reason for heating the food is other than to enable it to be consumed hot. This is a very narrow exemption and there are many factors that HMRC would examine to decide whether the zero rating is correct, including advertising, promotion and packaging, whether efforts are made to keep the food hot, the type of packaging, availability of condiments, napkins and utensils, food hygiene regulations and palatability.

In the majority of cases the pasty currently falls within the exemption. It is not altogether clear whether this is consistent industry practice and I am trying to obtain further evidence from bakeries on this.

The Proposed Changes

From 1 October 2012, the changes will apply VAT at the standard rate to all food which is at a temperature above ambient air temperature at the time it is provided to the customer, with the exception of freshly baked bread. Note 3(b) to Group 1 above will be amended to read:

> *For the purposes of paragraph 3(b) of Note 3, "hot food" means food which , or any part of which, is above the ambient air temperature at the time it is provided to the customer, other than freshly baked bread"*

I have my doubts as to how easy it will be to apply such a rule in practice.

THE EFFECT

The effect of this will be that pasties sold by bakeries will from 1 October 2012 be standard rated rather than zero rated and will suffer VAT at 20%. The cost of this will need to be either absorbed by the bakery/supplier or passed on to the consumer (or both). I am trying to obtain further evidence on the likely impact. It needs to be remembered that there is already quite significant raw material inflation.

The impact on jobs also needs to be assessed. There are a large number of bakeries still on our high streets and the danger is that any reduction in profitability could lead to job losses and bakery closures. Again, I am trying to obtain further evidence on this.

You will appreciate that this announcement has taken the industry by surprise and so there has been little time yet to assess the implications.

April 2012

APPENDIX 1

EXTRACT FROM THE VALUE ADDED TAX ACT 1994

SCHEDULE 8

Group 1—Food

The supply of anything comprised in the general items set out below, except—

(a) a supply in the course of catering; and

(b) a supply of anything comprised in any of the excepted items set out below, unless it is also comprised in any of the items overriding the exceptions set out below which relates to that excepted item.

General items

Item No

1. Food of a kind used for human consumption

NOTES:

(3) A supply of anything in the course of catering includes—

(a) any supply of it for consumption on the premises on which it is supplied; and

(b) any supply of hot food for consumption off those premises;

and for the purposes of paragraph (b) above "hot food" means food which, or any part of which—

(i) has been heated for the purposes of enabling it to be consumed at a temperature above the ambient air temperature; and

(ii) is above that temperature at the time it is provided to the customer.

APPENDIX 2

NOTICE 709/1 CATERING AND TAKEAWAY FOOD

EXTRACTS

4.3 *What does "hot" mean?*

Hot in this context means above the surrounding air temperature.

Examples of standard-rated sales when sold hot are:

— fish and chips, chicken and chips;
— chips;
— Chinese, Indian, Greek, Italian and any similar take-away meals and dishes;
— baked potatoes with a hot or cold filling;
— hot dogs and hamburgers;
— pies, rolls, sausage rolls, pasties and similar items (if sold "freshly cooked" see paragraph 4.4);
— toasted sandwiches;
— cups of tea, coffee, chocolate and other hot drinks;
— cups of soup; and
— roasted chestnuts

4.4 *What about freshly cooked products?*

If you sell freshly cooked products for consumption while they are still hot they are standard-rated, see paragraph 4.5.

Some of these products are, however, not sold with such an intention They may only be hot/warm as they are in the process of cooling down. Examples include pies, pasties, sausage rolls and similar savoury products, cooked chickens or joints of meat, bread products and croissants. The liability will depend, therefore, on how you prepare and sell them.

If they are sold	*they*
specifically for consumption whilst still hot (as a result of being freshly prepared, baked, cooked, reheated or kept warm)	will be standard-rated. See also paragraph 4.5
warm simply because they happen to be freshly baked, are in the process of cooling down and are not intended to be eaten while hot; or cold or chilled at the time of purchase	Can be zero-rated

4.5 *What do we mean by "specifically sold for consumption whilst still hot"?*

You sell food specifically for consumption whilst still hot if you either:

- have an established hot take-away trade and are selling the food as a part of that trade
- advertise it as either hot take-away food or in any other way which indicates that it is meant to be eaten while still hot
- sell it accompanied by napkins, forks, etc to enable it to be eaten before it cools

It does not matter where you sell the food—if it is for consumption while still hot, it will be standard-rated. This means that hot take-away food sold in supermarkets, kiosks at airports or stalls at train stations, etc, are all subject to the same rules.

APPENDIX 3

JOHN PIMBLETT AND SONS LTD V CUSTOMS AND EXCISE COMMISSIONERS [1988] STC 358

John Pimblett and Sons Ltd v Customs and Excise Commissioners

COURT OF APPEAL, CIVIL DIVISION

PARKER AND RALPH GIBSON LB AND CAULFIELD 4 DECEMBER 1987

Value Added Tax—Zero-rating—Supply in the course of catering—Whether food heated for the purpose of enabling it to be consumed at a temperature above the ambient temperature Value Added Tax Act 1983, Sch 5, Group 1, Note 3(b).

The taxpayer company operated a central bakery and eight retail shops. It produced amongst other things pies the fillings of which were cooked and enclosed in pastry covers in the bakery. The pies were then taken to the retail shops where they were baked to cook the pastry covering. The baking was done in two batches. The first batch was baked before the shops opened, then stacked on trays and, when cool enough to handle, restacked on wooden racks from which they were ordinarily sold. They were not subsequently reheated but remained pleasantly warm for about an hour. The second batch was baked shortly before the lunch hour when the demand for pies was at its peak. The main purpose of baking in the shops was not to enable the pies to be eaten hot but to provide a pleasant smell and atmosphere and to make it plain to the customers that they were getting freshly baked pies. Evidence showed that some customers bought the pies during the lunch hour for the purpose of consuming them hot. The commissioners decided that the pies were heated for the purpose of enabling them to be consumed at a temperature above the ambient temperature and accordingly did not fall to be zero-rated under Value Added Tax Act 1983, Sch 5, Group 1, Item 1, note 3(b)a. A value added tax tribunal determined that tax was payable on a proportion of the pies supplied since taking into account the categories of customers, the material part of the taxpayer company's purpose was to supply the pies to be consumed at a temperature above the ambient temperature within note 3(b). Taylor J allowed the taxpayer company's appeal holding that the tribunal had approached the matter in the wrong way by giving too much weight to the purpose of the customers rather than to the purpose of the taxpayer company. The commissioners appealed contending that part of the purpose of the taxpayer company in heating the pies was to enable them to be consumed hot because the taxpayer company was aware that was what would happen.

Held—The words used in note 3(b) could not be made to cover the supplies made by the taxpayer company save by implication or reading into them the words "or, which to the knowledge of the supplier, would or might be [so] consumed . . ." There was no warrant for reading into a taxing statute words which were not there. It followed therefore that the supplies of pies by the taxpayer company were not within note 3(b) and accordingly the appeal would be dismissed.

Notes

For supplies in the course of catering, see De Voil: Value Added Tax A11.27. For Value Added Tax Act 1983, Sch 5, Group 1, note (3), see ibid Part C.

Appeals

The Commissioners of Customs and Excise (the Crown) appealed against an order of Taylor J dated 19 January 1987 ([1987] STC 202) allowing an appeal by John Pimblett & Sons Ltd (the taxpayers) against a decision of a Manchester value added tax tribunal (Chairman: B C Maddocks) dated 18 September 1985 that the taxpayers made taxable supplies of hot food for the purpose of enabling the hot food to be consumed at a temperature above the ambient air temperature pursuant to the Value Added Tax Act 1983, Sch 5, Group I. The facts are set out in the judgment of Parker U.

Andrew Collins QC and *G R Sankey* for the Crown. Robin Mathew for the taxpayers.

PARKER LJ. Schedule 5 of the Value Added Tax Act 1983 details those items which are subject to zero-rating. As originally enacted, Group 1 (so far as material) was in the following terms:

> "The supply of anything comprised in the general items set out below, except—(a) a supply in the course of catering."

General item no I was:

> "Food of a kind used for human consumption." "Notes" at the end of that group included note (3):
>
> "A supply of anything in the course of catering includes—(a) any supply of it for consumption on the premises on which it is supplied . . ."

In 1984 it appears from the tribunal's finding in this case that the Chancellor of the Exchequer announced in his Budget Speech a decision to impose value added tax on hot take-away food and drink. The tribunal observed:

> "This directly covered such business as fish and chip shops, Chinese take-aways and hamburger houses."

That announcement having been made, the Finance Act 1984 amended note (3). The original provision ". . any supply of it for consumption on the premises on which it is supplied" was numbered *(a)* and there was added *(b)*—

any supply of hot food for consumption of those premises; and for the purpose of paragraph *(b)* above, "hot food" means food which, or any part of which,—

(i) it has been heated for the purpose of enabling it to be consumed at a temperature above the ambient air temperature; and

(ii) is at the time of the supply above that temperature."

Since value added tax is attracted on any individual supply, the application of that section strictly would involve measuring the ambient air temperature, whether inside or outside the shop or on any premises on which the food is ultimately consumed it is unnecessary to determine, and then, by means of some temperature probe, to find the temperature at which the food was at the moment of supply.

It is apparent that what happened was that the draftsman foresaw that there would be endless argument about what food was "hot" food, and sought to put the matter beyond doubt. The test is a precise one. It involves the remarkable result that frozen food would be regarded as hot food if the ambient temperature was one degree lower than freezing. A praiseworthy attempt to produce precision does not, in this instance, appear to me to have advanced clarity one wit.

This appeal concerns the supply of pies. The taxpayers are a family company running a bakery business which was founded in 1921 by a Mrs Pimblett. It operates a central bakery and eight retail shops, of which one is attached to the bakery. It produces in the bakery bread, items of confectionery and three sorts of pies, being meat and potato pies, steak pies and pasties. I shall refer to them simply as "the pies".

The pies are centrally prepared in the bakery. In the bakery the filling of the pies is cooked and the cooked fillings are enclosed in their pastry covers. They are then taken early in the morning to the retail shops, where the second process of heating takes place. They are baked in the shops in ovens with which the shops are equipped in order to cook the pastry covering which, in this process, re-heats the filling which had been previously cooked in the bakery. When the pies come out of the oven, properly cooked and for the first time in a condition to be sold, they are stacked on trays, and after an initial period to enable them to be cooled sufficiently to be handled, they are stacked in wooden racks stacking from the top downwards. When they are sold, they are sold also from the top downwards so that what the customer gets, short of a particular request for something else, will always be the coolest of the pies which are in the stacked rack.

There is not in any of the shops any means for keeping the pies hot; they are simply put in the racks where they cool naturally. It takes some considerable time for the pies to cool so that they are below the ambient temperature—whether one regards that as being the temperature within or without the shop—but they remain pleasantly warm for a period of about one hour.

There are two bakings which take place in the shops. The first of them is at or before the time when the shop opens. There is a second baking shortly before the lunch-hour when demand is at its peak. This system has been in operation for a long time. It is accepted that the major purpose of the baking in the shops is because it provides a pleasant smell and atmosphere, and makes it plain to customers that what they are getting are freshly-baked pies.

Evidence was given that it was no part of the intention of those in charge of the company that the heating which took place was to enable the pies to be eaten hot, let alone at or above the ambient temperature. It is, however, plain that during the lunch-hour some pies were purchased by customers whose purpose was to consume them off the premises relatively quickly, whilst they still had some heat in them.

The matter for consideration and determination on this appeal is whether the supplies or r art of the supplies of these pies were such as to attract value added tax. Before the tribunal, and before the judge at first instance, it was common ground that the test was a subjective test, and must be applied solely to the purposes of the seller; in other words, it had to be determined whether the purpose of the taxpayers was to enable the pies to be consumed at a temperature above the ambient air temperature.

Before this court, and without objection, counsel for the Crown submits firstly that the test is not truly a subjective test but an objective test; secondly, that even if it is a subjective test, that subjective test is satisfied in the present case on the basis that it was clear to the knowledge of the taxpayers that some at least of the pies which were supplied during the lunch-hour would in fact be consumed at or above the ambient temperature, and would leave the premises in that condition. He submits that since the taxpayers were aware that some of their pies would be so eaten and because it was part of their purpose to increase their sales, they were meeting the objective of increasing their sales by supplying pies which were capable of being consumed—and I use the word "hot" from now on although its meaning is somewhat doubtful.

The judge rejected the decision of the tribunal, which had accepted the contention that tax was payable on a proportion of the pies supplied, concluding that they had approached the matter in the wrong way and had given far too much weight to the purpose of the customer and too little weight to what was the central matter, namely, the purpose of the management.

The evidence which was given by the taxpayers' witnesses as to their purpose was not rejected; and indeed counsel for the Crown does not suggest that they were other j than perfectly honest witnesses. What he submits is that it must have been part of the purposes of heating the food to enable it to be consumed hot because the taxpayers were aware that that was what would happen.

We were referred to a number of authorities on the different wordings as to the meaning of "purpose". For my part, I find none of those authorities of any assistance. What has to be determined is what is intended by the words used in note (3); and the question which has to be asked is: Were these pies, or any of them, heated for the purpose of enabling them to be consumed hot?

The evidence was that it was not part of the purpose of the taxpayers to enable the pies to be consumed hot, but it is said that they must have had, unconsciously or consciously, a direct or indirect purpose that, to some extent at any rate, the heat was applied for that purpose.

For my part, I am unable to accept that that is the position. These pies were pies which were not capable of being sold at all until they had received their second baking. Having received their second baking, they would then be sold and no doubt, during the course of the lunch-hour, some people would buy them for their own purpose, namely, consumption hot. But I am unable to accept that, because that was the position, it must be regarded as the taxpayers' purpose to enable the pies so to be consumed.

What is in effect being advanced is that the provisions of note (3) should have read into them additional words. Instead of reading "has been heated for the purpose of enabling it to be consumed at a temperature above the ambient air temperature", there should be added these words also—

> "or which, to the knowledge of the supplier, would or might be consumed at a temperature above the ambient air temperature".

I can see no warrant for reading into a taxing statute words that are not there. It is a first principle of revenue law that the subject shall only be taxed by clear words, and it is impermissible to look at the substance or to imply or read in anything. The words used cannot be made to cover supplies in this case, in my view, save by implication or reading in. Furthermore, if one does look at the substance of the matter, it appears to me that what has happened in this case comes nowhere near any ordinary meaning of "catering". I accept that on the basis which has been held to be right by the judge, namely, what was the dominant purpose of the seller disregarding any inevitable results which might flow, there may be cases where there is unfairness as between trader and trader.

On the drafting of the provisions as they stand, I have however no doubt that whatever the meaning of the words is, there will inevitably be some degree of unfairness as between trader and trader and customer and customer. It may well be that the provision should be re-drafted so as to make it clearer what is covered and what is not covered. However, I have no doubt that the words do not cover the supply of pies by the taxpayers in this case.

The tribunal were perfectly entitled, as I see it, to look at the facts for one purpose and for one purpose only, and that is for the purpose of considering the validity of the evidence given by the taxpayers as to their purpose. It might well be that the facts were such that a tribunal in one case might come to the conclusion that the asserted purpose could not be accepted—as, for example, while stoutly asserting that it was no part of their purpose in heating the pies to enable them to be consumed hot, evidence was given that there were extensive heating cabinets in the shop which kept the pies hot. Given such facts, I can well see that a tribunal might conclude that the assertion that it was no part of the sellers' purpose to enable them, or some of them, to be consumed hot was unacceptable. The evidence in acceptable. But that goes to the weight of the evidence and to nothing else.

The evidence in this case is all way. It is not suggested that it was in any way false, and what is relied on is, in my view, wholly insufficient to bring this supply within the terms of Sch 5 as amended. I would therefore dismiss this appeal.

RALPH GIBSON U. I agree that his appeal should be dismissed for the reasons which my Lord has given.

CAULFIELD J. I too agree.

Appeal dismissed. Leave to appeal to the House of Lords refused.

Solicitors: Solicitor for Customs and Excise; Barrow & Cook (for the taxpayers)

Reference

[a] Note 3(b), so far as material, is set out at p 359f, post

Supplementary written evidence submitted by HM Treasury

Number of People Affected by the Additional Rate of Income Tax

The committee asked how many extra people are expected to pay the 45% rate of income tax as a result of behavioural change.

As set out in the Income tax rates 2013–14 Tax Information and Impact Note,[10] the reduction in the additional rate of tax from 50% to 45% is expected to impact on around 330,000 individuals. The Exchequer impact of the rate change included a significant behavioural response. However, it is not possible to break down this behavioural response between changes in the number of tax payers and changes in the incomes of those affected. This is because the behavioural response is estimated at an aggregate level using the taxable income elasticity. This measures the change in total taxable incomes to a change in marginal tax rates, but does not in itself attribute that change to any particular behavioural response. The possible behavioural responses to income tax rate changes are set out in chart 2.1. These include changes to effort, risk and hours worked; labour market participation; migration; tax planning; avoidance; and evasion.

As with the original costing of the yield from 50p, rather than quantifying each of these effects, the way these behavioural effects are calculated is expressed by the taxable income elasticity. It measures the change in total taxable incomes to a change in marginal tax rates. Rather than the 0.35 TIE used in the original costing, the reduction to 45p is uses a higher TIE of 0.45as set out in the document. This is slightly more cautious than the 0.46 TIE which the Mirlees' Review arrived at.

April 2012

Printed in the United Kingdom by The Stationery Office Limited
04/2012 020003 19585

[10] http://www.hmrc.gov.uk/budget2012/ootlar-main.pdf, page A2

ISBN 978-0-215-04384-9

9 780215 043849

PEFC™
PEFC/16-33-622