



House of Commons  
Treasury Committee

---

# **Budget 2009**

---

**Eighth Report of Session 2008–09**





House of Commons  
Treasury Committee

---

**Budget 2009**

---

**Eighth Report of Session 2008–09**

*Report, together with formal minutes*

*Ordered by the House of Commons  
to be printed 5 May 2009*

## The Treasury Committee

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

### Current membership

Rt Hon John McFall MP (*Labour, West Dunbartonshire*) (Chairman)  
Nick Ainger MP (*Labour, Carmarthen West & South Pembrokeshire*)  
Mr Graham Brady MP (*Conservative, Altrincham and Sale West*)  
Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)  
Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)  
Mr Michael Fallon MP (*Conservative, Sevenoaks*) (Chairman, Sub-Committee)  
Ms Sally Keeble MP (*Labour, Northampton North*)  
Mr Andrew Love MP (*Labour, Edmonton*)  
John Mann MP, (*Labour, Bassetlaw*)  
Mr George Mudie MP (*Labour, Leeds East*)  
John Thurso MP (*Liberal Democrat, Caithness, Sutherland and Easter Ross*)  
Mr Mark Todd MP (*Labour, South Derbyshire*)  
Mr Andrew Tyrie MP (*Conservative, Chichester*)  
Sir Peter Viggers MP (*Conservative, Gosport*)

### 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](http://www.parliament.uk).

### Publications

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](http://www.parliament.uk/treascom).

A list of Reports of the Committee in the current Parliament is at the back of this volume.

### Committee staff

The current staff of the Committee are Dr John Benger (Clerk), Sian Woodward (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young, and Jay Sheth (Committee Specialists), Phil Jones (Senior Committee Assistant), Caroline McElwee (Committee Assistant), Gabrielle Henderson (Committee Support Assistant), Laura Warren and Laura Humble (Media Officer).

### Contacts

All correspondence should be addressed to the Clerks 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](mailto:treascom@parliament.uk).

# Contents

---

<b>Report</b>	<i>Page</i>
<b>Summary</b>	<b>5</b>
<b>1 Introduction</b>	<b>8</b>
<b>2 The economy</b>	<b>9</b>
Growth forecasts	9
Rebalancing the economy	12
Fiscal stimulus	13
Unemployment	15
Quantitative easing and the Asset Purchase Facility	17
<b>3 Public finances</b>	<b>22</b>
State of the public finances	22
Recovering the public finances	25
Delaying the difficult decisions?	28
The fiscal framework	30
Gilt demand	32
<b>4 Other measures in Budget 2009</b>	<b>35</b>
Child poverty	35
Support for the property market	36
Local Housing Allowance	37
Stamp duty on properties under £175,000	38
Vehicle scrappage scheme	39
The 50p tax rate	41
Tax relief on pensions	43
<b>Conclusions and recommendations</b>	<b>46</b>
<b>Formal minutes</b>	<b>49</b>
<b>Witnesses</b>	<b>50</b>
<b>List of written evidence</b>	<b>50</b>
<b>Reports from the Treasury Committee during the current Parliament</b>	<b>51</b>



# Summary

---

## *The economy*

We note that there is considerable uncertainty around the Government's GDP growth forecasts for 2009–2011, reflecting the fact that the UK economy is in uncharted territory. Whilst it is possible that the Government will meet its growth forecasts, on the available evidence this is an optimistic assumption. We question the decision to assume that the economy will begin registering positive growth as early as the fourth quarter of 2009, and that the economy will register such strong growth in 2011. We are concerned that the sharp recovery in consumption forecast for 2011 might be too optimistic given that the UK economy will only just have emerged from a sharp downturn. The strong rebound forecast in consumption growth from 2011 onwards has important implications for whether the rebalancing of the UK economy, with a shift away from consumption and a rise in the savings ratio, is merely a short-term phenomenon.

We note that it is too early to judge whether the November 2008 fiscal stimulus has been successful. There has been much discussion of whether an additional fiscal stimulus is appropriate, separate from the stimulus provided by the automatic stabilisers. Any discussion will need to take account of both the implications for the public finances and the credibility of the Government's plans to bring the budget back into balance.

With unemployment likely to rise above three million, and approximately 40% of the unemployed likely to be young people aged under 25, unemployment measures will need to focus on assisting young people. It is, however, too soon to judge whether the Government's proposed guarantee of a job, work placement or training scheme for all young people who have been on Jobseeker's Allowance for 12 months, together with the monetary and fiscal stimuli, will be a sufficiently timely and substantial response to the unemployment challenge.

The Asset Purchase Facility is a crucial tool of monetary policy. We note the concern of some that not enough is being done to provide adequate liquidity in the corporate debt market. We expect the Bank of England to take every opportunity to use the £50 billion allotted to the purchase of corporate debt under the Facility to ensure those markets operate effectively. We also recommend that the Debt Management Office and Bank of England develop strategies for the Bank to dispose of its holdings of gilts and corporate debt.

## *Public finances*

We note that the Chancellor's forecasts for public borrowing and national debt represent the worst fiscal outlook since the Second World War. By any measure, those forecasts, along with those of many other OECD countries, are extremely high. It is now critically important that the public, and crucially, the markets believe that the Chancellor is working to an adequate plan to restore the public finances to good health. The credibility of any attempt to restore the public finances will depend on an acceptance that the structural deficit must be addressed as well as the consequences of the current extraordinary circumstances. We recommend that future Budgets and Pre-Budget Reports provide a

sectoral analysis of tax revenues, so that, as the UK economy becomes less dependent on financial services and other sectors become more prominent, the basis of the Treasury's revenue forecasts can be scrutinised.

The Temporary Operating Rule appears to us to offer no constraint at all on the fiscal decisions of the Chancellor. It is clear to us the only real financial discipline on the Chancellor is the opinion of the gilt market on the sustainability of the public finances. We note the reaction of the gilt markets to the Treasury's borrowing plans but consider it would be prudent for the Treasury to work up contingency plans for a weakening of demand for Government debt.

We believe that a thorough analysis of all the options for a fiscal framework should now be considered.

### *Child poverty*

We are concerned by the lack of any substantial measure to combat child poverty in both the Pre-Budget Report 2008 and Budget 2009. On current indicators the Government will fail to meet its 2010–11 target by a significant margin. We are dismayed that, despite our repeated warnings, the Treasury has failed to take sufficient positive action to ensure that the child poverty targets are met. We recommend that the Government use the Pre-Budget Report 2009 to indicate the numbers of children in both relative and absolute poverty and the measures it will take in order for its target to halve child poverty by 2010–11 to be met.

### *Housing market*

We call for a more stable framework for the payment of Local Housing Allowance. We are not convinced that schemes to boost the market, such as the stamp duty holiday, will have any marked effect. We call on the Government to provide a cost-benefit analysis of the stamp duty holiday and to report in the 2009 PBR on the implementation of the asset-backed securities scheme.

We welcome the help announced in the Budget for homeowners, but we regret the delays in implementation and the lack of clarity in respect of some of the schemes, especially in entitlement to Support for Mortgage Interest. We recommend that the Government takes urgent steps to ensure that clear information is provided for homeowners on the support that is available to them if they get into financial difficulties as a result of the recession.

### *Vehicle scrappage*

We recognize the importance of the car industry and note that the vehicle scrappage scheme has been welcomed in some quarters. Although it will support 300,000 new vehicle sales, it is likely that only one-third will be additional sales. Of the additional or accelerated new vehicle sales just 12,600 could be new UK-manufactured vehicles, although we acknowledge that most cars sold will contain a high proportion of UK-manufactured components and that car retailing will benefit. We await the 2009 Pre-Budget Report to assess how effective the scheme has been.

### *The 50p tax rise*

We believe that there are considerable uncertainties over the yield to be raised by the 50% top rate of income tax. We recommend that the Treasury should report in the 2011 PBR on the revenue raised, both nominally and as a percentage of the theoretical maximum revenue, by the new top rate of income tax, and assess at that time the yield obtained from the higher rate against its disadvantages. If the higher rate were to continue it would be appropriate to consider what reforms are required to prevent further leakage. The Treasury should indicate if it would revise the rate in the event that the estimated revenue yield fell well below its forecasts. We are concerned that the Chancellor lacked a robust basis for the selection of the threshold from which the new rate would apply and for choosing what that rate should be.

### *Tax relief on pensions*

We note that this Budget marks a departure from the long-standing principle that tax relief for pension contributions should be given at an individual's marginal rate tax. We urge the Treasury to monitor the effect of this change on pension savings and to keep under review the possibility that a cap on annual contributions might be a more equitable way of reducing the percentage of tax relief that benefits the highest earners.

# 1 Introduction

---

1. On Wednesday 22 April, the Rt. Hon. Alistair Darling MP delivered his second Budget, a Budget for what he described in evidence to us as “extraordinary and very uncertain times”.<sup>1</sup> Following our usual practice, we are producing this Report in time for the Second Reading of the Finance Bill. We took evidence on 27 April from independent economic experts; on 28 April from Treasury officials; and on 29 April from the Chancellor. We are grateful to all of our witnesses and to those who submitted the written evidence which is appended to this report. We are also grateful to our specialist advisors on this inquiry, Professor David Heald of Aberdeen University and Professor Geoffrey Wood of the Cass Business School, London.

2. In keeping with our usual practice this Report also draws on other evidence we have taken. In this Report we refer to oral evidence which we took from the Governor of the Bank of England, Mr Mervyn King, and other members of the Monetary Policy Committee (MPC) of the Bank of England, as part of our scrutiny of the MPC’s February 2009 Inflation Report.<sup>2</sup>

---

1 Q 242

2 Treasury Committee, *Bank of England February 2009 Inflation Report: Oral and Written Evidence*, HC (2008–09) 376-i

## 2 The economy

---

### Growth forecasts

3. At the time of Budget 2008, the Treasury forecast that GDP growth would be 1.75% to 2.25% in 2008, 2.25% to 2.75% in 2009 and 2.5% to 3% in 2010.<sup>3</sup> The forecast as presented in the Pre-Budget Report 2008—eight months later—was significantly weaker, with the Treasury forecasting 0.75% GDP growth in 2008, a range of -1.25% to -0.75% in 2009 and 1.5% to 2% in 2010, with growth reaching 2.75% to 3.25% in 2011.<sup>4</sup> At the time of the 2008 Pre-Budget Report, we noted that “the outlook for economic growth remains highly uncertain”, but that the “balance of risks to the Treasury’s forecast is on the downside”.<sup>5</sup>

4. Budget 2009 saw another substantial downward revision to the Treasury’s growth forecasts, with the Treasury now forecasting a contraction of 3.5% in 2009, followed by a resumption of economic growth of 1.25% in 2010 and a sharp increase of approximately 3.5% in 2011.<sup>6</sup> The 2009 Budget was delivered on the same day that the International Monetary Fund (IMF) published its growth forecasts for the UK economy. The IMF estimated that the UK economy would contract by 4.1% in 2009 with the economy continuing to contract by 0.4% in 2010.<sup>7</sup> Meanwhile, independent forecasts of growth in the UK economy—published by HM Treasury alongside the 2009 Budget—illustrate considerable uncertainty around growth prospects for the UK economy. The average of new forecasts was for -3.7% growth in 2009 and 0.3% growth in 2010, but estimates ranged between -4.5% and -1.3% for 2009 and -1.2% and 2.5% for 2010.<sup>8</sup>

5. Martin Weale, Director of the National Institute of Economic and Social Research (NIESR), and Roger Bootle, Managing Director of Capital Economics, explained the consequences for the Government’s 2009 growth forecasts of the publication by the Office for National Statistics (ONS)—two days after the 2009 Budget—of preliminary data showing that GDP had declined by 1.9% in the first quarter of 2009, worse than market expectations of a 1.5% decline. Mr Weale said that the 1.9% figure would be more likely to be revised downwards than upwards as “during a slump the experience is often that the early estimates are revised downwards slightly”.<sup>9</sup>

6. Mr Weale went on to explain that the consequences of this first quarter deterioration in the UK economy, meant that in order to meet the forecast of a 3.5% contraction in 2009 “we need essentially no or only a very small further contraction” through the rest of 2009. He expanded on this, telling us that the forecast could still be achieved if, for example, the economy contracted by around 0.1% in the second quarter with no output falls thereafter

---

3 HM Treasury, *Budget 2008*, p 157, Table B3

4 HM Treasury, *Pre-Budget Report 2008*, November 2008, p 166, Table A3

5 Treasury Committee, *Pre-Budget Report 2008*, Second Report of Session 2008–09, HC 27, p 7

6 HM Treasury, *Budget 2009*, 22 April 2009, (hereafter *Budget 2009*), p 199, Table B3

7 International Monetary Fund, *World Economic Outlook*, April 2009, p 65, Table 2.1

8 HM Treasury, *Forecasts for the UK economy: A comparison of independent forecasts*, April 2009, p 3

9 Q 68

or through a “further fairly sharp fall in output in the current [second quarter] and then a fairly sharp recovery in the fourth quarter”.<sup>10</sup> Roger Bootle agreed with Mr Weale that “you can get 3.5% if there is flat output for the rest of the year”, but explained that if output continued to contract in the second quarter then meeting the forecast would require “a recovery by the end of the year”. Mr Bootle believed that a recovery in the fourth quarter was “possible”, but concluded that that would be “going some”.<sup>11</sup> Dave Ramsden, Chief Economic Advisor for the Treasury, stressed that the ONS’s first estimate of GDP for the first quarter of 2009 should be treated with caution given that it was “made up of 50% of forecast” and given the “mixed messages coming from different data”. He emphasised that before the 2009 Pre-Budget Report the ONS would “produce at least two, if not three new estimates of what happened in Q1”.<sup>12</sup> Mr Ramsden confirmed that the Treasury had no intention of revising its growth forecasts in the light of the ONS figures.<sup>13</sup>

7. Mr Bootle believed that there was “a danger of focusing on the wrong year”, namely 2009, and that whilst there were some differences in forecasts for 2009, the differences were “not that big” compared to the differences in forecasts for 2010 and 2011.<sup>14</sup> Mr Weale told us that although he would “not be surprised to see an element of recovery” in 2010, he did not expect that recovery to lead to growth of 1% or more.<sup>15</sup> Mr Bootle, concurred, telling us that, whilst he did not “totally discount” the official forecasts, the uncertainties were “enormous”.<sup>16</sup>

8. Discussing the Government’s projection of 3.5% growth in 2011, Mr Weale reminded us that “the error margin surrounding all forecasts are inevitably large two years ahead”. He emphasised that during an economic recovery, growth would be faster than trend (trend output is currently assessed by the Treasury as 2.75%), and as a result did not “regard 3.25% as a ridiculous number”, although he was expecting growth [in 2011] to be lower than this. Mr Bootle disagreed, suggesting that whilst a 3.5% projection was not ridiculous it was “hardly cautious”.<sup>17</sup>

9. Mr Bootle cautioned against putting the IMF’s more pessimistic projections for the UK economy “on a pedestal above other forecasters”, arguing that their forecasting record was not particularly impressive. He did however note that the IMF had a reputation for producing “conservative” forecasts, which meant that when the IMF comes out “with a forecast which is notably more pessimistic than the Treasury ... that has rather more weight ... than an equivalent forecast from some other body”.<sup>18</sup>

---

10 Q 6

11 Qq 7-9

12 Q 87

13 Qq 88-89

14 Qq 69-70

15 Q 5

16 *Ibid.*

17 Q 72

18 Q 66

10. Mr Ramsden for the Treasury, rebutted the charge that the Government's growth forecasts for 2010 onwards were overly optimistic. He believed that there would be significant spare capacity at the beginning of the recovery and that there was "potential for that capacity to be taken up relatively quickly" given the "UK's flexible economy, flexible labour and product markets". He offered the parallel with the recovery from the early 1990s recession to support his stance, telling us that "growth grew at an average rate of 3.25% for five years in the 1990s".<sup>19</sup> Mr Ramsden went on to explain why the Treasury believed growth would resume in the fourth quarter of 2009:

we think that the forces which are underpinning eventual recovery are in place to give growth in Q4, and those are the very, very significant macroeconomic policy stimulus from the Bank of England, from the fiscal automatic stabilisers, from discretionary policy, the fall in inflation which will be coming through sharply for the remainder of this year, and the significant depreciation in the exchange rate. We think all those forces will help to lead to a pick-up in GDP towards the end of the year.<sup>20</sup>

Mr Ramsden also believed the recovery would be strengthened by two measures introduced in the 2008 Pre-Budget Report—the ending of the lower rate of VAT at the end of the year meant that there should be a relative price effect bringing forward consumption into the fourth quarter of 2009, and the measures on stamp duty would "encourage some increase in transactions and consumption related to that in Q4". Mr Ramsden concluded by saying he stood by "the judgments that we have made in our forecast".<sup>21</sup> The Chancellor stressed that forecasting economic growth was made more difficult by the fact that "we are living in extraordinary and very uncertain times", but defended the Treasury's forecasts:

My forecast for this year are not that out of line with the current range of forecasts around at the moment and, indeed, next year there are some that are more optimistic than I was.<sup>22</sup>

**11. The Treasury's forecast in the Budget is for the economy to begin recovering in the final quarter of 2009 before going on to register strong growth of 3.5% in 2011. There is, understandably, considerable uncertainty around the Government's growth forecasts for 2009–2011, reflecting the fact that the UK economy is in uncharted territory. This uncertainty is demonstrated by the large number of independent forecasts which are more pessimistic than the Government as well as the smaller number of forecasts which are more optimistic. In particular, we note that the IMF believes the UK will continue to contract in 2010. Whilst it is possible that the Government will meet its growth forecasts, on the available evidence, this is an optimistic assumption. We question the decision to assume that the economy will begin registering positive growth as early as the fourth quarter of 2009, and that the economy will register such strong growth in 2011.**

---

19 Q 86

20 Q 90

21 *Ibid.*

22 Q 242

## Rebalancing the economy

12. Budget 2009 noted that the tightening of credit conditions facing households and companies, and the depreciation of sterling since mid-2007, provided the backdrop for a “significant rebalancing of demand in the UK economy”.<sup>23</sup> This macroeconomic adjustment was likely to entail increased saving by households, increased investment by companies, and a rebalancing of domestic and external demand with net trade contributing positively to GDP growth over the period 2009–2011.<sup>24</sup>

13. Mr Ramsden confirmed that the Government was “expecting a significant rebalancing of the economy through the recession”. Indeed the Treasury told us that “developments in the second half of 2008 suggest that this adjustment may be taking place at a more rapid pace than many had expected”. It noted that the second half of 2008 saw a “slightly larger than expected fall in consumer spending but a slightly smaller than expected fall in investment”.<sup>25</sup> Mr Ramsden highlighted the fact that the savings ratio was predicted to pick up significantly” over the 2009–2011 forecast period,<sup>26</sup> with the savings ratio forecast to rise from 2% in 2008 to 4.5% in 2009, 5% in 2010 and 5.5% by 2011.<sup>27</sup> Over the same period, household consumption growth, which was 1.25% in 2008, was expected to fall by between 2.75% and 3.25% in 2009, thereafter growing modestly at around 0.25% in 2010 before rebounding sharply to 3–3.5% in 2011.<sup>28</sup> Mr Ramsden told us that by 2011 he expected household consumption “to be contributing significantly to growth”.<sup>29</sup> He rebuffed the charge that the Treasury was being over-optimistic in its assessment of the bounce-back in consumption in 2011, telling us that, with the savings ratio having risen and the vast majority of people remaining in employment, the conditions would be in place for household consumption to grow strongly.<sup>30</sup>

14. Mr Ramsden also highlighted the role net trade would play in contributing to growth over the 2009–2011 period telling us that it “contributes half a percentage point in 2009 and half a percentage point in 2010”.<sup>31</sup> He expressed the hope that it could make an even stronger contribution to growth than predicted over the forecast period. This was because, assuming the eurozone economy recovered as the Treasury was forecasting, the extent to which sterling had depreciated against the euro, would leave the UK in a strong position.<sup>32</sup> Our experts concurred that the depreciation of sterling put the UK “in a very good position”, but cautioned that export growth would “not materialise until our major trading

---

23 *Budget 2009*, p 203, para B.67

24 *Ibid.*, para B.67, Table B3

25 HM Treasury, *Supplementary Memorandum*, April 2009

26 Q 93

27 *Budget 2009*, p 204, Table B5

28 *Ibid.*

29 Q 92

30 Q 94

31 This comes after a period when net trade contributed negatively to growth. Net trade contributed, on average, -.25% to GDP growth between 200–2006 and –0.75% in 2007

32 Q 99

partners, which are Germany and the United States, start to recover themselves”.<sup>33</sup> We asked Mr Ramsden what would happen if the eurozone and the USA did not return to positive growth in 2010, as is forecast in the 2009 Budget.<sup>34</sup> He acknowledged that the “resumption of world trade and global activity” were “key conditioning assumptions for our forecasts” and that this was why the Government attached “so much importance to the G20 process” and for “G20 leaders to both commit to action and then take it”.<sup>35</sup> Mr Ramsden concluded by saying that, in the event that world trade and growth failed to pick up, the Treasury would begin looking at alternative ways to the achieve the “same growth rates”.<sup>36</sup>

**15. It is clear that the recession has acted as a catalyst for the rebalancing of demand in the UK economy. This rebalancing entails a shift away from consumption with a concomitant rise in the savings ratio, with net trade also playing a more important contributory role to growth over the 2009–2011 period. We note, however, that the contribution net trade will make to growth is contingent upon a speedy recovery in the UK’s major trading partners and on the fulfilment of commitments made at the G20. Consumption is forecast to recover sharply in 2011 but we are concerned that this may be too optimistic given that the UK economy will only just have emerged from a sharp downturn. Additionally, the strong rebound forecast in consumption growth from 2011 onwards has important implications for whether the rebalancing of the UK economy is merely a short-term phenomenon or whether the Government should take steps to ensure such changes prove more durable. Savings will need more encouragement.**

## Fiscal stimulus

16. The significant worsening of the economic outlook led the Government to announce a fiscal stimulus at the time of the 2008 Pre-Budget Report. The fiscal stimulus comprised a “temporary reduction in the VAT rate to 15% with effect from 1 December 2008 to 31 December 2009”, as well as the bringing forward of £3 billion of capital spending from 2010–11 to 2008–09 and 2009–10. According to the Pre-Budget Report 2008, this discretionary action, which would cost £16 billion, would deliver an overall fiscal stimulus of around 1% of GDP in total in 2009–10 and reduce the extent of the downturn by about 0.5%.<sup>37</sup> At the time of the 2008 Pre-Budget Report, we concluded that “the overall effect of the fiscal stimulus remains uncertain” and that “the cost of the reduction in VAT is considerable and, in the view of the majority of commentators, the Treasury’s analysis of its impact is an optimistic one”.<sup>38</sup>

---

33 Q 78

34 HM Treasury, *Pre-Budget Report 2008*, November 2008, p 185–186, para B.12,B.15

35 Qq 96-97

36 Q 96

37 HM Treasury, *Pre-Budget Report 2008*, November 2008, p 17, para 2.17–2.18

38 Treasury Committee, Second Report of Session 2008-09, *Pre-Budget Report 2008*, HC 27, p 12

17. We asked our expert witnesses whether the November 2008 fiscal stimulus, and in particular the reduction in VAT, could be described as a success. Martin Weale told us that the VAT cut was designed to “encourage people to buy in anticipation of future price rises” and that, if this was to occur, it would “be observed at the end of this year rather than at the moment”. Robert Chote cast further doubt on assessing the success or otherwise of the VAT reduction, noting that “the difficulty is discerning what would have happened to the path of consumer spending in the absence” of a reduction.<sup>39</sup>

18. The NIESR has called for a second fiscal stimulus at the time of the 2009 Budget, of around 2% of GDP<sup>40</sup> which Martin Weale explained could have been spent on a “one-off rebate to taxpayers and pension recipients”.<sup>41</sup> Mr Weale argued that the case for a further fiscal stimulus was the same as the case for the first fiscal stimulus, namely that:

in normal circumstances if governments borrow money it has to be repaid in the future and the short-term gains you might think are more or less exactly offset by the long-term losses, but in a recession, when you have people who would like to work and cannot work, that is no longer true, so the argument remains even despite the very large borrowing figures.<sup>42</sup>

19. Mr Chote focused on the implications for the public finances of further stimulus, explaining that such a stimulus would “pale into significance” in terms of the “impact on the path of public sector net debt compared to the underlying deterioration”. A further fiscal stimulus could be looked at in two ways:

One is that you would not even notice it given the rest of the deterioration. The other view that Mervyn King has expressed is that, given how high the debt is going to be, it is dangerous to even push it very modestly further.<sup>43 44</sup>

Mr Bootle told us that, whilst he had initially been in favour of a second fiscal stimulus at the time of Budget 2009, he had changed his mind “because of the emerging news about the sheer scale of the deficit”. He explained that any attempt to stimulate the economy with “an extra 1% or 2% or 3% of GDP would actually be quite dangerous in terms of the way the markets would perceive this”.<sup>45</sup> Mr Chote expanded on these comments, stressing that the ‘credibility’ of any further fiscal stimulus depended on “the quality of the plan the Government has in place to repair the underlying problem”.<sup>46</sup>

39 Q 12

40 ‘Fiscal stimulus—How do we get ourselves out of recession’, National Institute of Economic and Social Research Press Notice, 20 April 2009

41 Q 16

42 *Ibid.*

43 Q 17

44 Mr Chote was referring to the Governor of the Bank of England’s comments when he appeared before the Treasury Select Committee’s Inflation Report hearing on 24 March 2009. HC (2008-09) 376-I, IQ 97

45 Q 19

46 *Ibid.*

20. Mr Ramsden for the Treasury rejected the suggestion that Budget 2009 should have contained a second fiscal stimulus. He believed that there was “a very, very significant amount of stimulus already in the system”, citing, as examples, interest rates which were at “historic lows” as well as the Bank of England’s quantitative easing policies.<sup>47</sup> Mr Ramsden also referred to the “targeted stimulus” measures in the 2009 Budget. The Chancellor acknowledged that some economists, such as Martin Weale and Professor Blanchflower, had advocated a further fiscal stimulus, but countered that the Government had already introduced “quite a substantial fiscal stimulus” into the economy and that this was “sufficient”. He went on to say that there was a trade-off and that he needed “to balance what you do by way of stimulus with the fact that at the end of the day it has got to be paid for”.<sup>48</sup>

**21. It remains too early to judge whether the November 2008 fiscal stimulus—and in particular the VAT reduction—has been successful. There has been much discussion of whether a subsequent fiscal stimulus, separate from the stimulus provided by the automatic stabilisers was necessary, but ultimately the Government decided against introducing a further large-scale fiscal stimulus at the time of the 2009 Budget. No doubt the debate around the need for a further fiscal boost to the UK economy will continue, particularly if growth in the economy fails to pick up. Any discussion of additional stimulus must take into account both the implications for the public finances of such a boost and the credibility of the Government’s plans to bring the budget back into balance.**

## Unemployment

22. The economic downturn has led to a weakening of the labour market and an increase in unemployment. ONS figures published on the day of Budget 2009, showed a significant increase in unemployment—by 177,000 over the quarter and 486,000 over the year—to 2.10 million. As a result the unemployment rate for the three months to February 2009 now stands at 6.7%. This is the highest level of unemployment in the UK since 1997.<sup>49</sup>

23. In a recent speech, Professor David Blanchflower—a member of the Monetary Policy Committee—raised the spectre of unemployment potentially rising to the 4 million mark.<sup>50</sup> Professor Blanchflower noted, when he appeared before us in February 2009, that around 40% of the unemployed were aged 24 or under and warned that:

The numbers are going to change dramatically past June, when the class of 2009 enter the labour market, and the big problem ... is that a spell of unemployment when you are young has a long-lasting effect through the rest of your life.<sup>51</sup>

---

47 Q 94

48 Q 244

49 “Labour market statistics”, Office for National Statistics, 22 April 2009

50 “Unemployment could double to 4m, predicts Danny Blanchflower”, *Daily Telegraph*, 24 March 2009

51 HC (2008-09) 376-i, Q 64

Professor Blanchflower urged policy makers to focus on ‘unemployment’ and argued that assistance needed to be targeted on groups, such as the young “that are really going to be hurt”.<sup>52</sup>

24. Budget 2009 contained a number of measures to support employment, building upon policies introduced at the 2008 Pre-Budget Report. Measures announced in this year’s Budget included setting aside an additional £1.7 billion for the Department for Work and Pensions (DWP) over the next two years to ensure that Jobcentre Plus is sufficiently well-resourced. The £1.7 billion comes on top of an increase in funding of £1.3 billion for Job Centre Plus announced at the time of the 2008 Pre-Budget Report. There were also measures targeted at younger people, including:

- guaranteeing everyone aged between 18–24 who has been claiming Jobseekers Allowance (JSA) for 12 months a job, work placement or work-related skills training for at least six months;
- the establishment of CareFirst which will offer 50,000 traineeships for young people in the care sector with employers participating in the scheme receiving a subsidy for offering employment and training to young people who have been out of work for at least twelve months.<sup>53</sup>

25. Martin Weale was gloomy about the prospects for unemployment, predicting that it would rise above 3 million.<sup>54</sup> Mr Weale made one caveat to this prediction, however, saying that “one unknown factor which will have an impact on unemployment is the extent to which many of the recent immigrants into the country may return home”.<sup>55</sup> He was unsurprised that young people accounted for such a high proportion of the unemployed, telling us that the evidence showed that the problem of unemployment was most acute amongst “people entering the labour market” as well as those “closest to retirement”.<sup>56</sup> Mr Weale believed it was a good idea to target assistance at groups who were at high risk of unemployment and, as a result, he supported the Government’s approach of targeting assistance at younger workers, but said that it would be unlikely that these Government measures “would stop unemployment rising to three million”.<sup>57</sup> Mr Weale explained that this was because proposals such as guaranteeing a job, work placement or training after twelve months for those under 24 involved a significant “time lag” because they would only qualify after 12 months of claiming JSA.

26. Mr Ramsden would not comment on whether the Government’s proposals would prevent unemployment rising above 3 million. Instead he told us that Government policies were “a sufficient and serious response to the needs of the labour market”.<sup>58</sup> The

---

52 HC (2008-09) 376-i, Q 64

53 *Budget 2009*, p 95–96, para 5.25, Box 5.4

54 Q 21

55 *Ibid.*

56 Q 22

57 Q 24

58 Q 110

Chancellor expanded on Mr Ramsden's comments, telling us that, whilst the Government had targeted specific measures at those aged 24 or under, he was also "focused" on assisting unemployed people aged 25 or over.<sup>59</sup> He explained that the additional resources being pumped into Job Centre Plus were "designed to help anyone who loses their job", but felt that specific targeted support through the "guarantee for 18–25 year olds" was also necessary because a short spell of unemployment at a young age could "lead to quite a long period in and out of employment".<sup>60</sup>

**27. There is a strong possibility that unemployment will rise above three million, with some economists warning that it is possible that unemployment could rise as high as four million. Approximately 40% of the unemployed are likely to be young people aged under 25. We agree with Professor Blanchflower that this necessitates measures focused on assisting young people and, to this end, welcome the Government's approach of targeting resources on this group. That said, it is too soon to judge whether the Government proposal that all young people who have been on Jobseeker's Allowance for 12 months will be guaranteed a job, work placement or training opportunity, together with the monetary and fiscal stimuli, are a sufficiently timely and substantial response to the scale of the unemployment challenge.**

## Quantitative easing and the Asset Purchase Facility

28. In our Report on the 2008 Pre-Budget Report in January 2009, we noted that "the risk of a self-reinforcing deflationary cycle" existed in the UK economy.<sup>61</sup> Since then, the MPC has instituted a policy of 'quantitative easing', using the Asset Purchase Facility, to counter such a risk of a period of sustained deflation.

29. The Asset Purchase Facility was originally announced on 19 January 2009.<sup>62</sup> At that time, the aim of the Facility was to purchase "high quality private sector assets, including paper issued under the CGS [Credit Guarantee Scheme], corporate bonds, commercial paper, syndicated loans and a limited range of asset backed securities created in viable securitisation structures", up to a value of £50 billion.<sup>63</sup> The scheme was *sterilised*, which meant that it had no direct impact on the overall supply of money in the economy, as it was funded by Treasury Bills.<sup>64</sup> However, the Treasury left scope for the Facility to be widened. It permitted the MPC to request the use of asset purchases for monetary policy purposes should it conclude that this would be "a useful additional tool for meeting the inflation target".<sup>65</sup> The Governor wrote to the Chancellor on 17 February 2009 to request such a move.<sup>66</sup> He explained that the MPC had, at its February meeting, discussed its latest

---

59 Q 245

60 Q 244

61 Treasury Committee, Second Report of Session 2008–09, *Pre-Budget Report 2008*, HC 27, para 30

62 "Statement on financial intervention to support lending in the economy", HM Treasury press release 05/09, 19 January 2009

63 *Ibid.*

64 *Ibid.*

65 *Ibid.*

66 Bank of England website, [www.bankofengland.co.uk](http://www.bankofengland.co.uk), Letter from the Governor to the Chancellor, 17 February 2009

forecasts for GDP growth and CPI [Consumer Prices Index] inflation. Those forecasts pointed to “a substantial risk that inflation would undershoot the target in the medium term”.<sup>67</sup> As such, the Committee had unanimously concluded that “it might be necessary to use asset purchases at future meetings in order to meet the 2% target for CPI inflation”.<sup>68</sup> The Chancellor, in his reply on 3 March 2009, agreed to the requests of the MPC to:

- finance purchases under the Asset Purchase Facility using Central Bank Money; and
- extend the range of debt eligible to be purchased, by authorising the MPC to use the Asset Purchase Facility to purchase UK Government debt on the secondary market.<sup>69</sup>

30. By these changes, the Asset Purchase Facility had therefore changed into an *unsterilised* scheme, which would now increase the money supply directly. The Governor, in his letter to the Chancellor explained that if the facility could be used “to buy gilts on the secondary market financed by central bank money, this would be similar to the current implementation of monetary policy, except that the instrument of policy would shift towards the quantity of money provided”.<sup>70</sup> This was necessary after the Bank rate in the UK was reduced to 0.5% on 5 March 2009.<sup>71</sup> As the February 2009 Inflation Report pointed out:

Nominal market interest rates cannot ... fall below zero. That is because no one would want to make a loan or hold a deposit at negative rates because they would be better off holding cash (which yields a zero rate). That constrains the amount of monetary stimulus that can be applied through changes in Bank Rate alone.<sup>72</sup>

The new unsterilised Asset Purchase Facility would act as the tool of monetary policy now that the Bank rate had fallen too close to zero to be effective in that role. The Inflation Report outlined how this would work:

- First, by increasing the supply of broad money, private sector spending should be stimulated, both directly (through the increase in money holdings of private sector asset sellers) and indirectly (through an expansion by banks of the supply of credit).
- Second, to the extent that the extra reserves are used to make targeted purchases of high-quality but temporarily illiquid assets issued by private sector borrowers—in a way similar to the operations currently being conducted by the Bank—they should help to provide greater confidence to investors that they would be able to sell those assets should they need to, reducing illiquidity premia and stimulating trading activity. That

67 Bank of England website, [www.bankofengland.co.uk](http://www.bankofengland.co.uk), Letter from the Governor to the Chancellor, 17 February 2009

68 *Ibid.*

69 HM Treasury website, [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk), Letter from the Chancellor to the Governor, 3 March 2009

70 Bank of England website, [www.bankofengland.co.uk](http://www.bankofengland.co.uk), Letter from the Governor to the Chancellor, 17 February 2009

71 “Bank of England Reduces Bank Rate by 0.5 Percentage Points to 0.5% and Announces £75 Billion Asset Purchase Programme”, Bank of England press release, 5 March 2009

72 Bank of England, *Inflation Report*, February 2009, p 44

in turn should make it easier for some types of company to issue new market-based credit, reducing their reliance on the banking sector.<sup>73</sup>

31. In his letter to the Governor, the Chancellor outlined the size of the scheme. He authorised an increase in the scale of purchases to up to £150 billion, with up to £50 billion dedicated to the purchase of private sector assets.<sup>74</sup> The MPC voted at its March meeting to use only £75 billion of this sum, and the Governor told us that the aim would be to use close to this amount in three months.<sup>75</sup> This figure equated, roughly, to 5% of broad money<sup>76</sup> held by the non-financial sector, and it was felt by the MPC that this was the level of injection needed in the economy.<sup>77</sup> In its quarterly report on the implementation of the Asset Purchase Facility, the Bank noted that in the period up to the week ending 5 March 2009, some £985m of commercial paper had been bought under the Asset Purchase Facility, but that these purchases had been sterilised. Since then, over £14 billion had been spent using central bank money, with £982m on commercial paper, £128m on corporate bonds, and the majority, £12,993m, on gilts.<sup>78</sup>

32. We considered whether there remained the risk of a sustained period of deflation; for while the Retail Prices Index in the year to March 2009 fell by 0.4%, the Consumer Prices Index (as used in the Inflation Target) in the year to March 2009 had risen by 2.9%.<sup>79</sup> When asked whether he thought this danger had now passed, Mr Bootle told us that while it was “true that the recent inflation numbers have been rather disappointing if people were looking for a very sharp fall”, this was the wrong time period over which to be concerned about sustained deflation.<sup>80</sup> He believed that the real risk of this was not in the immediate future “but rather a bit further out, say, in a year or 18 months’ time”.<sup>81</sup> He explained that as average earnings growth fell to “about zero or below”, for which there was already some evidence, under normal productivity growth—or even slightly below normal—unit labour costs would start to fall.<sup>82</sup> At that point, competitive pressures would see businesses reduce their selling prices.<sup>83</sup> Mr Ramsden accepted that the Treasury had to be “vigilant” to the risk of sustained deflation but told us he saw sustained deflation “as a low probability risk”.<sup>84</sup> He thought that the period of negative inflation was “going to be temporary”.<sup>85</sup>

---

73 Bank of England, *Inflation Report*, February 2009, p 45

74 HM Treasury website, [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk), Letter from the Chancellor to the Governor, 3 March 2009

75 Bank of England, *Asset Purchase Facility Quarterly Report*, 2009 Q1, HC (2008-09) 376-I, Q 17

76 Broad money is a term used to describe a wider definition of the money supply than just notes and coins. It may include more illiquid instruments, such as bank deposits, certificates of deposit and estimated holdings of sterling bank bills.

77 HC (2008-09) 376-i, Q 14

78 Bank of England, *Asset Purchase Facility Quarterly Report*, 2009 Q1

79 Office for National Statistics, *Consumer price indices*, March 2009, p 1

80 Q 27

81 *Ibid.*

82 *Ibid.*

83 *Ibid.*

84 Q 165

85 *Ibid.*

33. Mr Weale expressed dissatisfaction with the mix of assets being bought by the Bank as part of its operations, with its heavy emphasis on gilt purchases:

I think had the policy focused on the corporate debt market we would have had much more liquidity in that market, the operations of the Bank of England would have to some extent compensated for the unwillingness of the joint stock banks to lend instead of merely creating a bit of extra liquidity and hoping that the joint stock banks would lend, and the corporate bond market might have enjoyed a bit of a revival, businesses might have found that they could issue more corporate bonds and so ease the credit constraints, at least in that part of the corporate sector.<sup>86</sup>

However, the Governor in his evidence on the Inflation Report, told us that the Bank of England expected its interventions in the corporate market to be “small”.<sup>87</sup> For the Governor, the criterion for success was not the amount of corporate purchases that were made, but rather the “leverage that such purchases might have on the credit spreads in markets and the private sector issuance of that paper”.<sup>88</sup> He was encouraged by the progress to date.<sup>89</sup> He provided the example of a company that “having been able to issue commercial paper to the Bank of England”, the next time found “it was actually possible to issue [commercial paper] at the same spread to the private sector in the market”.<sup>90</sup> Mr Ramsden explained that while there was “some way to go to the £50 billion”, there were “already indications in terms of what has been described as the liquidity premium in some of these markets, that the differential of these riskier assets over government bonds is coming down”.<sup>91</sup> This might reflect the impact of the twin-track approach of both gilt purchases and smaller interventions in the corporate sector debt markets.<sup>92</sup> The Chancellor agreed that the scheme should be judged not on the size of corporate purchases, but on their effectiveness.<sup>93</sup>

34. Mr Bootle was concerned that the lack of an exit strategy from the Asset Protection Facility was inhibiting a full commitment to quantitative easing. He explained that, according to economic textbooks, the central bank could produce infinite amounts of liquidity to beat deflation. However, he felt that the Bank of England had translated this “to infinity” to mean “£75 billion now and maybe another £75 billion later”.<sup>94</sup> He told us that the authorities were “understandably worried”, about the re-entry problem, that is to say, how the policy of quantitative easing could be reversed.<sup>95</sup> He concluded that if there were an exit strategy from quantitative easing which the markets found credible, then “the Bank

---

86 Q 29

87 HC (2008-09) 376-i, Q 10

88 *Ibid.*

89 *Ibid.*

90 *Ibid.*

91 Q 169

92 *Ibid.*

93 Q 251

94 Q 31

95 *Ibid.*

could feel more confident about expanding the scope and size of quantitative easing”.<sup>96</sup> The Governor however explained that “It may be that we do not need to take it [the additional liquidity] out, provided the further growth of money is in line with the growth of nominal national income”.<sup>97</sup> He suggested that the obvious successor measures would be to raise interest rates, and tighten monetary policy.<sup>98</sup> The Chancellor noted that the inflation target of 2% would mean that, should inflation rise because of quantitative easing, the Bank would be able to raise interest rates to meet this inflation target.<sup>99</sup> On disposing of the purchased corporate bonds and gilts, he acknowledged that it would have to be done “in discussion with the Government’s DMO operations anyway because the markets would want to have an idea of how the Bank of England was winding down its position”, but that such discussions were not pressing concerns.<sup>100</sup>

**35. The Asset Purchase Facility is a crucial tool of monetary policy, given the currently low level of Bank rate. We note the heavy bias towards the purchase of gilts under the facility. We note the concern of some that not enough is being done to provide adequate liquidity in the corporate debt markets. We expect the Bank of England to take every opportunity to use the £50 billion allotted to the purchase of corporate debt under the Asset Purchase Facility to ensure the effective operation of those markets. We also recommend that the Debt Management Office and the Bank of England develop strategies for the Bank to dispose of its increasing holdings of gilts and corporate debt.**

---

96 Q 31

97 HC (2008-09) 376-i, Q 19

98 *Ibid.*

99 Q 253

100 Qq 253-254

### 3 Public finances

#### State of the public finances

36. The 2009 Budget revealed a sharp increase in public spending, and a severe reduction in tax revenues as a result of the recession.<sup>101</sup> Government borrowing is now forecast to be higher than at any time since World War II, and the national debt is set to remain high for at least a generation. The forecasts for the public finances were also subject to an even greater degree of uncertainty than previously, as the Chancellor acknowledged: “Inevitably in forecasting, which is difficult even when times are pretty settled, the uncertainty around in this country and other countries makes matters more complicated”.<sup>102</sup> Table 1 below sets out the key fiscal projections from Budget 2009:

**Table 1: Summary of fiscal projections.**

	% of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-2010	2010-11	2011-12	2012-13	2013-14
Public sector net borrowing	2.4	6.3	12.4	11.9	9.1	7.2	5.5
Surplus on current budget	-0.4	-3.6	-9.3	-9.4	-7.2	-5.6	-4.3
Cyclically-adjusted surplus on current budget	-0.7	-3.1	-6.7	-6.4	-4.9	-3.9	-3.2
Public sector net investment	2.1	2.6	3.1	2.5	1.9	1.6	1.3
Public sector net debt excluding liabilities and unrealised losses from financial sector	36.5	43.0	55.4	65.0	70.9	74.5	76.2
Public sector net debt including unrealised losses on financial sector interventions	36.5	46.5	59.0	68.4	74.0	77.5	79.0

Source: HM Treasury, *Budget 2009*, p 20, Table 2.2

37. At the time of the 2008 Budget, the Treasury forecast that the current budget would move into surplus in 2010–11. In our Report arising from that document, we noted that this forecast was subject to “considerable downside risks”.<sup>103</sup> Our scepticism was vindicated by the 2008 Pre-Budget Report (PBR), which projected a significant further deterioration in the public finances, with the current budget in deficit throughout the forecast period, peaking at 5.3% of GDP in 2009–10, and then falling to 1.1% by 2013–14. The cyclically-adjusted current deficit was forecast to fall from 4.4% of GDP in 2009–10, to 1.0% in 2013–14, when the economy was “projected to return to trend, driven by a recovery of tax receipts and lower spending growth”.<sup>104</sup>

38. The 2009 Budget announced a further marked deterioration in the borrowing forecasts. Projections for the current budget deficit in each and every year until the end of the forecast period (2013–14) had increased by at least £50 billion from those made at the time of PBR 2008.<sup>105</sup> Net borrowing, which also includes net investment, is set to peak in this financial year at £175 billion, an alarmingly high 12.4% of GDP. Chart 1 places the size of

101 *Budget 2009*, p 226, table C4

102 Q 242

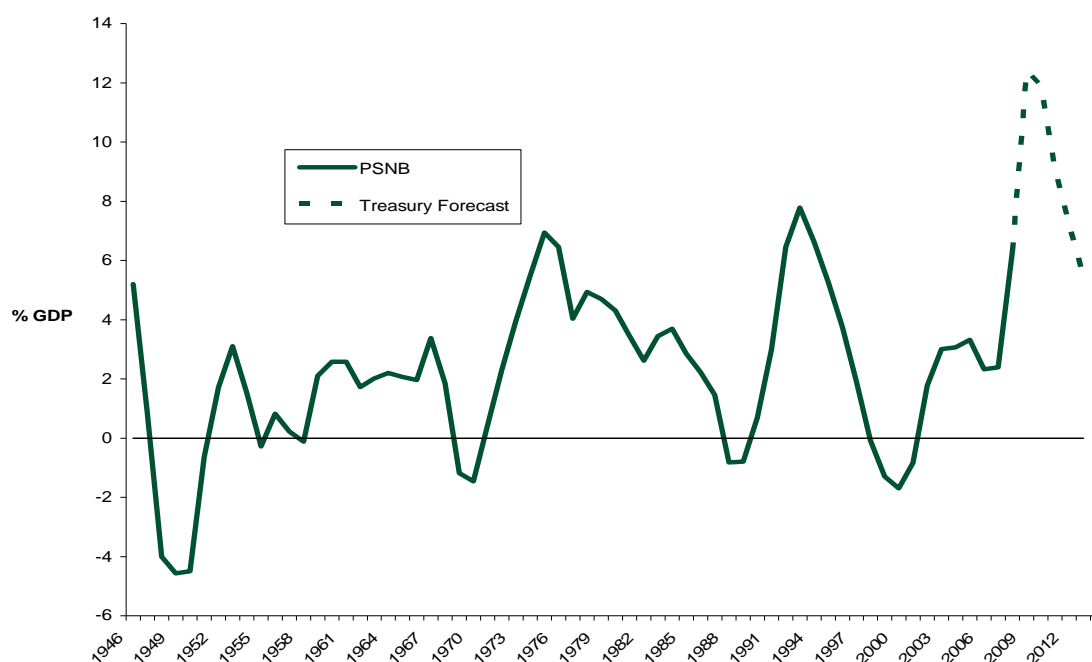
103 Treasury Committee, Ninth Report of Session 2007–08, *The 2008 Budget*, HC 430, para 31

104 HM Treasury, *Pre-Budget Report 2008*, Cm 7484, November 2008, p 190

105 *Budget 2009*, p 225, table C3

public sector borrowing in some historical context and shows that since 1946 at least, borrowing has not been so high as it is projected to be this year.

**Chart 1: Public sector net borrowing.**



Source: HSBC, "UK Budget 2009: Living on borrowed money", 23 April 2009

39. The Chancellor explained that borrowing had increased because, on the income side, revenue from the financial services sector was "way down" not least because of lower revenues arising from corporation taxes and taxation of financial sector bonuses, and stamp duty revenues were lower too "because of the general slowdown in the economy". Secondly, borrowing had risen because of the fiscal stimulus, which included deliberate policy choices such as the temporary VAT reduction, the increase in personal allowances, and various other measures set out in the Pre-Budget Report and the Budget. Thirdly, borrowing had risen because of the "automatic stabilisers", via which the cost of welfare payments rises with unemployment.<sup>106</sup>

40. Roger Bootle, writing in the *Daily Telegraph*, pencilled in a more pessimistic prediction of peak borrowing of £230 billion, or 16% of GDP next year, compared with the Chancellor's forecast of £173 billion.<sup>107</sup> In oral evidence, he explained that the reason why he took a different view from the Government on the future of the public finances was primarily because he took a more pessimistic view of the economy in general—"If I believed the Chancellor's economic forecast, I suspect my fiscal forecast would be largely the same".<sup>108</sup> Mr Ramsden, defending the Budget's forecasts, pointed out that they were less optimistic than the average of new independent forecasts had been prior to the Budget's publication, and advised us that this was because some of the Treasury's underlying assumptions "do build in some caution". He accepted that other forecasters predicted

106 Q 243

107 "If the Budget was a numbers game, the Chancellor definitely lost", *Daily Telegraph*, 23 April 2009

108 Q 36

higher borrowing, but nevertheless considered the Budget's projection to be a realistic forecast.<sup>109</sup>

41. According to the Budget, in 2009–10 public sector net borrowing will be 12.4% of GDP, of which 9.8% of GDP (or 79% of borrowing) is accounted for by structural, rather than cyclical factors.<sup>110</sup> A structural deficit represents borrowing that is not going to disappear when the economy returns to growth. Mr Ramsden explained that the large structural deficit in 2009/2010 resulted from the way in which the Treasury's method for making cyclical adjustments recognised the 5% permanent loss of productive capacity in the economy caused by the recession. If the recession's impact on the supply side of the economy turned out to be less than 5%, then the percentage of the deficit that was structural would be correspondingly lower.<sup>111</sup>

42. The Budget announced that public sector net debt (PSND) would increase rapidly through the forecast period. PSND excluding liabilities and unrealised losses from financial sector interventions, rises over the period to 2013–14, in particular in 2009–10 and 2010–11, reflecting the surge in additional borrowing in these years. By 2013–14 PSND on this measure reaches 76.2% of GDP. The inclusion of potential impacts arising from financial sector interventions on PSND makes for even worse reading—by 2013–14, PSND on this basis stabilises at around 79% of GDP.<sup>112</sup>

43. Until Pre-Budget Report 2008, public sector net debt had been limited by the Sustainable Investment Rule, which stated that PSND should be maintained below 40% of GDP in each and every year of the economic cycle.<sup>113</sup> The Treasury chose to depart from this Rule in PBR 2008, until such a time as the global shocks had worked their way through the economy in full.<sup>114</sup> The parlous state of the public finances can be ascertained when it is recognised that, if the Sustainable Investment Rule were still in force in 2013–14, the projected PSND would have been double that permitted by the rule. Indeed, a return to the 40% level is by no means imminent. The IFS has calculated that, based on Budget 2009 assumptions, this would not occur until February 2032. Chart 2 below portrays this trajectory for the national debt.

---

109 Q 137

110 *Budget 2009*, p 222, table C2

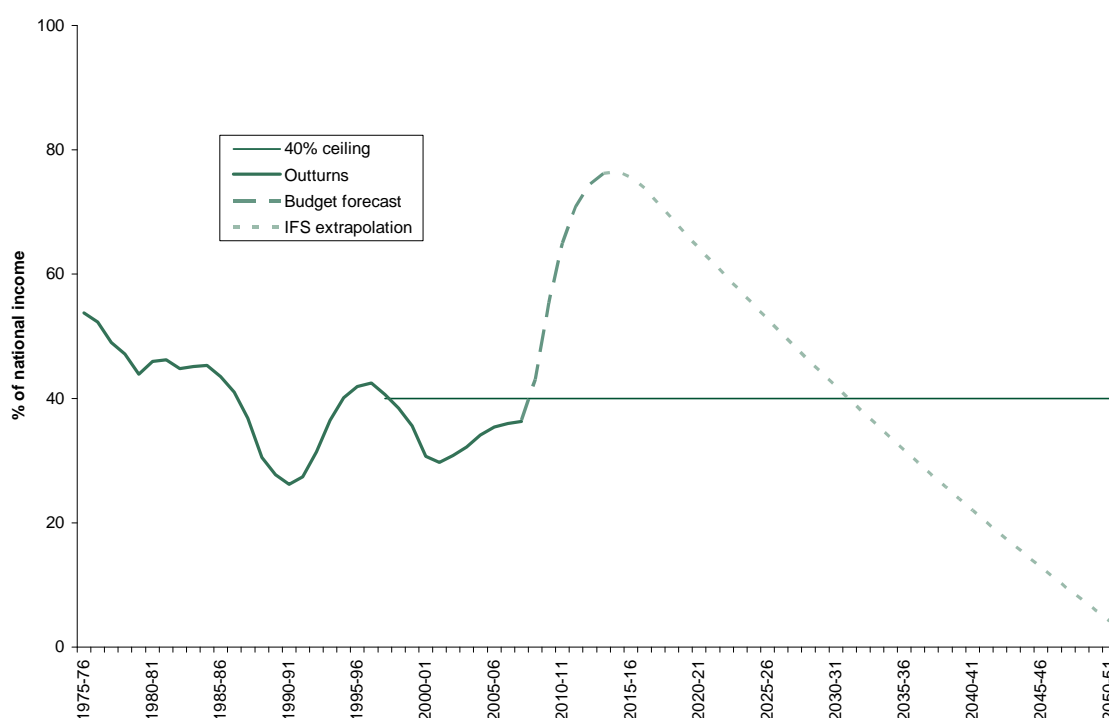
111 Q 112

112 *Budget 2009*, para 2.82

113 HM Treasury, *Pre-Budget Report 2006*, Cm 6984, December 2006, p 31, para 2.58

114 HM Treasury, *Pre-Budget Report 2008*, Cm 7484, November 2008, p 15

Chart 2: Public sector net debt.



Source: IFS, *Public finances: two parliaments of pain*, 23 April 2009

44. The Chancellor’s forecasts for public borrowing and national debt make sobering reading. By any measure, those forecasts, along with those of many other OECD countries, are extremely high: they have exceeded the fiscal rules from which the Government departed in PBR 2008 by a wide margin and these figures represent the worst fiscal outlook since the Second World War. We are very concerned about the state of the public finances. What is now of critical importance is that the public, and crucially the markets, believe that the Chancellor is working to an adequate, and credible, plan to restore the public finances to good health. The credibility of any attempt to restore the public finances will depend on an acceptance that the structural deficit must be addressed as well as the consequences of the current extraordinary circumstances. We discuss this plan in the next section of this Report.

## Recovering the public finances

45. The Chancellor told us there were two elements to his approach to fiscal policy. On the one hand, he was “trying to support the economy now” but, on the other, he was scheduling in “quite a substantial tightening as we come into recovery”, because it was important “to send a clear signal that whilst you support the economy now, like all countries, like all businesses, you have got to live within your means in the medium and longer term and we have got to have sustainable public finances”.<sup>115</sup> In Mr Chote’s opinion, the credibility of the public finances depended crucially “on the quality of the plan the Government has in place to repair the underlying problem” and whether people believed

that the Government, or a future government, was going to pursue the sort of fiscal tightening over the next Parliament, that was necessary.<sup>116</sup>

46. The Chancellor argued that the reason why borrowing and debt were “much, much higher” than previously was because of “the extraordinary circumstances” of the last couple of years. But he added that he was in no doubt that it was absolutely necessary, “to have a pretty clear view that this level of borrowing and the levels of debt need to come back down”. In line with that recognition, the 2009 Budget set a path for halving the deficit over the next five year period.<sup>117</sup> It also reaffirmed the Government’s commitment to ensuring sound public finances and protecting fiscal sustainability:

Sound public finances are essential for macroeconomic stability, which gives businesses and individuals the confidence to plan and invest for the long term. They also help to deliver low long-term interest rates, supporting businesses’ access to new financing and resources for growth.<sup>118</sup>

In order to ensure such sound public finances, the Budget set out tax and spending measures to be implemented at a time when the economy is forecast to be recovering and able to support fiscal consolidation. These plans “will deliver an average adjustment of over 0.8% a year in the cyclically-adjusted current budget between 2010–11 and 2013–14”.<sup>119</sup> Mr Chote explained that this plan gave somewhat limited information about where that tightening would fall:

About 10% of that is achieved by the tax increases that have already been announced, ... and then in addition the Government is anticipating getting about 15% of that gap filled by cuts in capital spending over the duration of the next Parliament, ..., and about 25% from squeezing current spending, ... That then leaves about half, which the Treasury is presuming will come either from as yet unannounced tax increases or as yet unannounced squeezes on non-investment spending.<sup>120</sup>

Mr Chote observed that “there is an awful lot of detail that needs to be filled in”, not least where any cuts would fall within current spending and within capital spending across departments.<sup>121</sup>

47. Professor David Heald argued that the “key feature of Budget 2009 is the collapse of tax revenue projections” between November 2008 and April 2009.<sup>122</sup> A decline in revenues is, of course, to be expected in a recession, as firms make lower profits and incomes fall. This recession has seen particularly sharp declines in revenues from the financial sector, both through corporation and income tax receipts. Financial company corporation tax had

<sup>116</sup> Qq 19, 46

<sup>117</sup> Q 258

<sup>118</sup> *Budget 2009*, p 30

<sup>119</sup> *Ibid.*

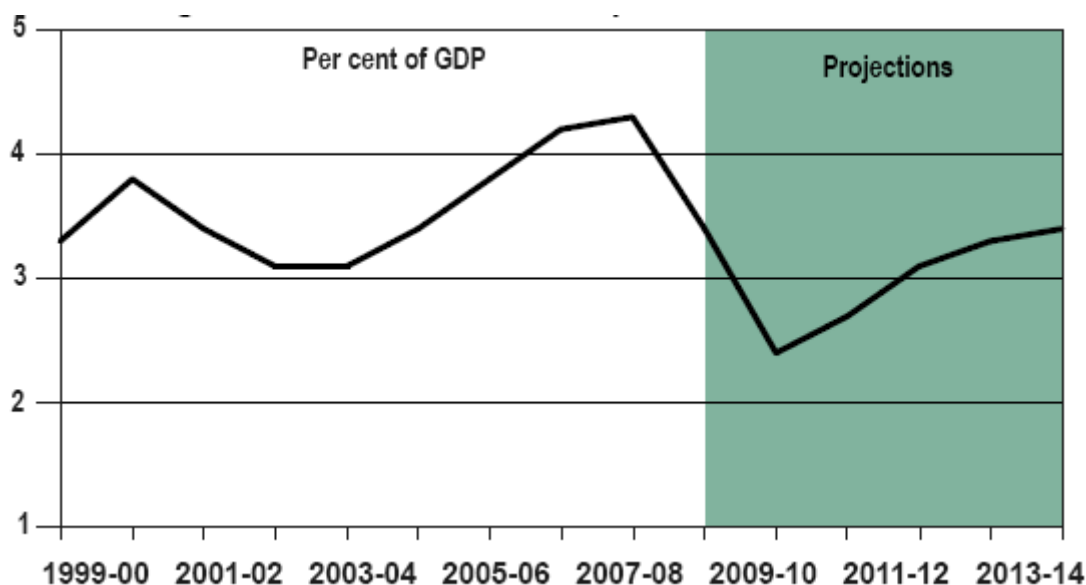
<sup>120</sup> Q 34

<sup>121</sup> *Ibid.*

<sup>122</sup> Ev 55

accounted for around 25% of overall corporation tax, and the sector provides significant amounts of income tax and national insurance contributions on salaries and bonuses. The housing sector provides revenue directly through stamp duty, inheritance tax and capital gains tax and indirectly through the VAT collected on housing-related consumption. Receipts from these sectors dropped sharply in 2008–09 and are expected to fall further in 2009–10. The Budget suggested that receipts were then expected to recover but not to the levels experienced in 2007–08.<sup>123</sup> Chart 3 below shows the Budget’s projections for housing and financial sector receipts.

**Chart 3: Housing and financial sector receipts.**



Source: HM Treasury, *Budget 2009*, p 229

48. Mr Weale was sceptical of the Budget’s projections for the recovery of the financial sector, believing that they were “grossly optimistic”.<sup>124</sup> He pointed out that the Treasury was expecting housing and financial sector receipts as a proportion of GDP to rebound to 1999 levels by 2013<sup>125</sup> and doubted whether this was likely.<sup>126</sup> But if revenues from financial services and housing do not bounce back fully, Mr Whiting contended, it was difficult to see which sectors would provide any substitute revenue growth:

the financial sector in particular is very vulnerable and it is hard to see that getting back to the sorts of yields for the Government that they have done in recent years for many, many years, if at all. The energy sector has been a significant contributor and maybe that will continue, but with the decline in North Sea [oil] there is clearly a bit of a risk to the downside in that as well. Housing you have alluded to. The retail

123 *Budget 2009*, p 229 and Q 138

124 Q 38

125 *Budget 2009*, April 2009, p 229

126 Q 52 [Weale]

sector is depressed. It is difficult to see which sector is going to deliver the increased tax yields that arguably we need.<sup>127</sup>

Karen Ward, HSBC's UK Economist, has observed that, even if growth were to return to the levels projected by the Budget, that growth could well see "a very different mix" of sectoral contributions.<sup>128</sup> In his Budget, the Chancellor expressed his vision of growth rebalanced towards investment by businesses in low-carbon, advanced manufacturing and communications.<sup>129</sup> But, Ms Ward observed, this was likely to generate "significantly less revenue" than growth driven by financial services, because whilst the financial sector only accounts for 3% of jobs, it accounted for 9% of total household income.<sup>130</sup>

**49. One of the important determinants of the restoration of health to the public finances is the extent to which tax revenues are able to rebound from their current low levels. It should be recognised that even before the current crisis the UK was running a structural deficit, although the scale of that deficit has been disputed and has been justified by the Chancellor on the grounds that this was a necessary investment. In our view, any restoration is not merely contingent on the economy meeting the challenging growth projections set in this year's Budget. What is also of importance is the composition of that growth. We note the inevitable shift away from the UK economy's dependence on financial services, and the Chancellor specified several industrial sectors which had promising futures. But it would be wrong to assume that these, or other sectors, will necessarily be as profitable as financial services. We recommend, therefore, that future Pre-Budget Reports and Budget documents provide a sectoral analysis of tax revenues, so that the basis of Treasury forecasts in a changing economy can be scrutinised. The Treasury already has the means to provide this information, as evidenced by its commentary on the financial and housing sectors, so to do this should not be particularly onerous.**

### Delaying the difficult decisions?

50. The Budget's proposes a consolidation in the cyclically-adjusted current budget so that balance is achieved in 2017–18. In the years to 2013–14, this consolidation path derives from policy decisions and the projected recovery in the economy, but from 2014–15 onwards, the consolidations needed in each year of 0.8% of GDP, are merely "illustrative projections".<sup>131</sup> For this period, no information is provided in the Budget as to what a consolidation of 0.8% of GDP per year would mean in policy terms. Chart 4 below depicts the consolidation in the public finances: green bars represent consolidation from announced policies; white bars represent illustrative projections, and so do not represent any specific policy choices.

---

127 Q 52 [Whiting]

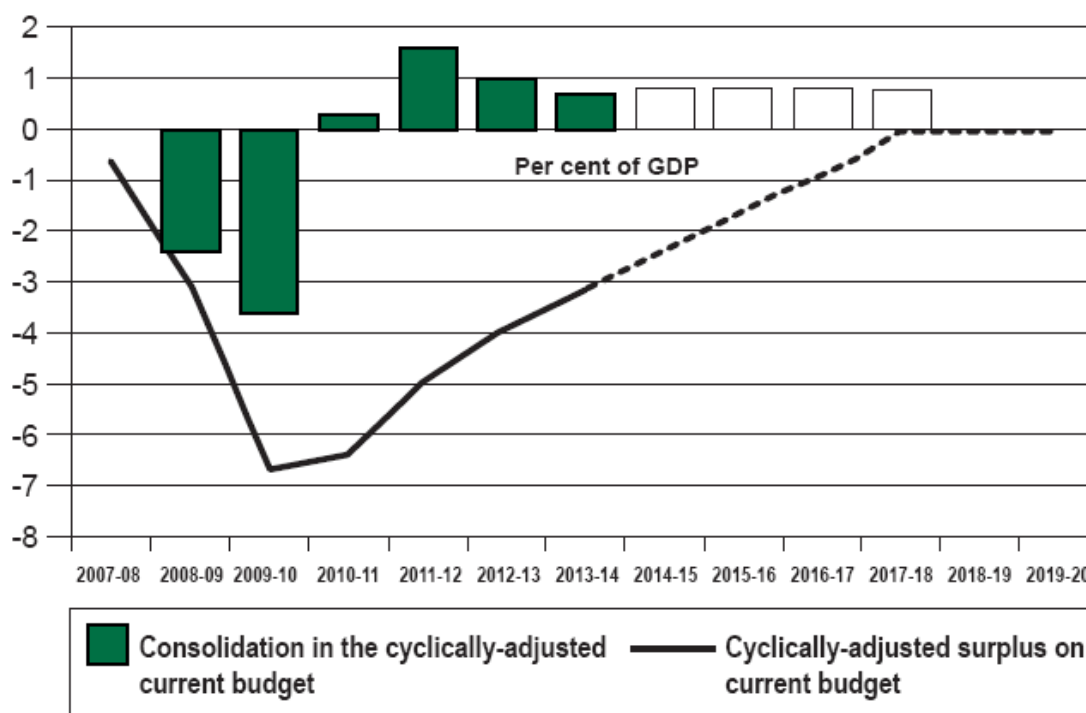
128 HSBC Global Research, *UK Budget 2009: Living on borrowed money*, 23 April 2009

129 *Budget 2009*, April 2009, p 80

130 HSBC Global Research, *UK Budget 2009: Living on borrowed money*, 23 April 2009

131 *Budget 2009*, p 35, Q 128

Chart 4: Balancing the cyclically-adjusted current budget



Note: For the financial years 2014-15 to 2019-20 the numbers presented here are illustrative projections  
 Figures include the on-going impact of a provisional estimate of unrealised losses on financial sector interventions of 3 and a half per cent of 2008-09 GDP

Source: HM Treasury, Budget 2009, p 35, Chart 2.2

51. Mr Chote said that it was “understandable” that there was “a degree of vagueness at this stage” regarding whether an incoming government in 2014 ought to be relying more or less on tax increases rather than spending cuts, and doubted whether a fully detailed plan would be any more credible than specifying “the broad orders of magnitude” as set out in the Budget document.<sup>132</sup> Mr Weale agreed that it would be wrong for the Chancellor to say now what the balance between taxation and spending was going to be in five years’ time, not least because there could be two general elections between now and then, but he thought that “some sense of how things might turn out and how the gap could be remedied purely as a guide would be quite helpful”.<sup>133</sup> Mr Bootle said that in “normal circumstances” macroeconomists were not particularly concerned about how future Governments would plug any gaps in the public finances, and that, largely, this decision could be left to the politicians. However, he argued that these were not normal times, and thought that a consolidation in the public finances based on tax rises would have a worse macroeconomic impact than one based on spending cuts:

if the public believed that the gap was going to be closed through much higher taxation I could see this having a much greater downward effect, serious effect, on confidence and, therefore, on spending than if the public in general and businesses believed it was going to be closed through expenditure restraint. That is not a

132 Q 41 [Chote]

133 Q 41 [Weale]

particularly orthodox answer and in different circumstances I think it could be proved wrong, but I suspect in the current conjuncture that is the balance of it.<sup>134</sup>

Mr Weale disagreed, suggesting that the economy could bear a tax burden of, say, 38-39% of GDP,” without the economy falling apart”, should that be needed.<sup>135</sup>

**52. In the medium term, the options for returning the public finances to balance present uncomfortable choices for the Government and consequences for the public, the broad alternatives being substantial tax increases, unprecedented cuts in public services, or a combination of the two. We recommend that in the Pre-Budget Report 2009, the Government sets out a range of options for closing the projected fiscal gap.**

### The fiscal framework

53. The Code for Fiscal Stability defined two rules against which the Government’s stewardship of the public finances could be assessed.<sup>136</sup> In October 2008, the Chancellor announced that the Government would temporarily depart from these two fiscal rules.<sup>137</sup> In their stead, the Government introduced a Temporary Operating Rule

to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.<sup>138</sup>

54. Roger Bootle and Martin Weale both labelled the Temporary Operating Rule as a “tautology” rather than a rule. Mr Weale explained what he meant as follows:

The tautology is that the Treasury can claim that the global shocks have not worked their way through the economy in full until it reaches a point where the current budget is in balance and debt is falling. As a consequence the question whether the Treasury is set to meet its rule is not worth asking unless there is a more precise definition of what is meant by it and a clear statement of how it will be assessed.<sup>139</sup>

55. Budget 2009 stated that the temporary operating rule was designed “to underpin a sustained fiscal consolidation once the economy is recovering”,<sup>140</sup> and contended that “on the assumption that the Government delivers a further consolidation of 0.8% of GDP a

134 Q 41 [Bootle]

135 Q 41 [Weale]

136 The golden rule: over the economic cycle, the Government would borrow only to invest and not to fund current spending; and the sustainable investment rule: public sector net debt as a proportion of GDP would be held over the economic cycle at a stable and prudent level. Other things being equal, net debt would be maintained below 40 per cent of GDP over the economic cycle.

137 Speech by the Chancellor at the Cass Business School, London, 29 October 2008 [Mais lecture].

138 HM Treasury, *Government’s Fiscal Framework*, November 2008, p 5

139 Q 47 and Ev 56

140 *Budget 2009*, p 31

year in the cyclically-adjusted current budget beyond 2013–14”, the fiscal projections were consistent with the Rule.<sup>141</sup>

**56. We do not see how the Temporary Operating Rule acts as any kind of constraint at all on the current fiscal decisions made by the Chancellor, and we struggle to imagine any course of action he might have taken in this year’s Budget that would have been inconsistent with it. For this Rule to have any bite whatsoever, the identification of the point in time at which “the global shocks have worked their way through the economy in full”, cannot be left to the judgement of the Treasury alone, but should be subject to parliamentary scrutiny. It is clear to us that the only real financial discipline that is currently imposed on the Chancellor is the opinion of the gilt market on the sustainability of the public finances.**

57. Following our inquiry into PBR 2008, we concluded that:

The fact that a temporary departure from the fiscal rules has been required serves to reinforce our view that a revised fiscal framework is needed. The forthcoming period during which the Temporary Operating Rule applies provides a good opportunity to re-evaluate the fiscal framework for the future. We recommend that the Treasury conduct a full public consultation on the design of such a framework.<sup>142</sup>

58. The Government rejected our recommendation, stating that “in advance of the public finances reaching cyclically-adjusted current balance, the Government will set out how it will apply the fiscal framework in future to continue to deliver its objectives”.<sup>143</sup> In oral evidence, the Chancellor said his “main focus at the moment ... was to work towards reducing the amount of borrowing and reducing the amount of debt”.<sup>144</sup>

59. Mr Chote argued strongly that there should be a rethink of the fiscal framework, stating that such a framework was inadequate if it only saved enough for “normal times”. Over the next 30–40 years, in his view, it was quite likely that there would be another recession, and so fiscal policies should be designed “with the aim of saving up for the next disaster instead of on the assumption that there will not be any more disasters”.<sup>145</sup> Although the Government had only ‘temporarily departed from’, rather than abandoned, the fiscal rules, Mr Bootle did not wish to see a return to the same fiscal framework. He contended that the 40% ceiling set by the Sustainable Investment Rule had “come out of the blue without very much rationale” and had turned out to have been “extraordinarily high” when confronted with the events of the last two years:<sup>146</sup>

if one wanted to establish the debt to GDP ratio at a level which was sufficiently low that it gave governments quite a lot of scope to respond, then we had set the objective

---

141 *Budget 2009*, p 19

142 Treasury Committee, Second Report of Session 2008–09, *Pre-Budget Report 2008*, HC 27, para 57

143 Treasury Committee, Third Special Report of Session 2008–09, *Pre-Budget Report 2008: Government Response to the Committee’s Second Report of Session 2008–09*, HC 431

144 Q 315

145 Q 44

146 Qq 45, 73

much too high because here we are with Government quite closely circumscribed. ... I am very struck by the fact that on the two previous occasions ... when we had massive public borrowing at 250% of GDP, it came after we had fought two huge wars. What I find concerning about the current situation is that if there were to be an enormous burden on the public finances from that source or perhaps from, God forbid, some ghastly pandemic ..., heaven help us, how would we cope?<sup>147</sup>

Mr Bootle expressed the hope that there would be an effective national debate about the fiscal rules because they “had done an enormous amount of harm in this country”: “they were misconceived, misapplied and they provided a smokescreen for a very destabilising policy”.<sup>148</sup>

**60. We believe that the Chancellor should now engage in what we regard as a crucial debate about the future of the UK fiscal framework. The majority of our expert witnesses found fault with the Golden Rule and Sustainable Investment Rule, so an eventual return to an unreformed framework would seem misguided. We sense that there is little consensus on what the best framework might be, which is all the more reason to commence a thorough analysis of all the options, drawing on international best practice, practical experience and academic theory. We are not suggesting that a new framework should be implemented now, but that the Treasury should open up a debate. To this end, we renew our recommendation made in our Report on PBR 2008 for a full public consultation.**

## Gilt demand

61. The burgeoning budget deficit, combined with the cost of financial sector interventions, has fed through to a substantial increase in the Central Government Net Cash Requirement to £220.8 billion, and a net financing requirement of £237.8 billion in 2009–10, the vast majority of which—£220 billion—is to be raised by gross gilt issuance.<sup>149</sup> The Treasury forecasts that its rate of interest will stay roughly the same (albeit on a much larger stock of debt).<sup>150</sup>

62. Richard Lambert, director-general of the CBI, said that “the key question for this Budget was whether it set out a credible and rigorous path for restoring the public finances to health. The CBI’s preliminary judgment must be that it does not.” He regarded as optimistic the Chancellor’s economic forecasts of a rapid end to the recession and growth well above trend from 2011–2014. In his view, “with annual government bond issue expected to exceed £200bn in the coming years and debt doubling by 2013, the government is running too much of a risk with the willingness of investors to finance UK debt”.<sup>151</sup> The risk would be that a reduction in demand for gilts would increase the financing costs of the UK Government at a time when the stock of debt was exceptionally high.

---

147 Q 73

148 Q 45

149 *Budget 2009*, p 245

150 See Q 48

151 “Concerns voiced over public finance risks”, *Financial Times*, 23 April 2009

63. However, Mr Ramsden, for the Treasury, was bullish about the market, telling us of his confidence that appetite for gilts, which had been “very strong” throughout 2008–09, would be sustained in 2009–2010 because “at the macro level we think we have set out a transparent and realistic set of forecasts and a credible consolidation plan into the medium term”.<sup>152</sup> Martin Weale added support to this prediction, telling us that the best forecast of future interest rates was what the long-term bond market was indicating, and that was saying rates were likely to stay in the 4–5% range for the foreseeable future.<sup>153</sup>

64. The sustained demand for Government debt investments might be considered surprising by some, as there could be an expectation of upward pressure on yields stemming from the supply shock of increased debt issuance over the fiscal forecast period, and the potential that the market might lose faith in the credibility of the Government’s stewardship of the public finances. On the other hand, in recessions there tends to be a flight to quality. Because Government debt is considered lower-risk than other assets such as corporate debt, investors seek the safety, and relative liquidity, of gilts rather than corporate bonds. In addition to other factors, the UK Government is, of course, in competition with other governments in its issuance of Government Stock. However, there is relatively buoyant demand for UK gilts from UK banks for regulatory reasons, and the Bank of England is also now buying gilts as part of its quantitative easing programme. The Chancellor added that investors liked the fact that UK sovereign debt was “comparatively longer dated than a lot of the stock that is available in the European markets”.<sup>154</sup>

65. Mr Bootle viewed the Treasury’s assumption about costs of financing as by no means unreasonable or outrageous:

I should have thought it was quite unlikely that we would get both a prolonged recession, or the absence of recovery, which produced even worse borrowing numbers than we have here and, therefore, a vastly increased supply of gilts and lack of demand for gilts at existing interest rates because if we were to get a very, very weak real outturn then that would bring on the deflationary prospect I was talking about earlier on and it would surely underpin a prolonged period of effectively zero short-term interest rates. On that basis I could imagine the demand for gilts being very strong indeed. In fact, historically there are a number of examples of this. It has tended to be when bond issuance has been terribly high that yields have been very low and one particular example of that is Japan in the 1990s, not unlike the position we are currently in—the numbers are slightly different—but at one point, despite the government having a huge deficit, not quite as large as ours but around about 8% of GDP, ten year Japanese Government bonds fell to a yield of 0.6%.

66. David Miles, of Morgan Stanley, argued in the IFS Green Budget in January 2009 that “there was no reason yet to be alarmed about borrowing costs rising significantly, but clearly there is huge uncertainty either way”.<sup>155</sup> Mr Chote observed that this was “a classic

---

152 Q 147

153 Q 50

154 Q 313

155 Referred to in Q 49.

example” of a case where it was just as important for the Government to say how it would respond if things turned out differently from the central forecast, as whether the central forecast itself was credible.<sup>156</sup> The Chancellor admitted that there was uncertainty—“we are in uncertain times but so far there appears to be a healthy demand for our gilts”<sup>157</sup>—but when we asked him, given this uncertainty, what he would do if the gilt markets started to lose faith in the Government’s ability to manage the public finances, he said it was “quite pointless” to speculate on “something that I do not anticipate being the case”.<sup>158</sup>

67. One of the harbingers of such an eventuality would be if there were to be a sequence of uncovered gilt auctions by the Debt Management Office (DMO). One such uncovered auction did occur on 25 March 2009.<sup>159</sup> Mr Bootle was unconcerned by the failure of this single gilt auction, because it was “perfectly possible to have a situation in which a gilt auction fails for whatever reason and yet the demand for gilts is still very strong over a prolonged period”. He would be more concerned if there were to be a series of uncovered gilt auctions as demand for gilts dried up. In this scenario, bond yields would “shoot up very considerably”, which would result in the Government’s cost of financing increasing significantly. He did not say that this eventuality was likely—indeed, he believed that the Treasury’s projection that the cost of borrowing would remain low was “reasonable” on recent form—but it was “plausible”, and if it happened, then we would be “in serious trouble”.<sup>160</sup> Nor had Mr Weale detected any great concern from the gilt market about the public finances, at least not from expectations of long-term interest rates on Government debt, which remained low. He cautioned that “obviously the market can be wrong, but at the moment the market does not appear to be frightened”.<sup>161</sup>

**68. We note the reaction of the debt markets to the Treasury’s ambitious borrowing plans. We believe there are strong reasons why the costs of financing the Government debt could well remain low. But if the gilt market were to lose its appetite for Government debt, which is by no means impossible, the cost of financing that debt could climb to perilous levels. Financial markets can be very volatile, and, as we have recently learnt in the financial crisis, can be quite poor at pricing risks initially, with any subsequent pricing corrections being sudden and unexpected. Under these circumstances, we consider that it would be prudent for the Treasury to work up contingency plans for a weakening of demand for Government debt.**

---

156 Q 49

157 Q 313

158 Q 311

159 HM Treasury, *Debt and reserves management report 2009-10*, April 2009, p 12

160 Q 40 [Bootle]

161 Q 40 [Weale]

## 4 Other measures in Budget 2009

---

### Child poverty

69. In 1999 the then Prime Minister pledged to eradicate child poverty by 2020, setting an interim target of halving it by 2010–11. There were 3.4m children in poverty in 1998–99.<sup>162</sup> The Government stated in the Pre-Budget Report 2008 that:

Since 1998–99 substantial progress has already been made, with 600,000 children lifted out of relative poverty and absolute poverty halved. Measures announced since Budget 2007 will lift around a further 500,000 children out of relative poverty.<sup>163</sup>

Mike Williams, Director, Personal Tax and Welfare Reform, HM Treasury, confirmed that there remained ‘about 600,000 children who would have to be lifted out to meet the target’.<sup>164</sup>

70. We have previously expressed concern that the Pre-Budget Report 2008 contained “no policy measures which will significantly advance meeting the 2010 child poverty target”. We further commented that the Government’s commitment to the 2010 target “needs to be demonstrated through firm action on tackling child poverty in the 2009 Budget”.<sup>165</sup>

71. Budget 2009 did contain some measures aimed at addressing child poverty. The Chancellor announced that the child tax element of the Child Tax Credit would increase by an additional £20 a year above indexation from April 2010.<sup>166</sup>

72. According to the IFS, however, this increase is “nowhere near enough to meet the target of halving child poverty”. It contended that of the £4.2 billion required, only £140 million had been found.<sup>167</sup> Indeed the Chancellor confirmed that:

my priority at this stage in this Budget was to ensure that we put more money into the economy to help people back into work as quickly as possible precisely because it has got merit in its own right, but also I was very mindful of the fact that people with children could lose their jobs and it was very important to get them back into work.<sup>168</sup>

73. The Child Poverty Action Group agreed that measures such as the investment in Jobcentre Plus were ‘absolutely necessary’ but cautioned that if the Government was committed to meeting its targets on child poverty then ‘emergency measures’ would be

---

162 Following consultation in 2003 the Department for Work and Pensions concluded that the Modified OECD equivalence scale should be used to measure child poverty, see Department for Work and Pensions, *Measuring Child Poverty*, December 2003.

163 HM Treasury, *Pre-Budget Report 2008*, p 86, para 5.11

164 Q 171

165 Treasury Committee, Second Report of Session 2008–09, *Pre-Budget Report 2008*, HC 27, para 72

166 *Budget 2009*, p 91, para 5.13

167 Presentation by the Institute for Fiscal Studies, Direct taxes and benefits, 23 April 2009

168 Q 353

necessary. When asked whether the Government would meet the 2010–11 target the Chancellor instead told us that ‘our overarching target is to abolish child poverty over the 20–year period.’<sup>169</sup> He also found it difficult to say how many children were currently in absolute poverty.<sup>170</sup>

**74. We acknowledge the pressure on Government finances but are concerned by the lack of any substantial measure to combat child poverty in both the Pre-Budget Report 2008 and Budget 2009. On current indicators the Government will fail to meet its 2010–11 target by a significant margin. We are dismayed that, despite our repeated warnings in past reports, the Treasury has failed to take sufficient positive action to ensure the child poverty targets are met. We recommend that the Government researches the impact of the recession on the number of children living in absolute as well as relative poverty and brings forward further proposals in the Pre-Budget Report 2009 to ensure that it achieves its targets on halving child poverty by 2010–2011 and then eliminating it. One perverse consequence of the use of a relative measure of child poverty is that a period of recession might reduce the numbers of children deemed to be in poverty even though an increasing number is suffering actual hardship.**

## Support for the property market

75. In the last year homeowners have witnessed an unprecedented slump in the property market; completed house sales halved in England and Wales between 2007 and 2008. House prices in March 2009 were 17.5% lower than the previous year, according to the Halifax house price index.<sup>171</sup> In his Budget speech, the Chancellor recognised that “the recession had made it harder for people to get on the property ladder”. This was not just a problem for first time buyers; the impact of the recession had undermined “the entire housing market”.<sup>172</sup>

76. The Budget announced five measures intended to support the property market:

- an extra £80m for shared ownership schemes;
- a £600 million funding package of measures to build more homes through unlocking sites which were currently dormant, which included £100m for local authorities to deliver new social housing at higher energy efficiency standards;
- an extension until December 2009 of a stamp duty holiday on homes under £175,000; and
- an asset-backed security scheme.<sup>173</sup>

---

169 Q 356

170 Q 355

171 Lloyds Banking Group, *Halifax House Price Index: March 2009*, 3 April 2009

172 HC Deb, 22 April 2009, col 241

173 *Budget 2009*, para 5.76

77. Mr James Richardson, Director, Public Spending, HM Treasury, told us that there was “a wide range of people in very different circumstances with a wide range of different housing needs” and therefore as the “match of demand to supply” was not uniform throughout the country, it was appropriate to provide “a policy response that reflects that”.<sup>174</sup>

78. Mr Weale questioned whether measures such as the stamp duty holiday and the asset-backed security scheme were “being well-targeted”.<sup>175</sup> However he was more positive towards other measures, regarding the policy of building of council housing as “very sensible indeed”. He pointed out that it was a housing boom that had boosted economic recovery in the 1930s and that encouraging house building would be very desirable.<sup>176</sup>

### **Local Housing Allowance**

79. Proposals for Local Housing Allowance were set out in Welfare Reform Green Paper in January 2006.<sup>177</sup> Local Housing Allowance (LHA) was introduced nationally on 7 April 2008. It is a new way of working out housing benefit for private tenants. The Budget announced that the cost of the LHA had exceeded the “planned expenditure”. Therefore in order to bring the cost “into line with what is affordable”, whilst still ensuring all recipients could afford their rent, the Budget announced that, from April 2010, there would no longer be scope for anyone to receive more LHA than they had to pay in rent. Existing claimants would be “moved onto the new arrangements on the anniversary of their claim”.<sup>178</sup> Mr Williams clarified the policy:

if you say that someone is in month eight of their current claim and getting more local housing allowance than they are paying in rent, say they are getting £10 extra, that £10 a week extra would continue to the anniversary of the claim at which point it would be reassessed.<sup>179</sup>

80. He explained that since the system’s introduction in April 2008, the costs had “very significantly exceeded” the expenditure that was planned into the policy, and Ministers had therefore decided it was necessary to “rein back the policy”.<sup>180</sup>

**81. Hitherto, those claiming the Local Housing Allowance had an incentive to seek competitively priced accommodation in order to maximise their benefit. Such an incentive will disappear in April 2010 which will cause problems for some. We recognise the prevailing economic pressures on the Government but recommend that more thought be given to creating a more stable framework for the payment of this benefit.**

---

174 Q 205

175 Q 55

176 *Ibid.*

177 DWP, Welfare Reform Green Paper, *A new deal for welfare: Empowering people to work*, January 2006.

178 *Budget 2009*, p 97, para 5.33

179 Q 206

180 Q 207

### **Stamp duty on properties under £175,000**

82. On 2 September 2008, the Government announced that there would be a one year stamp duty holiday for all purchases of houses costing up to £175,000.<sup>181</sup> Budget 2009 extended this holiday until 31 December 2009.<sup>182</sup> The Chancellor explained that the reduction in first-time buyers was undermining the housing market, therefore he had decided to extend the stamp duty holiday “until the end of the year”.<sup>183</sup> The Treasury calculated that 60% of residential properties would be exempt from stamp duty as a consequence of the initiative.<sup>184</sup> The Chancellor hoped that this would “encourage modest and middle-income home buyers”.<sup>185</sup>

83. We have previously questioned the effectiveness of this measure in our analysis of the 2008 Pre-Budget Report, where we noted that the stamp duty holiday was not “having any widespread effect”. We were also concerned that measures introduced by the Government might not “be adequate in the face of the crisis in lending”.<sup>186</sup> Mr Weale was concerned that the extension of the stamp tax holiday might “slow the adjustment of house prices to what many people would regard as a more sustainable level”.<sup>187</sup> John Whiting was also unsure if the stamp duty holiday helped a great deal “given the prices of housing generally”. He highlighted the greater importance of improving “the availability of mortgage credit for those who wish to borrow, continued low interest rates so it can be serviced and the confidence that both will continue”.<sup>188</sup>

84. The Chancellor told us that owning a home was an aspiration for “millions of people” and the Government wanted “to help people fulfil that.”<sup>189</sup> There were two fundamental aspects to supporting this aspiration: one was “the availability of employment because it is people’s jobs and their incomes which will determine their willingness and their ability to purchase, and the second is the availability of mortgages”.<sup>190</sup>

85. Mortgage lenders have been unable to provide previous levels of mortgage finance in recent months as credit markets have tightened. As we have discussed in previous reports, the dependence of mortgage lenders on securitisation<sup>191</sup> increased markedly between 2005

181 HM Treasury, *The Budget 2009*, 22 April 2009, para 5.74

182 HC Deb, 22 April 2009, col 241

183 *Ibid.*

184 *Budget 2009*, para 5.74

185 HC Deb, 22 April 2009, col 241

186 Treasury Committee, Second Report of Session 2008–09, *Pre-Budget Report 2008*, HC 27, paras 138-140

187 Q 55

188 Q 56

189 Q 329

190 *Ibid.*

191 For a definition and discussion of securitisation, see Treasury Committee, Sixth Report of Session 2007–08, *Financial Stability and Transparency*, HC 371, para 35

and mid-2007.<sup>192</sup> Since the start of the current financial market disruption, these markets have effectively been closed to new issuance.<sup>193</sup>

86. The Government announced in January 2009 that it would establish a guarantee scheme for asset-backed securities to help support the availability of mortgage finance<sup>194</sup>. The Budget revealed that initially the scheme would be available until October 2009, for “banks and building societies to use alongside the existing Credit Guarantee Scheme to support their lending in the economy”.<sup>195</sup> The Chancellor told us that the scheme would allow “for greater securitisation, therefore, as the market picks up, more money”.<sup>196</sup>

**87. The recovery of the housing market is clearly linked to the recovery of the economy as a whole. It is therefore vital that the Government take steps to reinvigorate the market at this time. However, we note that the resurgence of the property market is particularly dependent on the availability of mortgage credit to homebuyers and we are unconvinced that other schemes to boost the market, such as the stamp duty holiday, will have any marked effect. We call on the Government to report in the PBR on the implementation of the asset-backed securities scheme and to provide a cost-benefit analysis of the effectiveness of the stamp duty holiday.**

**88. We welcome the help announced in the budget for homeowners. Whilst we welcome the diversity of the schemes, we regret the delays in implementation and the lack of clarity, in respect of some of the schemes, especially in entitlement to Support for Mortgage Interest. We recommend that the Government takes urgent steps to ensure that clear information is provided for homeowners on the support that is available to them if they get into financial difficulties as a result of the recession.**

## Vehicle scrappage scheme

89. In Budget 2009 the Government announced the introduction of a vehicle scrappage scheme to “give a boost to the car industry during the current downturn”.<sup>197</sup> From mid-May 2009 until the start of March 2010,<sup>198</sup> a discount of £2,000 will be offered to consumers buying a new vehicle to replace a vehicle more than ten years old which they have owned for more than twelve months. The Government will fund £1,000 of the discount and the remaining £1,000 will be funded by participating manufacturers.<sup>199</sup> The Government will spend up to £300m on the scheme, supporting the sale of up to 300,000 new vehicles.<sup>200</sup>

---

192 HC (2007–08) 453–i, Q 17

193 HM Treasury, *Housing Finance Review: Analysis and Proposals*, p 21. March 2008

194 “Statement on the Government’s Asset protection scheme”, HM Treasury press notice, 19 January 2009

195 HM Treasury, *The Budget 2009*, 22 April 2009, para 5.73

196 Q 329

197 *Budget 2009*, April 2009, p. 75

198 The scheme will finish earlier than March 2010 if all the Government funding is used before then.

199 *Budget 2009*, p. 75

200 Q 152

The Society of Motor Manufacturers and Traders Limited welcomed the scheme, which it believed would kick-start demand in the car and van market.<sup>201</sup>

90. The evidence we gathered suggested the scheme would provide only a small boost to the car industry. The Treasury told us that, although difficult to model how much extra demand would be created, it estimated 90,000–100,000 of the 300,000 new vehicles supported could be considered additional sales or purchases made earlier than planned.<sup>202</sup> This corresponds with issues raised by the IFS. It suggested that, since a significant proportion of cars more than ten years old were already scrapped each year, a large part of the scheme would support vehicle replacements that occurred anyway.<sup>203</sup> Some households would bring forward their vehicle replacement, leading to fewer sales after the scheme ended.<sup>204</sup> Mr Chote also queried the focus on just one industry, suggesting arguments could be made for helping a number of different industries at this time.<sup>205</sup> He told us, “when people talk about the particular strategic importance of the car industry over other industries, I am not entirely clear exactly on what basis those judgements are made”.<sup>206</sup>

91. Not only could the scheme fail to generate many additional new vehicle sales, it will also boost the foreign-based car industry more than British motor manufacturers. Mr Chote told us that benefits of the scheme could go abroad since very few new vehicles bought in the UK are produced in the UK.<sup>207</sup> The Treasury subsequently confirmed that around 86% of new cars sold in the UK are imported.<sup>208</sup> When this proportion is applied to the estimated 90,000–100,000 additional new vehicle sales expected from the scheme, it means only 12,600–14,000 new British-made vehicles might be supported.

92. The possibility that the scheme could support the sale of only a few new UK manufactured vehicles raises doubts about its value for money. If the Government’s £300 million of funding supported the sale of only an extra 12,600 new British-made vehicles, this is the equivalent of spending more than £23,000 on each vehicle. This is obviously much larger than the Government’s nominal contribution of £1,000 towards each new vehicle sold through the scheme. It demonstrates that a considerable amount of the £300 million funding could be spent on supporting sales of foreign-manufactured cars that would have happened anyway. The scheme will also contain potentially large ‘dead weight’ costs.

93. When questioned about possible ‘dead weight’ costs, the Chancellor told us that there were arguments that “you can run both ways” about the scheme.<sup>209</sup> He highlighted the fact

---

201 “Vehicle scrappage scheme good news for buyers”, Society of Motor Manufacturers and Traders press release, 22 April 2009

202 Q 154

203 “Initial budget response”, The Institute of Fiscal Studies (IFS), 22 April 2009

204 *Ibid.*

205 Q 62

206 *Ibid.*

207 Q 59

208 Q 155

209 Q 316

that, whilst many cars might be assembled abroad, they would have British-made components, and that the distributive part of the car trade would benefit regardless.<sup>210</sup> He also said that he had looked at similar schemes operating abroad such as in Germany, where the scheme had cost more and had been extended. He had concluded that “on balance, given the importance of the [car] industry...it was right to see whether or not [the scheme] would work, but that it is cash...and time limited”.<sup>211</sup>

**94. We recognise the importance of the car industry. The vehicle scrappage policy has been welcomed in some quarters. Although it will support 300,000 new vehicle sales, it is likely that only one-third at most will be additional sales. Moreover, of these additional or accelerated sales, just 12,600 could be new UK-manufactured vehicles, although we accept that most other cars sold contain high quantities of UK-manufactured parts and that car retailing will benefit. We note the Chancellor’s reservations regarding the scheme and await the Pre-Budget report 2009 to assess how effective it has been.**

### The 50p tax rate

95. In its 2008 Pre-Budget Report, the Government announced that it would restrict the income tax personal allowances of those with incomes over £100,000, and would introduce a new top income tax band of 45 per cent for those with incomes above £150,000 from April 2011.<sup>212</sup> The Government then amended its proposals for the new top rate in Budget 2009, moving implementation forward to April 2010, and raising the top rate of income tax to 50 per cent for those with incomes over £150,000.<sup>213</sup> HM Treasury estimated that via the introduction of this new rate of tax, the Government would raise £1,130m in 2010–2011, £2,480m in 2011–12 and £2,400m in 2012–13.<sup>214</sup> The Chancellor stated that his intention was “that this was the fair way of ensuring that we did raise sufficient revenue”.<sup>215</sup> Also announced in Budget 2009 was a measure to cap the income tax relief available on payments into their pensions of those earning over £150,000 from 2011–12.

96. Our expert witnesses commented on the behavioural changes that might impact on whether the Government would raise these projected revenues from the introduction of the new top rate of income tax. Mr Chote, for the IFS, outlined several ways in which high income earners might try to circumvent the new top rate of income tax. He suggested out that “There could be a conventional labour supply response in the sense of people simply thinking that it is not worth working as hard or as long or worth taking opportunities to earn more than they could do”.<sup>216</sup> Other responses might include outward migration from the UK or people who were considering working in the UK being deterred from coming to

---

210 Q 318

211 Q 319

212 HM Treasury, *2008 Pre-Budget Report*, p 3, para 1.8

213 *Budget 2009*, p 3, para 1.8

214 Indexed figures. These figures also include the yield from the increase in the trust rate to 50%; *Budget 2009*, p 11, table 1.2; HM Treasury, *2008 Pre-Budget Report*, p 10, table 1.2

215 Q 337

216 Q 74

the country.<sup>217</sup> As well as this, some high-earners might choose to top up their pension.<sup>218</sup> Other high earners might also decide to try and shift some of their income into capital growth. John Whiting explained the consequence of such a move: “people will look at ... capital growth to try and build a business rather than just take income and maybe that is no bad thing. But it does mean an 18% tax rather than 50% plus national insurance.”<sup>219</sup> The Chancellor himself suggested that another route out of paying the tax would be if people took advantage of his increase in the maximum permitted levels of ISAs.<sup>220</sup>

97. Mr Williams, Director, Personal Tax and Welfare Reform, HM Treasury, told us how the Treasury believed these behavioural changes would impact on the revenue raising capability of the new top rate of income tax. He explained that the theoretical maximum amount that could be gained in revenue could be calculated by looking at those currently earning above £150,000, and paying 40%, and then applying the new 50% tax rate.<sup>221</sup> When the Treasury then took into consideration the behavioural effects, it expected the yield to be 31% of the theoretical maximum amount available.<sup>222</sup> When the pension changes discussed below are implemented from 2011–12, the Treasury expected the yield to rise to 38% of the theoretical maximum, as one of the ways of avoiding paying would have disappeared.<sup>223</sup> When we asked the Chancellor whether he thought such a high level of loss would undermine public support for the measure, he explained that:

Tax-planning has been with us, presumably, since the beginning of the 19th Century when, you will remember, income tax was introduced on a temporary basis during the Napoleonic Wars and, I dare say, ye olde tax planners have been doing a roaring trade ever since. It is perfectly legitimate for people to tax-plan. They are only obliged to render unto Caesar what is due to Caesar and that has always been a feature of their case. What I tried to do here though, I am raising revenue both in indirect taxes and from next year from those earning over £100,000 in direct taxes, and of course I will always be vigilant about loopholes and indeed we announced various measures in the Budget there. I think the answer to your question is that to dig up the entire system at the present time would have been, I think, difficult to justify.<sup>224</sup>

98. In a report on the initial Pre-Budget Report 2008 measure of a 45% new top rate of tax, the IFS suggested that the Treasury was possibly overestimating the revenue to be gained from raising the tax on those who earn over £150,000, in two ways. Firstly, using a different estimate to that of the Treasury’s of the “taxable income elasticity”<sup>225</sup> might mean that such

---

217 Q 74

218 *Ibid.*

219 Q 75

220 Q 341

221 Q 219

222 *Ibid.*

223 Q 219

224 Q 343

225 This is the rate at which taxable income falls when the effective marginal tax rate rises.

a higher top rate would actually lose revenue, rather than raise it.<sup>226</sup> The IFS's second concern was that the Treasury appeared not to have taken into account the impact of this measure on other taxes other than income tax.<sup>227</sup> This included taxes such as VAT, which might see a reduction as a consequence of reduced spending by this income group. The Treasury noted that the costing of the new top rate of income tax included direct behavioural effects, such as those associated with labour supply decisions, including around migration, and use of tax reliefs. The costing however excluded indirect effects that the new top rate of income tax may have on levels of income and spending, which the Treasury stated were meant to be taken account of by changes to the economic forecast.<sup>228</sup>

99. We also questioned why the figure of £150,000 had been chosen as the threshold beyond which the top rate of income tax would be 50%. The Chancellor acknowledged that little analysis had been used to determine the threshold: "There is no science behind it, it is just simply my judgment that I thought that figure was an appropriate figure. It is the top 1%, as it happens, of earners in this country and I decided that that was the right level at which to pitch it."<sup>229</sup>

**100. We believe there are considerable uncertainties over the yield to be raised by the new 50% top rate of income tax. We therefore recommend that the Treasury, in the 2011 Pre-Budget Report, should report on the revenue raised, both nominally and as a percentage of the theoretical maximum revenue, by the new top rate of income tax. We also recommend that the Treasury assess at that time the yield obtained from the higher rate against its disadvantages. If the higher rate were to be continued it would be appropriate to consider what further reforms would be needed to prevent further leakage of potential revenue from this measure. The Treasury should indicate if it would revise the rate in the event that the estimated revenue yield fell well below their forecasts. Finally, we were concerned that the Chancellor lacked a robust basis for selecting the threshold from which the new top rate of tax would apply and for choosing what that rate should be.**

## Tax relief on pensions

101. Budget 2009 introduced measures to restrict tax relief on pension contributions for those with incomes of £150,000 and over. Currently individuals receive tax relief on pension contributions at their marginal rate of income tax. This means that a basic rate taxpayer would receive tax relief at 20% and those paying the higher rate of income tax at 40%. As Budget 2009 noted this meant that "those on highest incomes benefit disproportionately from this relief" whereby "in 2008–2009 individuals with incomes over £150,000 represented 1.5% of pension savers, yet received a quarter of all tax relief on contributions (£6.1 billion)". The proposed changes—on which the Government plans to consult—mean that for those with incomes of £150,000 or more, the value of pension tax

---

226 Mike Brewer and James Brown, *Can more revenue be raised by increasing income tax for the very rich*, IFS Briefing note BN84, p 25

227 *Ibid.*, p 26

228 Ev 71

229 Q 335

relief will be tapered down until it is 20% for those on incomes over £180,000, which Budget 2009 explains would make it “worth the same for each pound of contribution to pension entitlement as for a basic rate income taxpayer”. These reforms leave in place the £1.8m lifetime allowance on size of pension pot and the annual allowance on pension contributions which currently stands at £245,000 or 100% of income whichever is the lower.<sup>230</sup>

102. Mr Chote told us that one of the reasons behind the changes to the pension tax relief regime was “in part to close off one of the opportunities that people have to avoid paying that [the 50 pence] rate”.<sup>231</sup> Our expert witnesses cautioned that the changes would introduce complexity into the system and offered alternative ways in which the Government could reduce the tax relief paid to higher earners. John Whiting, Chartered Institute of Taxation and PricewaterhouseCoopers, wondered why the Government had:

not just adjusted the existing annual amount that one can be contributing, which would at least be simple ... logic might say if you want to control the amount that very high earners can contribute, why not cap the amount at that level, i.e. £150,000, and have done?<sup>232</sup>

Mr Chote reminded us that Adair Turner, now Lord Turner, who chaired the Pension Commission looking at the long-term future of UK pensions “had said the only practical way to limit tax relief to higher earners in order to distribute it to low earners would be to reduce the value of the 1.8 m limit”. Mr Chote referred to the complexity of the changes, telling us that the “whole issue about how do you value employer contributions to define benefit schemes means that ... it is going to be enormously complicated to operationalise this”. Mr Mike Williams, Director, Personal Tax and Welfare Reform, defended the Treasury against the charge that reducing the lifetime allowance would have been a simpler way to proceed:

I think there are two reasons primarily why the option is not as good as I agree it looks prima facie to be. First, and I think most crucially, if we do significantly reduce the lifetime allowance you are in some circumstances hitting people much lower down on the income scale.<sup>233</sup>

Mr. Williams did not however, offer any argument against the reduction of the annual contribution limit as a means to the same end.

103. The Chancellor defended the principle of the tax relief measures, telling us that whilst he could “see the logic ... of simply aligning the relief with whatever the rate of tax happens to be”, there was a stage where:

if a quarter of everything that the general taxpayer forgoes in terms of tax relief is going to 1% of top earners, you do begin to think, “That can’t be right”, and it is

---

<sup>230</sup> *Budget 2009*, April 2009, p 107

<sup>231</sup> Q 74

<sup>232</sup> Q 76

<sup>233</sup> Q 232

about £3.5 billion, it is quite a lot of money. “if you were starting from here, you would not develop a system where a quarter of all the relief you get goes to 1% of the top earners”.<sup>234</sup>

**104. We note that this budget marks a departure from the long-standing principle that tax relief for pension contributions should be given at an individual’s highest marginal rate. We urge the Treasury to monitor the effect of this change on pension savings and to keep under review the possibility that a cap on annual contributions might be a more equitable way of reducing the percentage of tax relief that benefits the highest earners.**

# Conclusions and recommendations

---

## The economy

1. The Treasury's forecast in the Budget is for the economy to begin recovering in the final quarter of 2009 before going on to register strong growth of 3.5% in 2011. There is, understandably, considerable uncertainty around the Government's growth forecasts for 2009–2011, reflecting the fact that the UK economy is in uncharted territory. This uncertainty is demonstrated by the large number of independent forecasts which are more pessimistic than the Government as well as the smaller number of forecasts which are more optimistic. In particular, we note that the IMF believes the UK will continue to contract in 2010. Whilst it is possible that the Government will meet its growth forecasts, on the available evidence, this is an optimistic assumption. We question the decision to assume that the economy will begin registering positive growth as early as the fourth quarter of 2009, and that the economy will register such strong growth in 2011. (Paragraph 11)
2. It is clear that the recession has acted as a catalyst for the rebalancing of demand in the UK economy. This rebalancing entails a shift away from consumption with a concomitant rise in the savings ratio, with net trade also playing a more important contributory role to growth over the 2009–2011 period. We note, however, that the contribution net trade will make to growth is contingent upon a speedy recovery in the UK's major trading partners and on the fulfilment of commitments made at the G20. Consumption is forecast to recover sharply in 2011 but we are concerned that this may be too optimistic given that the UK economy will only just have emerged from a sharp downturn. Additionally, the strong rebound forecast in consumption growth from 2011 onwards has important implications for whether the rebalancing of the UK economy is merely a short-term phenomenon or whether the Government should take steps to ensure such changes prove more durable. Savings will need more encouragement. (Paragraph 15)
3. It remains too early to judge whether the November 2008 fiscal stimulus—and in particular the VAT reduction—has been successful. There has been much discussion of whether a subsequent fiscal stimulus separate from the stimulus provided by the automatic stabilisers was necessary, but ultimately the Government decided against introducing a further large-scale fiscal stimulus at the time of the 2009 Budget. No doubt the debate around the need for a further fiscal boost to the UK economy will continue, particularly if growth in the economy fails to pick up. Any discussion of additional stimulus must take into account both the implications for the public finances of such a boost and the credibility of the Government's plans to bring the budget back into balance. (Paragraph 21)
4. There is a strong possibility that unemployment will rise above three million, with some economists warning that it is possible that unemployment could rise as high as four million. Approximately 40% of the unemployed are likely to be young people aged under 25. We agree with Professor Blanchflower that this necessitates measures focused on assisting young people and, to this end, welcome the Government's approach of targeting resources on this group. That said, it is too soon to judge

whether the Government proposal that all young people who have been on Jobseeker's Allowance for 12 months will be guaranteed a job, work placement or training opportunity, together with the monetary and fiscal stimuli, are a sufficiently timely and substantial response to the scale of the unemployment challenge. (Paragraph 27)

5. The Asset Purchase Facility is a crucial tool of monetary policy, given the currently low level of Bank rate. We note the heavy bias towards the purchase of gilts under the facility. We note the concern of some that not enough is being done to provide adequate liquidity in the corporate debt markets. We expect the Bank of England to take every opportunity to use the £50 billion allotted to the purchase of corporate debt under the Asset Purchase Facility to ensure the effective operation of those markets. We also recommend that the Debt Management Office and the Bank of England develop strategies for the Bank to dispose of its increasing holdings of gilts and corporate debt. (Paragraph 35)

## Public finances

6. The Chancellor's forecasts for public borrowing and national debt make sobering reading. By any measure, those forecasts along with those of many other OECD countries, are extremely high: they have exceeded the fiscal rules from which the Government departed in PBR 2008 by a wide margin and these figures represent the worst fiscal outlook since the Second World War. We are very concerned about the state of the public finances. What is now of critical importance is that the public, and crucially the markets, believe that the Chancellor is working to an adequate, and credible, plan to restore the public finances to good health. The credibility of any attempt to restore the public finances will depend on an acceptance that the structural deficit must be addressed as well as the consequences of the current extraordinary circumstances. We discuss this plan in the next section of this Report. (Paragraph 44)
7. One of the important determinants of the restoration of health to the public finances is the extent to which tax revenues are able to rebound from their current low levels. It should be recognised that even before the current crisis the UK was running a structural deficit, although the scale of that deficit has been disputed and has been justified by the Chancellor on the grounds that this was a necessary investment. In our view, any restoration is not merely contingent on the economy meeting the challenging growth projections set in this year's Budget. What is also of importance is the composition of that growth. We note the inevitable shift away from the UK economy's dependence on financial services, and the Chancellor specified several industrial sectors which had promising futures. But it would be wrong to assume that these, or other sectors, will necessarily be as profitable as financial services. We recommend, therefore, that future Pre-Budget Reports and Budget documents provide a sectoral analysis of tax revenues, so that the basis of Treasury forecasts in a changing economy can be scrutinised. The Treasury already has the means to provide this information, as evidenced by its commentary on the financial and housing sectors, so to do this should not be particularly onerous. (Paragraph 49)

8. In the medium term, the options for returning the public finances to balance present uncomfortable choices for the Government and consequences for the public, the broad alternatives being substantial tax increases, unprecedented cuts in public services, or a combination of the two. We recommend that in the Pre-Budget Report 2009, the Government sets out a range of options for closing the projected fiscal gap. (Paragraph 52)
9. We do not see how the Temporary Operating Rule acts as any kind of constraint at all on the current fiscal decisions made by the Chancellor, and we struggle to imagine any course of action he might have taken in this year's Budget that would have been inconsistent with it. For this Rule to have any bite whatsoever, the identification of the point in time at which "the global shocks have worked their way through the economy in full", cannot be left to the judgement of the Treasury alone, but should be subject to parliamentary scrutiny. It is clear to us that the only real financial discipline that is currently imposed on the Chancellor is the opinion of the gilt market on the sustainability of the public finances. (Paragraph 56)
10. We believe that the Chancellor should now engage in what we regard as a crucial debate about the future of the UK fiscal framework. The majority of our expert witnesses found fault with the Golden Rule and Sustainable Investment Rule, so an eventual return to an unreformed framework would seem misguided. We sense that there is little consensus on what the best framework might be, which is all the more reason to commence a thorough analysis of all the options, drawing on international best practice, practical experience and academic theory. We are not suggesting that a new framework should be implemented now, but that the Treasury should open up a debate. To this end, we renew our recommendation made in our Report on PBR 2008 for a full public consultation. (Paragraph 60)
11. We note the reaction of the debt markets to the Treasury's ambitious borrowing plans. We believe there are strong reasons why the costs of financing the Government debt could well remain low. But if the gilt market were to lose its appetite for Government debt, which is by no means impossible, the cost of financing that debt could climb to perilous levels. Financial markets can be very volatile, and, as we have recently learnt in the financial crisis, can be quite poor at pricing risks initially, with any subsequent pricing corrections being sudden and unexpected. Under these circumstances, we consider that it would be prudent for the Treasury to work up contingency plans for a weakening of demand for Government debt. (Paragraph 68)

### Other measures in Budget 2009

12. We acknowledge the pressure on Government finances but are concerned by the lack of any substantial measure to combat child poverty in both the Pre-Budget Report 2008 and Budget 2009. On current indicators the Government will fail to meet its 2010–11 target by a significant margin. We are dismayed that, despite our repeated warnings in past reports, the Treasury has failed to take sufficient positive action to ensure the child poverty targets are met. We recommend that the Government researches the impact of the recession on the number of children living in absolute as well as relative poverty and brings forward further proposals in the

Pre-Budget Report 2009 to ensure that it achieves its targets on halving child poverty by 2010–2011 and then eliminating it. One perverse consequence of the use of a relative measure of child poverty is that a period of recession might reduce the numbers of children deemed to be in poverty even though an increasing number is suffering actual hardship. (Paragraph 74)

13. Hitherto, those claiming the Local Housing Allowance had an incentive to seek competitively priced accommodation in order to maximise their benefit. Such an incentive will disappear in April 2010 which will cause problems for some. We recognise the prevailing economic pressures on the Government but recommend that more thought be given to creating a more stable framework for the payment of this benefit. (Paragraph 81)
14. The recovery of the housing market is clearly linked to the recovery of the economy as a whole. It is therefore vital that the Government take steps to reinvigorate the market at this time. However, we note that the resurgence of the property market is particularly dependent on the availability of mortgage credit to homebuyers and we are unconvinced that other schemes to boost the market, such as the stamp duty holiday, will have any marked effect. We call on the Government to report in the PBR on the implementation of the asset-backed securities scheme and to provide a cost-benefit analysis of the effectiveness of the stamp duty holiday. (Paragraph 87)
15. We welcome the help announced in the budget for homeowners. Whilst we welcome the diversity of the schemes, we regret the delays in implementation and the lack of clarity, in respect of some of the schemes, especially in entitlement to Support for Mortgage Interest. We recommend that the Government takes urgent steps to ensure that clear information is provided for homeowners on the support that is available to them if they get into financial difficulties as a result of the recession. (Paragraph 88)
16. We recognise the importance of the car industry. The vehicle scrappage policy has been welcomed in some quarters. Although it will support 300,000 new vehicle sales, it is likely that only one-third at most will be additional sales. Moreover, of these additional or accelerated sales, just 12,600 could be new UK-manufactured vehicles, although we accept that most other cars sold contain high quantities of UK-manufactured parts and that car retailing will benefit. We note the Chancellor's reservations regarding the scheme and await the Pre-Budget report 2009 to assess how effective it has been. (Paragraph 94)
17. We believe there are considerable uncertainties over the yield to be raised by the new 50% top rate of income tax. We therefore recommend that the Treasury, in the 2011 Pre-Budget Report, should report on the revenue raised, both nominally and as a percentage of the theoretical maximum revenue, by the new top rate of income tax. We also recommend that the Treasury assess at that time the yield obtained from the higher rate against its disadvantages. If the higher rate were to be continued it would be appropriate to consider what further reforms would be needed to prevent further leakage of potential revenue from this measure. The Treasury should indicate if it would revise the rate in the event that the estimated revenue yield fell well below their forecasts. Finally, we were concerned that the Chancellor lacked a robust basis

for selecting the threshold from which the new top rate of tax would apply and for choosing what that rate should be. (Paragraph 100)

18. We note that this budget marks a departure from the long-standing principle that tax relief for pension contributions should be given at an individual's highest marginal rate. We urge the Treasury to monitor the effect of this change on pension savings and to keep under review the possibility that a cap on annual contributions might be a more equitable way of reducing the percentage of tax relief that benefits the highest earners. (Paragraph 104)

# Formal minutes

---

**Tuesday 6 May 2009**

Members present:

John McFall, in the Chair

Nick Ainger

Mr Graham Brady

Mr Michael Fallon

Ms Sally Keeble

Mr Andrew Love

John Mann

Mr George Mudie

John Thurso

Mr Mark Todd

Mr Andrew Tyrie

Sir Peter Viggers

Draft Report (*Budget 2009*), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 104 read and agreed to.

Summary agreed to.

*Resolved*, That the Report be the Eighth Report of the Committee to the House.

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

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

[Adjourned till Tuesday 12 May at 9.30 am.]

## Witnesses

---

### Monday 27 April 2009

Page

**Robert Chote**, Institute for Fiscal Studies, **Roger Bootle**, Managing Director, Capital Economics, **John Whiting**, PricewaterhouseCoopers, and **Martin Weale**, NIESR

Ev 1

### Tuesday 28 April 2009

**Dave Ramsden**, Chief Economic Adviser, **Edward Troup**, Director, Business and Indirect Tax, **Mike Williams**, Director, Personal Tax and Welfare Reform, **Peter Schofield**, Director, Enterprise and Growth Unit, and **James Richardson**, Director, Public Spending, HM Treasury

Ev 15

### Wednesday 29 April 2009

**Rt Hon Alistair Darling, MP**, Chancellor of the Exchequer, **Dave Ramsden**, Chief Economic Adviser, and **Mark Bowman**, Director, Budget and Tax, HM Treasury

Ev 33

## List of written evidence

---

1	Association of British Insurers (ABI)	Ev 49
2	Aldersgate Group	Ev 50
3	Environmental Industries Commission	Ev 52
4	Professor David Heald	Ev 55
5	ICAEW Tax Faculty	Ev 57
6	Professor Tim Jackson, Economics commissioner, Sustainable Development Commission	Ev 63
7	The Rank Group	Ev 64
8	Martin Weale, National Institute of Economic and Social Research	Ev 66
9	John Whiting	Ev 67
10	HM Treasury	Ev 70, Ev71

# Reports from the Treasury Committee during the current Parliament

---

## Session 2008–09

First Report	Administration and expenditure of the Chancellor's departments, 2007–08	HC 35
Second Report	Pre-Budget Report 2008	HC 27
Third Report	Work of the Committee, 2007–08	HC 173
Fourth Report	Appointment of Paul Tucker as Deputy Governor of the Bank of England for Financial Stability	HC 34-I
Fifth Report	Banking Crisis: The impact of the failure of the Icelandic banks	HC 402
Sixth Report	MPC Appointment Hearing: Paul Fisher, Executive Director, Markets, Bank of England	HC 419
Seventh Report	Banking Crisis: dealing with the failure of the UK banks	HC 416

## Session 2007–08

First Report	The 2007 Comprehensive Spending Review	HC 55
Second Report	The 2007 Pre-Budget Report	HC 54
Third Report	The Work of the Committee in 2007	HC 230
Fourth Report	Climate change and the Stern Review: the implications for Treasury policy	HC 231
Fifth Report	The run on the Rock	HC 56
Sixth Report	Financial Stability and Transparency	HC 371
Seventh Report	Administration and expenditure of the Chancellor's departments, 2006–07	HC 57
Eighth Report	Re-appointment of Dr Andrew Sentance to the Monetary Policy Committee	HC 454

Ninth Report	The 2008 Budget	HC 430
Tenth Report	Re-appointment of Mervyn King as the Governor of the Bank of England	HC 524
Eleventh Report	Counting the population	HC 183
Twelfth Report	Inherited Estates	HC 496
Thirteenth Report	Budget Measures and Low Income Households	HC 326
Fourteenth Report	Appointment of Lord Turner of Echinwell as Chairman of the Financial Services Authority	HC 916
Fifteenth Report	Appointment of Charlie Bean as Deputy Governor of the Bank of England	HC 917
Sixteenth Report	Appointment of Spencer Dale to the Monetary Policy Committee of the Bank of England	HC 1009
Seventeenth Report	Banking Reform	HC 1008

### Session 2006–07

First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
Fifth Report	The 2007 Budget	HC 389
Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	Progress on the efficiency programme in the Chancellor's department	HC 483
Ninth Report	Appointment of the Chair of the Statistics Board	HC 934
Tenth Report	Private equity	HC 567

Eleventh Report	Unclaimed assets within the financial system	HC 533
Twelfth Report	The Monetary Policy Committee of the Bank of England: ten years on	HC 299
Thirteenth Report	Financial inclusion follow-up: saving for all and shorter term saving products	HC 504
Fourteenth Report	Globalisation: prospects and policy responses	HC 90

### Session 2005–06

First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111
Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595

Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	"Banking the unbanked": banking services, the Post Office Card Account, and financial inclusion	HC 1717

---