



House of Commons
Treasury Committee

June 2010 Budget

First Report of Session 2010–11

Report, together with formal minutes, oral and written evidence

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The Treasury Committee

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1 Introduction

1. In previous Parliaments, it was the practice of the Treasury Committee to take evidence on the Budget and to report before the Second Reading of the Finance Bill. This year, that has not been possible. Our predecessor Committee took evidence on the first Budget of the year in March 2010, but was unable to report on it, because of the imminent election. The current Chancellor presented the second Budget of the year on 22 June 2010, and the Second Reading of the Finance Bill took place on 6 July. This Committee was established on 12 July. We immediately decided to take evidence on the Budget, and on 13 July we took evidence from the following witness panels:

Office for Budget Responsibility

Sir Alan Budd, Chairman, Budget Responsibility Committee

Geoffrey Dicks, Member, Budget Responsibility Committee

Graham Parker, Member, Budget Responsibility Committee

Experts

Ray Barrell, Director of Macroeconomic Research and Forecasting, National Institute of Economic and Social Research (NIESR)

Roger Bootle, Managing Director, Capital Economics

Robert Chote, Director, Institute for Fiscal Studies (IFS)

Alan Clarke, Economist, BNP Paribas

John Whiting, Tax Policy Director, Chartered Institute of Taxation

HM Treasury Officials

Dave Ramsden, Chief Economic Adviser

Andrew Hudson, Managing Director, Public Services and Growth

Edward Troup, Managing Director, Budget, Tax and Welfare

On 15 July we took evidence from the Chancellor of the Exchequer, the Rt Hon George Osborne MP, Sir Nicholas Macpherson, Permanent Secretary of HM Treasury, and Mark Bowman, Director, Budget and Tax. We are very grateful to all our witnesses; because of their co-operation we have been able to produce this Report in time for Third Reading of the Finance Bill.

2. There is a degree of political consensus over the need to reduce the deficit in the medium term, although there is debate about the speed and depth of reduction needed. The Fiscal

Responsibility Act 2010 introduced by the previous administration, required that the Treasury must ensure:

public sector net debt as at the end of the financial year ending in 2016 expressed as a percentage of gross domestic product (centred on 31 March 2016), is less than public sector net debt as at the end of the previous financial year expressed as a percentage of gross domestic product (centred on 31 March 2015).¹

The Chancellor has set himself a similar target for net debt:

For this Parliament, the fiscal mandate will be supplemented by a target for debt as a share of GDP to be falling at a fixed date of 2015–16, ensuring that the public finances are restored to a sustainable path [...]

3. However, there are differences in approach to public sector net borrowing, even though both administrations proposed some fiscal tightening. The previous Chancellor estimated that net borrowing would reach £166.5bn in 2009–10; in the March Budget he proposed fiscal adjustments which meant borrowing was expected to fall to £74bn by 2014–15, a reduction of 56%. Although borrowing in 2009–10 was lower than expected, the OBR estimated that the fiscal adjustments announced in the June Budget by the current Chancellor meant that net borrowing would fall from £155bn in 2009–10 to £37bn by 2014–15, a reduction of 76%.²

4. The previous administration's Fiscal Responsibility Act requires the Treasury to ensure that public sector net borrowing as a percentage of GDP falls each year from 2011 to 2016, and that for the financial year ending in 2014, public sector net borrowing expressed as a percentage of gross domestic product is no more than half of what it was for the financial year ending in 2010.

5. In his Budget statement the Chancellor set out a formal fiscal mandate:

that the structural current deficit should be in balance in the final year of the five-year forecast period, which is 2015–16 in this Budget.³

At this Budget, the end of the forecast period is 2015–16. However, under current plans the structural current deficit is expected to be in balance a year early, in 2014–15. Although there are differences in the definitions used, in that the Fiscal Responsibility Act refers to all public sector net borrowing, while the fiscal mandate is expressed in terms of the structural deficit, it is clear that the Chancellor is proposing a significantly faster fiscal adjustment than that set out in the previous Government's March 2010 Budget.

6. There is international controversy over what would be a prudent speed for fiscal consolidation. In June 2010, the President of the United States of America wrote to his G20 colleagues urging caution, saying:

¹ Fiscal Responsibility Act 2010, C.3, section 1

² June 2010 Budget, p 99, table C.10

³ HC Deb, 22 June 2010, col 167

We must be flexible in adjusting the pace of consolidation and learn from the consequential mistakes of the past when stimulus was too quickly withdrawn and resulted in renewed economic hardships and recession.⁴

The Chartered Institute for Personnel and Development (CIPD) has warned:

[...] historical precedent would suggest that the application of stronger fiscal discipline to an economy in too weak a state to bear it will both slow the rate of economic growth and stem the pace of job creation.⁵

7. In contrast, the Chancellor considers that without a more rapid adjustment, the UK will face:

Higher interest rates, more business failures, sharper rises in unemployment, and potentially even a catastrophic loss of confidence and the end of the recovery.⁶

Ray Barrell of NIESR told us:

Tighter fiscal policy is needed to pay down the debt stock, and the government's general plan to do that is welcome. As the UK is the only large OECD country that has never defaulted on its debt, it is very unlikely that the UK will face a Greek style confidence crisis. It is therefore unlikely that we will see a noticeable premium on interest payments on UK debt. However, debt reduction is needed both to ensure we are fair to our children by not consuming their inheritance, and also to prepare our defences for the next financial crisis when debts will have to rise again.⁷

8. This is the central and most difficult decision any Chancellor has to take. We have not attempted to challenge the Chancellor's judgement on the Budget as a whole. There are risks on either side of the Budget judgement. The Chancellor has chosen a somewhat more radical path than his predecessor. Furthermore, he has been explicit that his aim is not only to reduce debt, but to rebalance the economy away from the public and toward the private sector. In this Report, we examine some of the risks and uncertainties in this approach. We expect that the consequences of the Chancellor's decision will be the subject of many of our future inquiries.

⁴ <http://www.whitehouse.gov/the-press-office/letter-president-g-20-leaders>, accessed 19 July 2010

⁵ CIPD, CIPD responds to 'optimistic' Office for Budget Responsibility employment forecasts, 30 June 2010

⁶ HC Deb, 22 June 2010, col 166

⁷ Ev 47

2 Macroeconomy

The overall growth forecast

9. There have already been three UK Government economic forecasts in 2010. One forecast was produced by the previous Government in the March Budget Report (the March Budget forecast)⁸, and two forecasts were produced by the newly founded Office for Budget Responsibility (OBR), on 14 June 2010 (the June Pre-Budget forecast) and 22 June 2010 (the June Budget forecast).⁹ The OBR's GDP growth forecasts can be seen in Table 1 below.

Table 1: GDP growth forecast (Percentage change on a year earlier)

	2009	2010	2011	2012	2013	2014	2015
Pre-Budget Forecast	-4.9	1.3	2.6	2.8	2.8	2.6	
June Forecast	-4.9	1.2	2.3	2.8	2.9	2.7	2.7

Source: OBR Pre-Budget forecast, June 2010, p 26, Table 3.3; June 2010 Budget, pp 4, Table C2

The OBR warned however that a comparison between the June Pre-Budget forecast and the June Budget forecast may be misleading:

The pre-Budget forecast does not provide a firm basis for an estimate of the effects of the Budget measures on the economy because the pre-Budget and Budget forecasts are both based on market expectations of interest rates. These are likely to have incorporated some expectation of further fiscal tightening but it is impossible to judge how much [...]. This may have introduced an upward bias into the pre-Budget forecast and make comparison misleading.¹⁰

These caveats should be borne in mind in reading the following section.

Impact of the June Budget

10. The June 2010 Budget proposed a significant fiscal consolidation above that envisaged in the March 2010 Budget of the previous Government. There is concern that such a consolidation may come too early and cut too deeply, and as such cause the economic recovery to falter, leading to a “double dip” recession. As the June 2010 Budget acknowledges, the impact of the fiscal consolidation is uncertain:

The overall economic impact of fiscal consolidation depends on the combination of:

- direct and indirect effects, from reduced public spending or increased taxation. These will tend to reduce demand growth in the short term; and

⁸ HM Treasury, *Budget 2010*, March 2010

⁹ Office for Budget Responsibility, *Pre-Budget forecast*, June 2010; HM Treasury, *Budget 2010*, June 2010, p 93, para C.53

¹⁰ HM Treasury, *Budget 2010*, June 2010, p 93, para C.53

- wider economic effects, which depend on the reaction of the private sector and monetary policy to the changed fiscal environment. These will tend to boost demand growth, could improve the underlying performance of the economy and could even be sufficiently strong to outweigh the negative effects.¹¹

11. When we questioned the OBR as to whether the June Budget had increased the chance of a “double dip” recession, Mr Dicks replied that:

We discourage, you will see in the Red Book, from making these direct comparisons but there are some Budget measures which will have reduced demand and, in aggregate, between our pre-Budget and post-Budget forecasts, we have taken 0.5% off GDP. So the near-term outlook for GDP is not as good as it was before the Budget. I still do not think that will mean a double-dip, but logically the chances of that happening have increased.¹²

Mr Barrell explained that because of the change in the central projection, the fan of possible outcomes around that central projection had also moved. And since the forecast had weakened near-term growth, slightly more of the fan would now be negative.¹³ He therefore suggested that this meant that “the probability of a double-dip recession has risen by 4%, or some such number”.¹⁴

12. Mr Bootle, of Capital Economics, considered that it was unhelpful to think of a “double dip” recession, replying that “I think the more meaningful thing is: is growth going to be significantly weaker or stronger than the forecasts over the period? I think the Budget has increased the chance that growth will be significantly weaker over the forecast period.”¹⁵ When asked to quantify by how much his central projection had changed, he replied:

You know there is no certainty in this, but, for the sake of argument, the emergency Budget forecast for next year suggests that the economy will grow by about 2.3%. My own forecast is more like 1.5%. It is difficult to be precise about how much the Budget itself has reduced growth prospects, not least because so much depends upon what happens to monetary policy and bond yields, and on that of course there can be umpteen different views.¹⁶

13. Mr Clarke, of BNP Paribas, told us that:

Just to keep this in context, I am forecasting 1% growth, the OBR 2.3%, and the most optimistic person in the consensus is looking for 3.2%, so the OBR is in the middle of the road. [...] for the economy to go about 2.3% and then almost 3% the year after that, the newspapers said this was going to be the most painful Budget in living

¹¹ HM Treasury, *Budget 2010*, June 2010, p 19, Box 1.3

¹² Q 28

¹³ Q 99

¹⁴ Q 98

¹⁵ Q 92

¹⁶ Q 93

memory. Well, 2.3% and then 3% is not painful at all. I think a quarter on quarter growth could get down to about zero, but then we recover from there. That is not a double dip, that is a soft patch.¹⁷

Mr Dicks defended his central GDP forecast, telling us that:

Our forecasts at least for this year and next are in line with the consensus, bang in line with the consensus, 1.2 this year and 2.3 next year, and I think the consensus is either 1.3 and 2.2 or something like that. In the medium term, we are a little bit more optimistic than some forecasters, but by then the recovery, we believe, will have got some momentum, not just in the UK, but elsewhere, and we do think that the forces of recovery will gather strength.¹⁸

14. The Chancellor strongly denied that his Budget was placing the economy at risk. He told us that:

I would say I am reducing the risk faced by the British economy. When I became Chancellor of the Exchequer the country had the highest budget deficit in the G20, the second highest in the European Union after Ireland, the credit rating agencies of the world had raised serious questions about Britain's credit rating and our market interest rates were similar to those of Spain. In the last eight or nine weeks there has been a general view around the world that Britain has taken decisive action to deal with its budget deficit. [...] I think it is worth drawing the Committee's attention to what has happened to market interest rates for the United Kingdom since the March Budget. Ours have fallen by half a per cent and Spain's have increased by half a per cent. That is a very significant monetary stimulus to the economy and also has helped to deal with the tail risk which the OBR draws everyone's attention to in its report but says it is not possible to put in its growth forecast.¹⁹

15. Although there are problems in comparing the OBR's two forecasts, it appears that there has been a slight increase in the chance of near-term negative growth and an increased likelihood of positive growth in the outer years. We will continue to monitor the macroeconomic environment, through our regular hearings with the Bank of England and the Office for Budget Responsibility.

Rebalancing the economy

16. Rebalancing is a term applied to a variety of distinct concepts. For example, it can be used to cover a change in allocation of resources between public and private sector; changes in the balance between imports and exports, both at a national level and between nations; changes in the extent to which consumers spend or save; changes in the relative importance of particular industries or sectors in the economy or changes in economic activity between different regions

¹⁷ Q 95

¹⁸ Q 50

¹⁹ Q 216

17. In the June 2010 Budget, the Treasury noted that the OBR in its June Budget forecast suggested a rebalancing in the UK economy “with net exports and business investment making a greater contribution to growth than in the recent past, and government spending making a negative contribution to growth as fiscal consolidation is implemented”.²⁰ The Treasury went on to assert that “This is a crucial part of the rebalancing of the economy that is required for a sustainable recovery.”²¹ The Chancellor reiterated his desire to rebalance the economy, telling us that he wanted “to create over the longer term an economy that is not so dependent on household debt, overleveraged banks, over indebted government, but where we invest more and we export more, and I think that is going to be a more stable economic model for this country going forward”.²²

18. Table 2 outlines how the different parts of the economy will contribute to GDP growth over the June Budget forecast horizon. As can be seen, from 2011, business investment and net trade are the drivers of this rebalancing, and so we discussed with witnesses the risks around the OBR’s forecast for these two contributors to GDP growth.

²⁰ HM Treasury, *Budget 2010*, June 2010, p 18, para 1.48

²¹ *Ibid.*

²² Q 217

Table 2: Contributions to GDP growth¹

	Percentage points, unless otherwise stated						
	2009	Forecasts					
		2010	2011	2012	2013	2014	2015
GDP growth, per cent	-4.9	1.2	2.3	2.8	2.9	2.7	2.7
Main contributions							
Private consumption	-2.1	0.2	0.8	1.1	1.3	1.4	1.4
Business investment	-2.1	0.1	0.8	1.0	1.1	1.1	1.0
Dwellings investment ²	-0.6	-0.2	0.2	0.2	0.3	0.2	0.2
Government ³	0.8	0.3	-0.7	-0.6	-0.6	-0.6	-0.4
Change in inventories	-1.2	1.2	0.4	0.0	0.0	0.0	0.0
Net trade	0.7	-0.5	0.9	0.9	0.7	0.5	0.5

Source: June 2010 Budget, p 85, Table C3

¹ Components may not sum to total due to rounding, omission of transfer costs of land and existing buildings, and the statistical discrepancy

² The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.

³ The sum of government consumption and general government investment.

Net trade

19. Despite a significant devaluation in sterling, Table 2 shows that net trade is forecast to make a negative contribution to GDP growth in 2010. The OBR explained that “Net trade is forecast to subtract from growth in 2010, as relatively robust import growth outweighs still-sluggish exports”.²³

20. Table 2 also shows that from 2011, net trade is forecast to make a significant positive contribution to GDP growth. Given the performance of net trade in 2010, we questioned whether the forecast contribution to GDP growth from net trade from 2011 onwards would actually materialise. Mr Barrell explored the outlook for exports:

Over the next year or two, there are serious risks from our major market, the European Community. We have seen a major decline in the value of sterling against our competitors in the last two years and that will eventually feed through into stronger volumes, and I base that not on comparisons with previous recessions, but just on the standard statistical work we do all the time on the relationship between relative prices, the level of demand and the level of exports. Exports at some point or other will take off, but it could take two or three years for the effects to feed through, so it will happen slowly, we think.²⁴

²³ HM Treasury, *Budget 2010*, June 2010, p 83, para C.28

²⁴ Q 108

21. Mr Dicks, defending the OBR's forecast, told us that, on the imports side “we have a pretty downbeat forecast for domestic demand—and particularly consumer spending—so we are not going to be sucking in imports”,²⁵ and that on the export side:

I agree it is disappointing so far. Exporters seem to have taken the depreciation of sterling on their profit margins, but that is always—and has been in the past—the first stage under which you get a supply side response. Profitability of exports has improved; we are more competitive overseas. [...] We have looked in detail at the recovery of the 1990s and 1980s, trying to draw comparisons, and the forecast that we have this time round, generally, is a pale shadow of the recoveries we saw in the 1990s and 1980s. We are quite comfortable, given the headwinds, given problems in the financial sector, that the outlook is weaker, but only in degree. I would expect the shape of this recovery, including a strong contribution from net trade, which was your question, to be of an order of magnitude similar to what we have had before.²⁶

Mr Ramsden was also sanguine about whether the increase in exports would be seen. He told us:

You were asking are there doubts that we are going to see this export performance. This is something that we monitor, as we have been doing, from one month to the next and one year to the next. Experience in the UK shows that it takes time for the volumes to adjust, but they do adjust and the UK has adjusted in the past and moved on to a stronger export trajectory.²⁷

22. We also questioned whether the forecast for the contribution of net trade to the GDP growth forecast took sufficient account of the pattern of UK trade. Our major trading partners are in the more developed countries, whereas recent economic growth has been seen in the emerging market economies. Mr Dicks felt that the OBR forecast had taken account of the risk presented by this development:

Our forecasts for the euro area are below the consensus, so I agree with you there that—well, we are not getting a lot of help in terms of our export markets from our largest export market, but that is part of our central forecast.²⁸

Mr Ramsden also accepted that “the emerging markets that have been growing more strongly than the developed world”, and that the pattern of UK trade was not ideal :

the UK has a trade pattern which is very significantly determined by history. For example, that means one of our biggest trading partners is Ireland given our very close links with Ireland over centuries. It is a feature of the UK economy, which was something I was quite struck by when I was analysing the data, that in terms of shares of trade our share of trade with the rapidly growing and emerging economics,

²⁵ Q 43

²⁶ Q 41

²⁷ Q 143

²⁸ Q 42

the BRICs—Brazil, Russia, India and China—is about 5% or 6% whereas it is about three times that with the euro periphery economies. I have mentioned Ireland but we also have strong trade links with others. That share with the emerging market economies has grown very significantly in recent years. I think it has doubled compared with 2000 when it was 2.5% and it is now just over 5%.²⁹

Mr Ramsden went on to note though:

Government policy is very much focused on looking for the opportunities, and this is something that the Treasury as an economics ministry is very focused on thinking about, how can we encourage stronger growth both in terms of macro policy settings but also whether there are any micro policy interventions.³⁰

The Chancellor also emphasised the Government's intention to explore trade relations with emerging economies:

The Prime Minister is leading a large delegation to India, an incredibly important export market for the future, in order to try and kick-start a better trade relationship with India. I think it is a striking fact about the British economy that we export more to Ireland than we do to Brazil, India, China and Russia put together. There is certainly scope as the world grows and these emerging economies become larger and become nations of consumers for British exports to those markets.³¹

23. We note that despite a significant sterling devaluation, net trade is currently not expected to contribute positively to GDP growth in 2010. The OBR forecasts a significant increase on the path of net trade but there are differences about the speed of change.

Business investment

24. As part of the forecast rebalancing of the economy, business investment is expected to make a significant contribution to GDP growth (see Table 2). The OBR forecasts that in 2012, business fixed investment will grow by 10.0% on a year earlier, rising to 10.9% in 2013.³² There is a significant risk to the overall GDP growth forecast if business investment is not as robust as predicted. As Professor David Blanchflower, a former external member of the Monetary Policy Committee, wrote, "It is unclear whether firms will increase investment, but for the Government's Budget to succeed, it is vital that they do."³³

25. Mr Dicks considered the forecast reasonable. We questioned whether there would be the bank lending available to support such strong forecasts for business investment. Mr Dicks replied that:

²⁹ Q 141

³⁰ Q 141

³¹ Q 237

³² HM Treasury, *Budget 2010*, June 2010, p 84, Table C.2

³³ Ev 48

it is a well-known statistic that something like 80% of all investment is done by 20% of the largest companies who, typically, finance it from internal resources. You could say exactly the same question to me about the first quarter: how come business investment was up 7.5% at a time when the banks are not lending? I think that is part and parcel of the internal financing investment argument, and the private non-financial corporate sector has built up £100 billion of net assets over the last two years; they are not cash-poor. We think[...] the fact that it fell such a long way means it has got a long way to come back relative to GDP before you get to a normal investment to GDP ratio.³⁴

Mr Ramsden considered the current economic environment supported business investment, noting that “We have very, very low interest rates both at the short end and the long end which businesses can borrow at. As I think you heard earlier, large businesses have rebuilt their cash positions and they are in a good position financially”.³⁵ Mr Ramsden also felt that one of the key determinants for holding back business investment was uncertainty, and that the Budget had taken steps to reassure businesses:

There is a supportive economic environment with the surveys suggesting that quite a lot of investment is being held back because of lack of confidence about the future. That is not surprising when you think of the crisis that the UK and world economies have been through. It was a crisis of confidence through the winter of 2008 and early 2009 and businesses have been affected by that. When you look against that kind of backdrop and those kinds of drivers in 1995 UK business investment grew by 7.8%, in 1996 by 10.4% and in 1997 by 10%. You get significant growth rates in business investment for a number of years because after a shock like we have had, and which the economy saw to a lesser extent in the early 1990s, there is a need to rebuild the capital stock, there is a need to invest and if the environment is there to do it with low cost of capital it can do it.³⁶

26. Mr Ramsden and Mr Dicks also thought the cuts in corporation tax would contribute to business confidence.³⁷ Indeed, Mr Ramsden said the Budget provided certainty about:

the business investment regime over the whole period of this Parliament and four years of cuts in the main rate of corporation tax. One thing we get back very strongly from businesses when we discuss with them is that they want stability and certainty in this kind of regime. I think that the corporation tax reforms are strategic, have given them that certainty and macro conditions stay supportive.³⁸

³⁴ Q 46

³⁵ Q 145

³⁶ Q 145

³⁷ Qq 46, 145

³⁸ Q 145

Employment

27. On 30 June 2010, the Office for Budget Responsibility (OBR) published a forecast for General Government and private sector employment. On 13 July 2010, the day of our hearing, the OBR released further information on a change in methodology for general government employment forecasts, between the pre-Budget, and Budget forecasts, which then allowed a comparison.³⁹ Table 3 brings together in summary these separate forecasts.

Table 3: OBR Employment forecasts

		2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
General Government average earnings growth	Pre-Budget forecast	2.3%	1.7%	1.9%	2.5%	2.7%	
	Budget forecast	2.3%	0.8%	0.8%	3.1%	3.1%	3.1%
General Government employment growth	Pre-Budget forecast	-0.1%	-2.4%	-2.9%	-2.0%	-1.4%	
	Budget forecast	-0.1%	-1.2%	-1.3%	-3.0%	-3.7%	-2.4%
General Government employment level (Millions, end of financial year)	Pre-Budget forecast	5.53	5.40	5.24	5.14	5.07	
	Pre-Budget forecast ¹		5.49	5.43	5.35	5.20	
	Budget forecast	5.53	5.47	5.39	5.23	5.04	4.92
Whole economy Employment (LFS measure, millions, end of financial year)	Pre-Budget forecast	28.93	29.17	29.47	29.77	30.02	
	Budget forecast	28.89	29.08	29.36	29.69	29.97	30.23

Source: OBR Forecast: Employment, 30 June 2010; OBR: General Government Employment Growth Forecasts, July 13 2010

¹ Hypothetical Estimated Pre-Budget Forecast under Budget assumptions

28. We are conducting another inquiry into the formation of the Office for Budget Responsibility, where we will consider the impact of the release of these forecasts. The release on 30 June led to political controversy about the effects of Budget measures on employment, based the mistaken assumption that the first two projections were based on similar assumptions. As Sir Alan Budd noted, “In retrospect, I wish that we had provided more information and a specific warning against using the numbers to estimate Budget effects”.⁴⁰ **It is unfortunate that the independence of the OBR has been called into question. This makes it all the more important to get the structure and the statutory basis of the permanent organisation right, as the both the OBR and Chancellor recognise. We will consider in our inquiry into the OBR what further steps need to be taken to ensure its independence.**

29. The OBR’s June Budget forecast suggests that between 2010–11 and 2014–15, whole economy employment will rise by around 1.08 million. In the same period, general government employment will fall by around 0.49 million. As such, the OBR is forecasting growth in employment outside General Government of around 1.57 million, a significant rebalancing of employment between the public and private sectors.

30. Commenting on the release of the OBR’s employment forecasts, Dr John Philpott, Chief Economic Adviser at the Chartered Institute of Personnel and Development (CIPD),

³⁹ Office for Budget Responsibility, *General Government Employment Growth Forecasts*, 13 July 2010

⁴⁰ Q 1

noted that “The OBR forecast for public sector employment to 2015–16 is close to that made by the CIPD both before and after the General Election. By contrast, however, the OBR forecasts for growth in total employment look optimistic.”⁴¹ He noted that:

a dynamic economy with almost 30 million people in work, which in a normal year is capable of more than making up for the 0.5 million jobs lost as a result of annual improvements in labour productivity, should be able to cope with a phased period of large scale public sector downsizing without this resulting in higher unemployment. But a favourable outcome depends on a return to health of the wider economy and increased demand for labour from the private sector. The conditions necessary for such a favourable outcome are at present far from self-evident and unlikely to emerge simply as a consequence of swifter and tougher action to reduce the deficit. [...] the employment outlook is likely to be far weaker than the OBR forecasts and the coalition government hopes, with a rise in unemployment toward 3 million in the next two years a distinct possibility.⁴²

Mr Clarke also questioned the hiring capacity of the private sector:

In what sectors will the jobs be coming? Manufacturing has done quite well for now, but a lot of the upstream indicators are turning down, so I do not think they will have such a good run over the next 12 months or so. The services sector has fared a little bit better, but I do not think there is going to be as much hiring as the OBR assumes because I do not think we will be growing in excess of the economy’s trend growth and, when that is the case, you tend to have job losses.⁴³

However Mr Dicks strongly defended the forecast of the OBR, and explained that:

[...] we have had fiscal consolidations before, a relatively minor one in the 1980s and a stronger one in the 1990s. If you look at our employment forecast as an example, we are forecasting 5% employment growth over the next six years. In the fiscal consolidation of the 1990s, which was similar in magnitude, the deficit went from 7.7% of GDP to a small surplus, so a similar sort of deficit reduction programme, we had employment growth of 7%, and in the 1980s we had 13%. Now, I am sorry to keep coming back to what has happened before, but it is the best guide. We are in a big fiscal consolidation and previous fiscal consolidations have not derailed the recovery, and I do not think this one will either.⁴⁴

Sir Nicholas Macpherson, Permanent Secretary to the Treasury, also told us that “The economy is now recovering and employment, as the figures released yesterday confirmed, is rising and the conditions look pretty good for the labour market. There are good grounds for confidence.”⁴⁵

⁴¹ CIPD, CIPD responds to ‘optimistic’ Office for Budget Responsibility employment forecasts, 30 June 2010

⁴² CIPD, CIPD responds to ‘optimistic’ Office for Budget Responsibility employment forecasts, 30 June 2010

⁴³ Q 102

⁴⁴ Q 49

⁴⁵ Q 233

31. The OBR's publication of forecasts for employment is new and welcome. We note the forecast of both considerable public sector job losses, and strong private sector hiring. This forecast depends on the assumptions in the wider forecasts, and is subject to the same risks. We will continue to monitor the impact of reforms on the labour market.

Part-time and youth employment

32. We questioned the Chancellor on the impact of the recession on full-time employment. The Office for National Statistics released its Labour Market Statistics on 14 July 2010.⁴⁶ It noted that while part-time employment increased, there was a fall in full-time employment:

The number of people in employment increased by 160,000 on the quarter to reach 28.98 million. The quarterly increase in total employment was mainly driven by part-time employees, which increased by 117,000 on the quarter to reach 6.63 million, and self-employment, which rose by 59,000 on the quarter to reach 3.93 million. The number of full-time employees fell by 22,000 on the quarter to reach 18.20 million.⁴⁷

Responding on the rise in part-time working against the fall in full-time working, the Chancellor noted that:

A feature of any recession is that people move on to part-time work and partly that is a reflection of labour market flexibility. Of course, coming out of recession into recovery you want people who are working part-time who want to be able to work full-time, and of course there are people who want to stay working part-time, to have the opportunity to do that. One of the measures which I have not mentioned so far, but essentially one of the largest items that we had in the Budget, is an increase in the employers' National Insurance threshold by £21 which will make it cheaper to employ people earning less than £20,000 than it is today and, indeed, cheaper across the income spectrum compared to the plans that I inherited from the previous government. We are making it easier for employers to take people on and reducing the burdens on employment and as we come out of recession into recovery we want to see people who want to move into full-time work.⁴⁸

When questioned on the steps that need to be taken to tackle youth employment, he noted that:

The big policy change here is a more effective welfare system. My colleagues in the Department for Work and Pensions are working on the Work Programme which we believe will provide more effective help than existing schemes have to help in particular young people get into sustainable jobs, in other words not to find themselves constantly recycled through government training programmes and

⁴⁶ Office for National Statistics, *Labour market statistics*, July 2010

⁴⁷ Office for National Statistics, *Labour market statistics*, July 2010, p 2

⁴⁸ Q 235

possibly hold work for 13 weeks only to drop back into unemployment in the 14th or 15th week. Using the plan that was originally developed by Lord Freud for the previous government, but not implemented, and being less theological about the division between DEL and AME, and by increasing the diversity of providers for Welfare to Work schemes and increasing the incentives on them, I think we will have better targeted and more effective support for younger people who are currently unemployed. You are quite right to draw everyone's attention to them because we have one of the highest youth unemployment rates in Europe.⁴⁹

Migration

33. We also sought information on the level of migration forecast over the period, and its impact on trend output. Mr Dicks told us that the OBR's migration figure was "based on the ONS's best migration projection statistics". He noted that "It was as high as 190,000 before, so we are assuming that the overall economic environment will not be so conducive to inward migration, but 140,000 or thereabouts will still be coming."⁵⁰ Mr Barrell told us that:

We judge that perhaps the recession and the scar on output will reduce the stock of migrants in the UK by about 350,000, and that is a permanent shock and there are two reasons for that. Countries such as Poland, Australia and the Indian Sub-Continent have actually suffered less in this crisis than we have and people are less willing to come. Secondly, the Poles who have gone back, and it is the Poles in particular who are interesting, came here because we, the Irish and the Swedes were the only people who allowed them to work. When they start to come back as the whole of the European economy recovers, they will have the German, the French, the Italian and the other markets open to them, so they will not all come back here, so we are unlikely to see such a large rise in the number of migrants after the recession as we have seen beforehand, so I suspect a lot of those jobs will not be taken by Poles because they can earn more in Germany than they can in the UK [...] I personally would revise my projection downwards and, if downwards, that is a larger impact on the stock of migrants than we previously thought.⁵¹

34. When the Chancellor was asked whether migration was the "stimulant for growth", he told us that "I am working on the assumption of is that our Welfare to Work reforms will increase the incentives to work in this economy, will get people off out of work benefits, on which too many people sit permanently, and ensure there are British people of the skills and ability to take on some of the jobs that previously went to people who came as economic migrants to this country".⁵² The Chancellor also noted that the Government "has

⁴⁹ Q 236

⁵⁰ Q 61

⁵¹ Q 107

⁵² Q 263

a plan to put a cap on economic migration”, and Mr Barrell concluded that changes in policy to reduce migration would also have an effect.⁵³

Inflation and Monetary Policy

35. Monetary policy remains loose in the United Kingdom. The official Bank Rate is currently set at 0.5%, and has been since 5 March 2009.⁵⁴ Quantitative easing remains in place, as the Monetary Policy Committee (MPC) of the Bank of England decided to keep the “stock of asset purchases financed by the issuance of central bank reserves at £200 billion” in July 2010.⁵⁵ Mr Dicks outlined the role played by the Bank of England in maintaining a loose monetary policy:

the Bank of England has taken extraordinary measures to try and keep the economy moving ahead, and one would imagine that, as long as inflation remains under control, the Bank of England will be supportive.⁵⁶

And the Chancellor emphasised to us that “It has always been my view that monetary stimulus is the most powerful tool available to stimulating growth”.⁵⁷

36. In its forecast, the OBR noted that one impact of the Budget was to slow the return of the inflation rate to target in the short term:

CPI inflation stays around 3 per cent in the near term. It then declines more gradually than in the pre-Budget forecast because of the rise in the standard rate of VAT to 20 per cent in January 2011 and the higher oil price assumed in the Budget forecast. Once the short-term effects of the VAT increase have passed through, the larger output gap and cuts in public spending place downward pressure on inflation in line with the pre-Budget forecast. CPI inflation falls back to a little under 2 per cent in early 2012 and then settles at the 2 per cent target over the medium term.⁵⁸

Mr Bootle warned of the dangers if the OBR’s inflation forecast proved incorrect:

There is, however, an underlying uncertainty about how co-operative, as it were, the economy will be in producing that sort of inflation rate. I think the point is that, if it is not very co-operative, the implicit assumption in the OBR’s document is that the Bank of England will take monetary policy action to bring inflation to the target, and that of course could make things very uncomfortable for the growth environment.⁵⁹

⁵³ Qq 260, 107

⁵⁴ Bank of England, News Release: Bank of England Maintains Bank Rate at 0.5% and the Size of the Asset Purchase Programme at £200 billion, 8 July 2010

⁵⁵ Bank of England, News Release: Bank of England Maintains Bank Rate at 0.5% and the Size of the Asset Purchase Programme at £200 billion, 8 July 2010

⁵⁶ Q 50

⁵⁷ Q 219

⁵⁸ HM Treasury, *Budget 2010*, June 2010, p 81, para C.19

⁵⁹ Q 101

Mr Bootle's warning came after the minutes of the June 2010 MPC meeting showed that Andrew Sentance, an external member of the MPC, had voted to raise interest rates by 0.25 percentage points, the first vote for an interest rate rise since 7 August 2008.⁶⁰ The MPC minutes record that:

For one member, developments over the past month were consistent with a pattern which had been developing over the past year. Inflation had proved resilient in the aftermath of the recession, casting doubt on the future dampening impact of spare capacity on inflation. Demand had recovered at home and abroad, and the average growth of the main measures of UK nominal demand in recent quarters had been above typical pre-recession rates. Despite current uncertainties, for this member, it was appropriate to begin to withdraw gradually some of the exceptional monetary stimulus provided by the easing in policy in late 2008 and 2009.⁶¹

Professor Blanchflower emphasised the sensitivity of the economy to any potential rise in interest rates, but also warned that further Quantitative Easing would have an uncertain effect:

Monetary policy of course is playing a large part, with interest rates at 0.5%. Over four million households on tracker mortgages have ridden out the storm pretty well as the payments on their mortgages have dropped substantially. Increases in interest rates would be extremely harmful to the economy in general and to home owners in particular. There is no room to cut rates further and it is unclear what impact additional amounts of quantitative easing would have.⁶²

37. The economic recovery in the OBR forecast will depend, in part, on supportive monetary policy. However, in the short term, Budget measures such as the VAT increase will affect inflation. We look forward to discussing this in more detail with the Monetary Policy Committee very soon.

Trend Growth

38. The forecast for trend growth is important, as it impacts on the assessment of the level of the output gap, which then feeds into the assessment of the level of the structural deficit. Table 4 highlights the differences in assumptions on trend growth between the March Budget and the June pre-Budget forecast.

⁶⁰ Bank of England, Minutes of the Monetary Policy Committee meeting, 9 and 10 June 2010, p 9

⁶¹ Bank of England, Minutes of the Monetary Policy Committee meeting, 9 and 10 June 2010, p 8

⁶² Ev 48

Table 4: OBR and March Budget trend growth and output gap assumptions (per cent)

	Trend growth		Output gap at end of 2009	Implied levels adjustment 2015 ¹
	2010 Q3 to 2013 Q4	2014 Q1 to 2015 Q1		
March Budget (economy)	2.75	2.75	-6.25	-5.25
March Budget (public finances)	2.50	2.50	-6.25	-6.50
OBR	2.35	2.10	-4.00	-8.75

¹Level of trend output at the start of 2015 relative to the level implied by trend growth of 2.75 per cent from the end of 2006

Source: OBR, *Pre-Budget forecast*, p73, Table B.1

39. In its June pre-Budget forecast, the OBR explained that it had reduced trend growth due to changes in assumptions on the impact of the financial crisis, and demographic changes.⁶³ In the June Budget forecast, the OBR then explained that “It is possible for policy changes to have permanent effects to the extent that they improve or worsen the supply-side performance of the economy. Our judgement on the effect of the [June] Budget policy package is based on the assumption that trend output will not be changed.”⁶⁴

40. We asked Treasury officials what measures in the Budget would enhance the supply side and trend growth rate of the economy. Mr Ramsden replied:

This was something we thought about quite seriously [...] The reductions in the main rate of corporation tax over a sustained period will have potential implications for the supply side. The increase in VAT, moving VAT to 20%, will contribute to rebalancing the economy, and you see that indeed in the OBR’s forecast. Whilst the OBR’s assumption is that there is no impact, overall this is an assumption. I think this is an area that over the months ahead requires a lot more work from within the Treasury and with the OBR as they become more established to assess both the individual impacts of these measures and the overall impact on the UK economy.⁶⁵

The Chancellor told us that raising the growth trend rate was achieved by “trying to improve our education system, make our tax system competitive, make our regulatory system appropriate and so on. There are big structural reforms to the British economy which are required and which all parts of the Government are engaged in: educational reform, welfare reform and so on.”⁶⁶

41. We note the OBR’s assumption that the June Budget had no impact on trend output. We also note that the Budget did not set out a policy for improving trend growth. The Treasury recognises the need to do more work on assessing the impact of Budget measures on trend growth and we look forward to seeing it.

⁶³ Office for Budget Responsibility, *Pre-Budget forecast*, June 2010, p 12, para 3.9

⁶⁴ HM Treasury, *Budget 2010*, June 2010, p 96, para C.60

⁶⁵ Q 134

⁶⁶ Q 276

3 The Public Finances

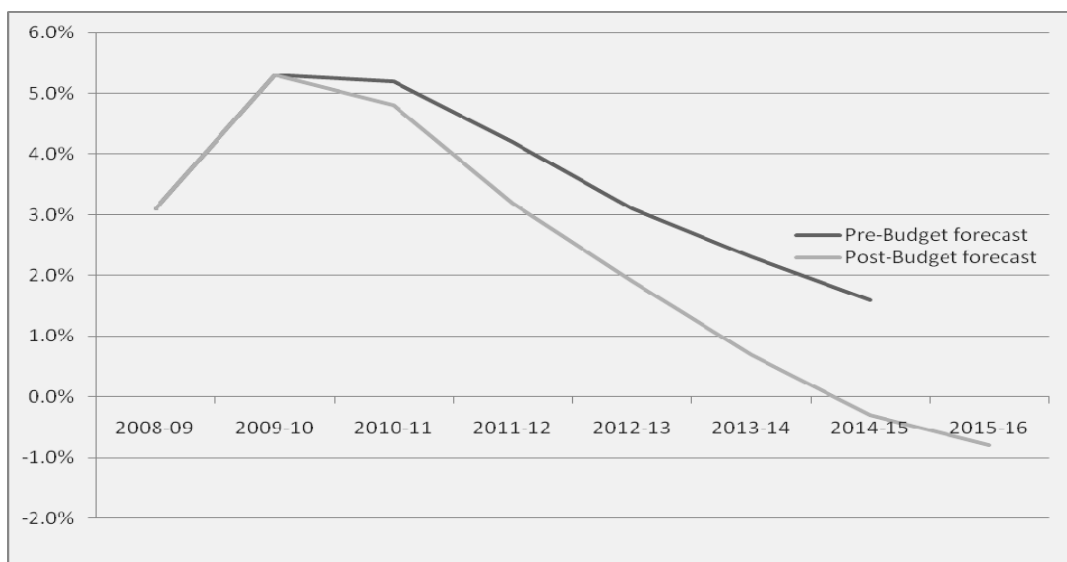
The structural deficit

42. In its pre-Budget forecast, based on the policies announced in the March Budget, the OBR estimated that the cyclically-adjusted deficit on current budget, or structural current deficit, would fall from 5.3% of GDP in 2009–10 to 1.6% of GDP in 2014–15. To accelerate the deficit reduction, the Chancellor announced a new set of measures in the June Budget, which would save £40bn a year when fully implemented by 2014–15. The measures included £32bn additional spending cuts, of which £11bn will come from welfare reform savings, and £8bn of net tax increase, with the proposed rise in VAT contributing an increase of £13.5bn in tax revenue.

43. The Chancellor also announced a new fiscal mandate and a plan to set a fixed target for debt. The mandate is forward-looking “to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period”.⁶⁷ This fiscal mandate will be supplemented by a “target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015–16,”⁶⁸ although the precise target has yet to be announced.

44. Taking the policies in the June Budget into account, the OBR estimated that the structural current deficit will be eliminated by 2014–15 (see Chart 1 below). The forecast is now for a cyclically adjusted surplus of 0.3% of GDP in 2014–15.⁶⁹ Using its central forecasts, the OBR also believes that there is a greater than 50% chance that the Government will achieve its fiscal mandate and target for debt.

Chart 1: Changes in OBR’s structural current deficit forecast after June Budget



Source: OBR, *Budget forecast*, p77, table C1 in *Budget June 2010*; OBR, *pre-Budget forecast*, p30, table 4.1

⁶⁷ HM Treasury, *Budget 2010*, June 2010, p 12

⁶⁸ HM Treasury, *Budget 2010*, June 2010, p 12

⁶⁹ HM Treasury, *Budget 2010*, June 2010, p 99, table C.10

45. We asked Mr Bootle whether the structural deficit could be eliminated over a slightly longer period, without a significant impact on market confidence in the UK. He stated that ‘the political process intervenes because what the Government wanted to do was to eliminate the structural deficit within a Parliament. In straightforward economic terms, I am not sure it would make a great deal of difference if the adjustment were over a longer period, but we have to face the political reality of when parliaments change’.⁷⁰

46. When asked the same question, the Chancellor admitted that there was political judgement in deciding the timeframe of eliminating the deficit, but stressed that having a credible plan to deal with the deficit was also important:

It is a political judgment about what is an economic necessity, I guess. The Governor of the Bank made it clear within days of my appointment that the most important thing now is for the new Government to deal with the challenge of the fiscal deficit. It was clear on arrival that no-one believed that Britain had a credible plan to deal with the Budget deficit. The G20 subsequently called for countries with serious fiscal challenges, and after all we have got the biggest budget deficit of the G20, to accelerate the pace of fiscal consolidation. The OECD in a report well worth reading yesterday said that the Budget was an essential starting point for future recovery. I think there is quite a lot of international support for the view that Britain did not have a credible plan and has introduced one.⁷¹

Spending cuts vs. tax increases

47. There has been a great deal of debate about the way to implement the fiscal tightening, in particular about the balance between cutting spending and increases taxes. In his Budget speech, the Chancellor stated that:

Our approach is supported by the international evidence, compiled by the Organisation for Economic Cooperation and Development, the International Monetary Fund and others, which found that consolidations delivered through lower spending are more effective at correcting deficits and boosting growth than consolidations delivered through tax increases. [...] This is the origin of our 80:20 rule of thumb—roughly 80 per cent through lower spending and 20 per cent through higher taxes.⁷²

48. We asked our expert witnesses whether they agreed that the majority of fiscal consolidation should come from spending cuts. Mr Bootle told us that:

I do not think it is possible to defend, as it were, precisely 80:20 or 75:25 on the basis of the evidence, but there is quite a lot of evidence from a range of fiscal consolidations in the past ranging across Canada in the 1990s, Sweden, Finland... to suggest that it is more likely that your fiscal consolidation could be accompanied by

⁷⁰ Q 116

⁷¹ Q 290

⁷² HC Deb, 22 June 2010, col 168

sustained economic growth and it is preponderantly done with regard to spending cuts rather than taxation [...] I think the evidence is pretty clear that in this country we have not been suffering from excessively low taxation and we perhaps have been suffering from excessively high public spending.⁷³

Mr Barrell was also unsure about the precise balance which would be desirable in current conditions:

It is quite clear that in the 1970s and 1980s and maybe even the early 1990s cutting spending was more effective than raising taxes because it involved more commitment. The recent research by the European Commission, who are very much spending-cutters rather than tax-risers, suggests that that balance of advantage has actually changed and that, although there may be some advantage to cutting spending, raising taxes with the right institutions in place, such as the Office for Budget Responsibility, might well be equally effective [...], so there is a decision to be made. Does the economic evidence support the 80:20? If you look at the last 50 years, yes. If you look at the last 15 years, less so [...] 80:20, there is some evidence for it, and 60:40, there is also some evidence for that.⁷⁴

The European Commission research he referred to stated that:

As regards the composition of successful fiscal consolidation, the EU experience confirms that cuts in current primary expenditure are more likely to produce a lasting effect than higher revenues or large cuts in government investment. However, the validity of this by now familiar notion is somewhat weakened for consolidations enacted since the beginning of the 1990s. The composition of adjustment per se seems to have lost some of its weight in securing the success.⁷⁵

49. There are precedents for successful fiscal consolidations which were focussed on spending cuts rather than raising taxes. We also note more recent work on the impacts of varying ratios of spending cuts to tax rises. We recommend the Treasury revisit recent literature. We understand that the 77:23 split will not be reached until the final year of the forecast period.

⁷³ Q 123 [Mr Bootle]

⁷⁴ Q 123 [Mr Barrell]

⁷⁵ European Commission, *Received wisdom and beyond: Lessons from fiscal consolidation in the EU* by Larch and Turrini, April 2008, p 4

Investors' demand for gilts

50. Market interest rates for the UK have fallen in the last few months. Yields on 10-year gilts are at 3.3%, compared to 4.0% at the time of the March Budget. More importantly, over the same period, UK yields have fallen by more than the German Bund, which is seen as a benchmark for AAA-rated countries. 10-year yield has fallen by 69 basis points since the March Budget, compared to the 55 basis points fall in the German Bund.⁷⁶

51. As noted above, the Chancellor considered UK policy had contributed to these changes:

It is striking, and I am sorry to repeat myself, that the interest rates for UK businesses are a full 1% lower than they are for Spanish businesses and that was not the case at the time of the March Budget. There is a stimulating effect that is driven by confidence that the UK is able to deal with its fiscal problems.⁷⁷

52. Market commentaries suggest that the fall in UK rates partly reflects investors' confidence in the measures announced in the June Budget. However several other factors, such as Quantitative Easing, the Eurozone crisis and even speculative activities could also have led to an increased demand for gilts. For example, the sovereign debt crisis in the Eurozone has led to a significant increase in interest rates in the region—in Spain, interest rates have gone up by 60 basis points since March.⁷⁸

53. Gilt yields have fallen in the last few months. This appears in part in response to the Budget. It must be borne in mind that other factors than the Budget may also affect the demand for gilts.

Credit Ratings Agencies

54. The role of credit rating agencies has come under increased scrutiny since the start of the financial crisis. Their poor record in predicting losses on structured products, and the potential conflicts of interest, when they receive payments from institutions whose products and debt they rate, led to concerns about their effectiveness in estimating the creditworthiness of investment products. Mr Ramsden told us:

Credit rating agencies tend overall to follow rather than lead the markets. In the vast majority of cases a rating agency action will reflect what the markets have already concluded [...] [where] rating agencies can be useful, along with international organisations, is in the surveillance that they provide on an economy.⁷⁹

⁷⁶ *Financial Times*, www.ft.com/marketsdata, accessed 19 July 2010

⁷⁷ Q 219

⁷⁸ *Financial Times*, www.ft.com/marketsdata, accessed 19 July 2010

⁷⁹ Q 169

55. We asked the Chancellor whether the measures announced in the June Budget were designed specifically to satisfy the rating agencies or the credit markets. He stressed that keeping market interest rates low was a priority:

What I am trying to do is make sure that British businesses and families can borrow at reasonable market rates and competitive market rates and obviously I want to finance the government debt. Those things are both made easier by keeping the country's AAA credit rating which, as we know, has been put under question. The good news is that two of the three credit rating agencies responded very positively to the Budget and the third wanted to see whether this Parliament had the stomach to actually implement the measures. Things are looking quite favourable.⁸⁰

56. The financial crisis has shown the credit rating agencies can be wildly wrong. Excessive reliance on credit rating agencies for an assessment of credit risk is now recognised as having been a mistake. We welcome the positive comments from the agencies following the June Budget, but also acknowledge the Chief Economic Adviser's recognition that agencies tend to follow rather than lead the markets.

⁸⁰ Q 267

4 Welfare

Measures announced in the June 2010 Budget

57. The June 2010 Budget contained a significant number of policy measures on tax, tax credits and benefits. In his Budget statement the Chancellor of the Exchequer stressed that “the explosion in welfare costs” had “contributed to the growing structural budget deficit in the middle part of this decade” and that total welfare spending had increased from £132 billion ten years ago to £192 billion today”. He said this represented “a real terms increase of a staggering 45 per cent”. The Chancellor went on to explain that his overriding goal was “to put the whole welfare system on a more sustainable and affordable footing”.⁸¹ In his Budget Statement the Chancellor said that “taken together, all these measures to control the costs of welfare will save the country £11 billion by 2014–15”.⁸²

58. Key changes proposed by the Chancellor on welfare spending included changing the basis for up-rating benefits and tax credits from the retail price index (RPI) to the consumer price index (CPI) from 2011–12.⁸³ The Chancellor said that this would save over £6 billion a year by the end of the Parliament.⁸⁴ He also outlined plans to:

- Abolish what he described as “the poorly-targeted” Health in Pregnancy Grant from April 2011;
- Restrict the Sure Start maternity grant to the first child only;
- Freeze the rates of child benefit for first and subsequent children for three years from April 2011;⁸⁵
- Introduce an objective medical assessment for Disability Living Allowance (DLA) for new and existing claimants;⁸⁶
- Change the benefit rules for lone parents whose youngest child is aged 5 or above who would now be eligible for Jobseekers Allowance rather than Income Support.⁸⁷

59. Freezing child benefit will save £1.8 billion in 2012–13, with savings rising to almost £2 billion by 2014–15. In his Budget Statement, the Chancellor said freezing child benefit was “a tough decision”, but said it struck “the right balance between keeping intact this popular universal benefit while ensuring that everyone, across the income scale, makes a contribution to helping our country reduce its debts”. Changes to Disability Living

⁸¹ HC Deb, 22 June 2010, col 172

⁸² HC Deb, 22 June 2010, col 174

⁸³ HM Treasury, *Budget 2010*, June 2010, p 47, para 2.32

⁸⁴ HC Deb, 22 June 2010, col 172

⁸⁵ HC Deb, 22 June 2010, col 173

⁸⁶ HC Deb, 22 June 2010, col 173

⁸⁷ HM Treasury, *Budget 2010*, June 2010, p 49, para 2.59

Allowance will begin producing cost savings in 2013–14 of £360 million, rising to £1.1 billion in 2014–15. The Chancellor said changes to the allowance were necessary because “three times as many people claim it [DLA] today than when it was introduced eighteen years ago” and that costs had “quadrupled in real terms to over £11 billion, making it one of the largest items of government spending”.⁸⁸

Housing Benefit reform

60. The Chancellor also outlined his determination to reform Housing Benefit, where spending had “risen from £14 billion ten years ago to £21 billion today”, which he said represented “close to a 50 per cent increase over and above inflation”. The Chancellor described the situation as one where “costs are completely out of control” and emphasised that the system of housing benefit was “in dire need for reform”.⁸⁹ Reform measures on Housing Benefit in the Budget included:

- Setting Local Housing Allowance (LHA) rates at the 30th percentile of local rents rather than the median as is presently the case;
- Capping the maximum Local Housing Allowance Rates for each property size from April 2011;
- Uprating LHA rates in line with the consumer price index from 2013–14;
- Reducing Housing benefit awards, from April 2013, to 90% of the initial award after twelve months for claimants receiving Jobseekers Allowance.

The Chancellor stated that this package of measures would reduce “the costs of the benefit by £1.8 billion a year by the end of the Parliament, or 7 per cent of the total budget”. He suggested that it would “also improve incentives to work”.⁹⁰

61. Our inquiry focussed on one particular Housing Benefit rule change—namely, the proposal to reduce Housing benefit awards, from April 2013, to 90% of the initial award after twelve months for claimants receiving Jobseekers Allowance. Citizens’ Advice told us that this seemed “a crude measure as it appears that it will apply even where the tenant is fully complying with their JSA requirements to actively seek work”. They felt that the cut would “fall hardest on those who face disadvantage in the labour market, such as people in poor health or with a disability who have failed the harsher medical tests for incapacity benefit and employment and support allowance, and have therefore been moved onto JSA”.⁹¹

⁸⁸ HC Deb, 22 June 2010, col 173; *Budget 2010*, June 2010, p 40–41, table 2.1

⁸⁹ HC Deb, 22 June 2010, col 174

⁹⁰ HC Deb, 22 June 2010, col 174; *Budget 2010*, June 2010, p 48, para 2.50–2.57

⁹¹ Citizens Advice Bureau, *Briefing: The Coalition Budget 2010: Key welfare changes and their impact on low income households*, July 2010

62. Edward Troup explained that the rationale behind the measure was “sharpening work incentives” and “creating greater incentives to get out and find a job”.⁹² When questioned as to whether the sanction would apply to those who had followed the JSA rules and had been looking for work, but unable to find a job, Mr Troup started talking about the cost of Housing Benefit rather than work incentives:

I think it goes to the wider question of what is the right package of support for those people who are out of work and how long should that support continue. It goes to the point that the cost of housing benefit has increased by 50% over the last 10 years and there is a need to impose some degree of control over it. I think it goes to the point that even at the end of these reforms, and we recognise that there are some quite difficult aspects of these reforms, we are still going to see in real terms housing benefit running at the same level that it was in 2008–09.⁹³

63. Mr Troup went on to acknowledge that there were “people who try extremely hard to find work and I do accept that individually there are some difficult cases”. However, he restated his belief that this measure would “improve work incentives” and “encourage people to get back to work”. The Chancellor when quizzed about the 10% reduction in housing benefit to JSA claimants who have been receiving JSA for more than one year referred to the 50% rise in the housing benefit budget to £21 billion before going on to say that the proposals would also “encourage people into work”.⁹⁴ The Treasury later provided us with more information on this measure, for which we are grateful.

64. The proposals to reduce Housing Benefit to JSA claimants after a year are designed both to sharpen work incentives and to cut the cost of Housing Benefit. These changes to JSA will require primary legislation. The information provided by the Treasury shows that up to 300,000 individuals may be affected by this measure. However, those scrutinising the legislation would be helped by fuller information, such as the extent to which the changes affect households with children, and a projection of the numbers expected to move into employment as a result of this measure, given the Treasury’s assertion that some claimants may not be fully considering certain vacancies when looking for work.

Tax credits

65. The Chancellor considered that “tackling spiralling welfare costs” also meant “addressing the bill for tax credits”. He highlighted the fact that spending on tax credits had increased from £18 billion in 2003 to £30 billion this year and pointed out that there were “over 150,000 families with incomes over £50,000 receiving tax credits”. The Chancellor described this situation as “unsustainable”.⁹⁵

⁹² Q 184

⁹³ Q 186

⁹⁴ Qq 299–303

⁹⁵ HC Deb, 22 June 2010, col 172

66. The Chancellor proposed:

- Reducing the second income threshold for the family element of the child tax credit from £50,000 to £40,000 from April 2011, whilst from April 2012 withdrawing the family element of the child tax credit;
- Raising the rate at which tax credits are reduced as income rises from 39% to 41% from 2011–12;
- Removing the baby element from the child tax credit from April 2011 and removing the 50 plus element from the working tax credit from April 2012;
- Reducing the level of in-year rises of income that will be disregarded from calculations of tax credit entitlement from £25,000 to £10,000 for two years from April 2011 with a further reduction to £5,000 from April 2012;
- Reducing the period for which a tax credit claim and certain changes of circumstances can be backdated from three months to one month;
- Reversing the supplement for each child aged one and two from April 2012, which was announced at the March 2010 Budget.

67. However, as well as making these changes, the Chancellor also announced that in April 2011, the child element of the child tax credit would increase by £150 above CPI indexation and in April 2012 would increase by £60 above indexation.⁹⁶ This represents a substantial rise in the payments made to qualifying households and will cost the Government approximately £1.8 billion in 2012–13, rising to almost £2 billion by 2014–15.⁹⁷

A progressive Budget?

68. There has been considerable public debate over whether the Budget is ‘progressive’ or ‘regressive’. The Government has argued that it has acted in a progressive way. In his conclusion to the Budget Statement, the Chancellor declared that his priority:

in putting together this Budget has been to make sure that the measures are fair. That all sections of society contribute, but that the richest pay more than the poorest. Not just in terms of cash, but as a proportion of income as well. That is far from straightforward when the deficit is this high and when the burden of reduction must rightly fall on government spending. Too often when countries undertake major consolidations of this kind, it is the poorest—those who had least to do with the cause of the economic misfortunes—who are hit hardest.⁹⁸

69. As well as the benefit changes detailed above, the Chancellor also announced a number of changes to the tax system, including:

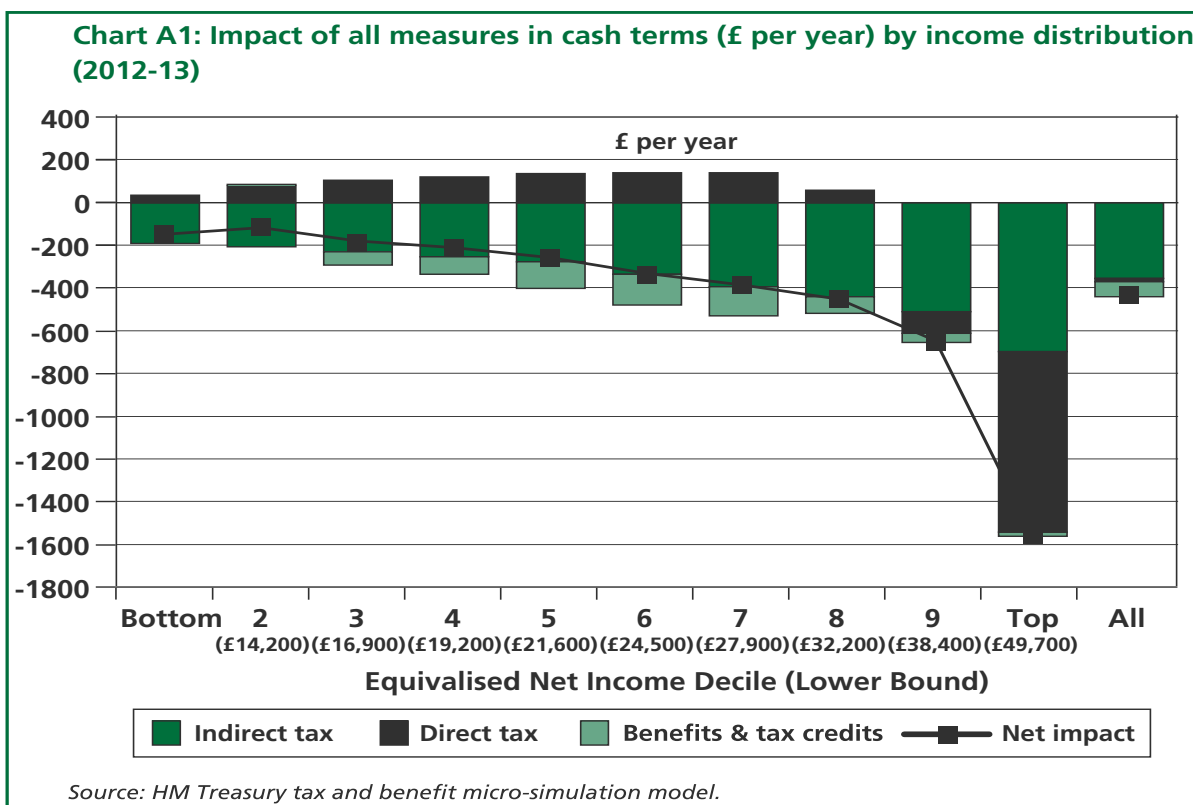
⁹⁶ HM Treasury, *Budget 2010*, June 2010, p 47–48, para 2.37–2.44

⁹⁷ HM Treasury, *Budget 2010*, June 2010, p 41, table 2.1

⁹⁸ HC Deb, 22 June 2010, col 180

- Increasing the personal allowance for under 65s by £1,000 to £7,475 in 2011–12, with a corresponding decrease in the levels at which the 40% higher rate of tax and the two per cent rate of NICs are paid, to ensure that the majority of higher rate taxpayers will pay the same total level of tax and National Insurance Contributions as previously planned.⁹⁹ This was estimated to cost £3.5 billion in 2011–12, rising to £3.9 billion in 2014–15;¹⁰⁰
- An increase in VAT from 17.5% to 20% from January 2011. This was estimated to raise £12.1 billion in 2011–12, rising to £13.5 billion by 2014–15.¹⁰¹

70. The Chancellor has argued that the Government’s policies taken as a whole mean “that all sections of society contribute, but that the richest pay more than the poorest”. This analysis is presented in charts A1 and A2 which were produced by the Treasury as part of the June 2010 Budget and which, as the Chancellor emphasised to us was “the first time any Chancellor has ever published a table like this”.¹⁰² These tables—which are a snapshot for the year 2012–13—demonstrate that the impact of all Budget measures (which includes measures announced in the previous Government’s March 2010 Budget and which the present Government intends to take forward as well as the policy proposals contained in the June 2010 Budget) result in the lowest income decile paying less than the top income decile, both in cash terms and as a percentage of net income.



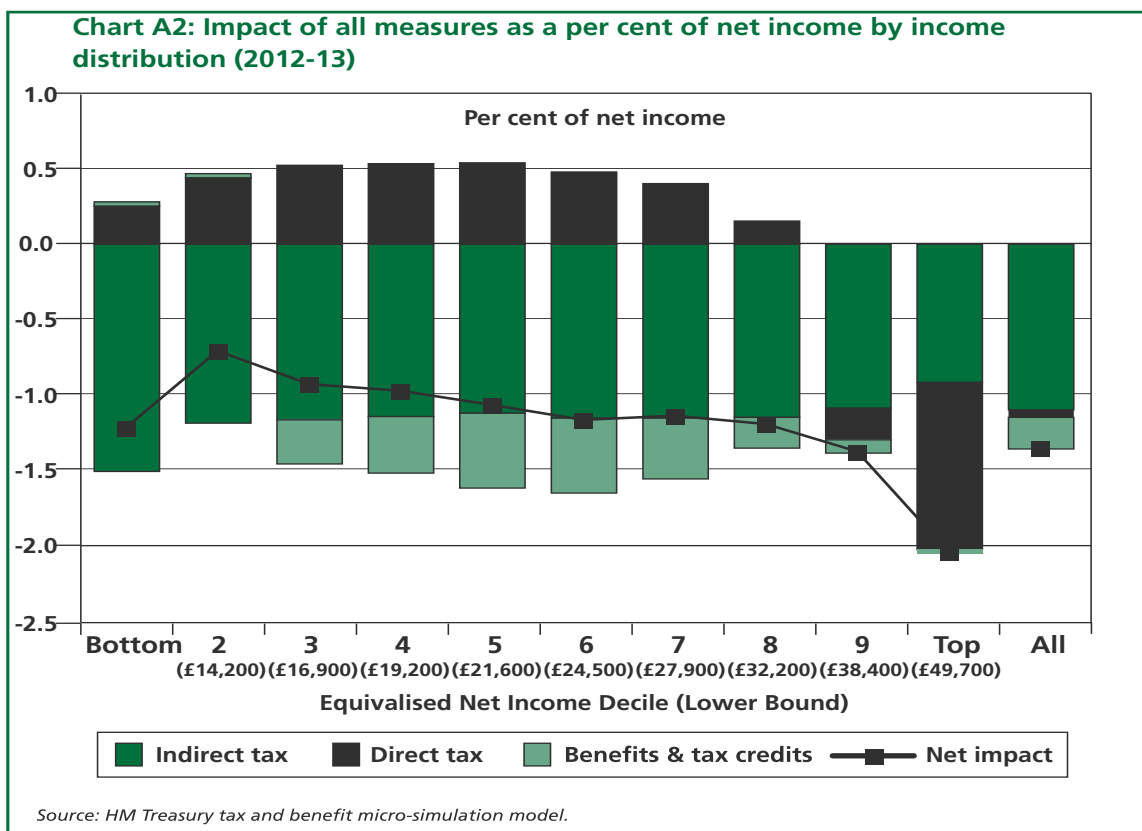
⁹⁹ HM Treasury, *Budget 2010*, June 2010, p 46, para 2.22

¹⁰⁰ HM Treasury, *Budget 2010*, June 2010, p 40, table 2.1

¹⁰¹ HM Treasury, *Budget 2010*, June 2010, p 40, table 2.1

¹⁰² Q 200

71. Although the Chancellor is right to claim that the Budget measures impacted more on those with the highest incomes than those on the lowest incomes, Chart A2 of the Red Book shows that as a percentage of income the poorest are worse affected than those in the middle of the income distribution. The Chancellor did not refute this claim, but responded by telling us that there was “inevitably a focus of public expenditure, like welfare spending towards lower deciles” which meant lower-income groups would be affected during a period of fiscal consolidation. He went on to say that the Government had attempted to “mitigate the impact of that by increasing, for example, the child tax credit”.¹⁰³ The Chancellor also made reference to his decision to increase the personal tax allowance by £1,000. He explained this would not benefit the lowest income decile because “these tend to be people who are not paying direct taxes”, but “that deciles two, three, four, five and so on would benefit from the income tax changes”.¹⁰⁴



72. The Chancellor went on to argue that the bottom income decile included “groups of people such as students who have irregular income patterns”, telling us that this meant “the figures for the bottom 10% are somewhat distorted”.¹⁰⁵ When questioned as to whether he was suggesting the figures were “dodgy” or “unreliable”, he replied:

No, I am just saying that in any income distribution in the bottom 10% there are always going to be categories of people who have low incomes but, for example,

¹⁰³ Q 200

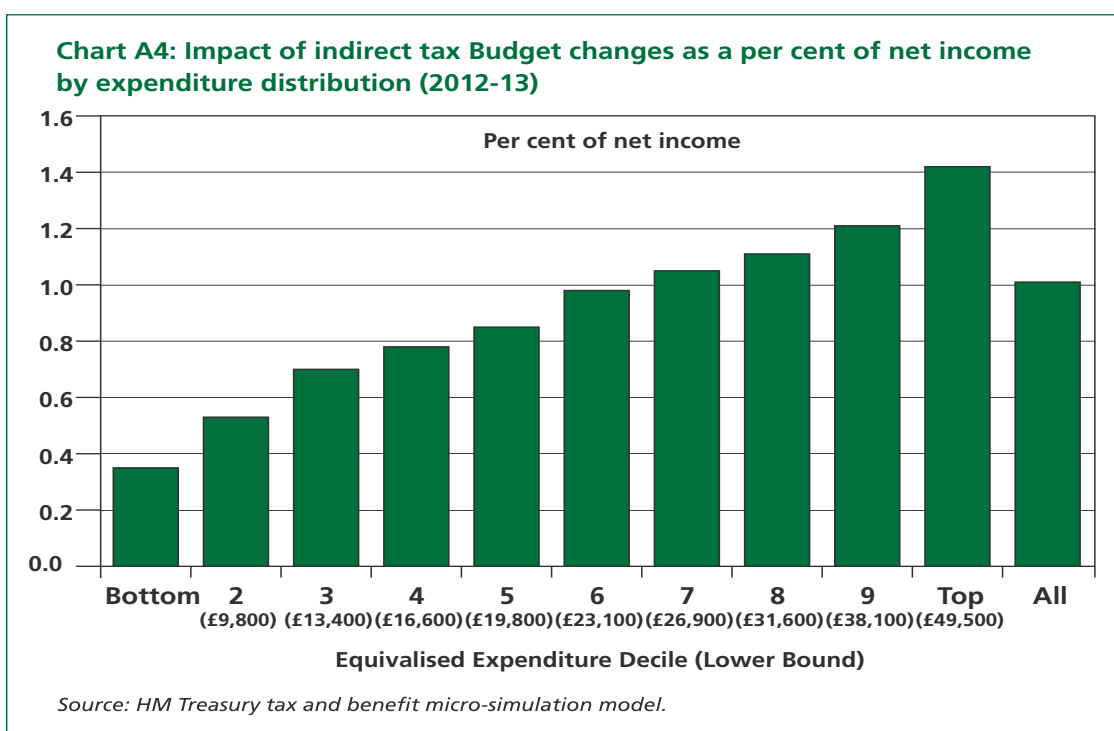
¹⁰⁴ Q 198

¹⁰⁵ Q 196

relatively high expenditure. That is why among the tables we produced we also produced the impact of the changes in indirect taxes on incomes as assessed by expenditure.¹⁰⁶

(The table to which the Chancellor referred is shown below in Chart A4). In subsequent analysis the Treasury told us “In the bottom decile 43 per cent of households contain an adult that is self-employed, unemployed or a student. While some of these households may have permanently low incomes many may not.” We note that the Treasury makes no attempt to disaggregate these three categories.

73. The Chancellor expanded on his statement later in the session, stating that if “you break the population up by expenditure distribution you can see that the impact of indirect taxes is very clearly progressive and the lowest decile pay the lowest”.¹⁰⁷



Policy measures not included within Treasury analysis

74. Charts A1 and A2 in the Red Book do not tell the whole story about the income distribution consequences of the Budget measures. Robert Chote told us that:

the Treasury does not take account, and neither would we in an analysis because it is very difficult to allocate them to specific households, of the impact of things like cuts to housing benefit, disability living allowance and the in-year changes to tax credits, all of which, you might assume, would hit the poorer half of households harder than the rich. On the other hand, the Treasury analysis does not include capital gains tax

¹⁰⁶ Q 197

¹⁰⁷ Q 199

changes, which you would expect to hit the rich harder than the poor, but those are relatively small.¹⁰⁸

This point was reiterated in briefing received from the Trades Union Congress (TUC) who said the model only included two-thirds of the benefits and tax credit changes proposed in the Budget. They listed some of the changes which were not included:

- Housing Benefit changes;
- Disability Living Allowance changes;
- increased lone parent conditionality;
- the abolition of the Health in Pregnancy Grant and the Sure Start Maternity Grant;
- the reduction in the tax credit income disregard.¹⁰⁹

75. The Chancellor acknowledged the charts excluded a number of measures, but argued that excluded items also included measures “that affect people right at the top of the income distribution”. The Chancellor went on to refer to the difficulties in modelling the impact on income of certain policy changes, justifying his approach on the grounds that it was “almost identical to the approach of the Institute of Fiscal Studies”.¹¹⁰ When pressed, the Chancellor agreed to a commitment to consider again whether it was possible to assess the impact of certain benefit changes, but stopped short of a full commitment on the grounds that he did “not want to commit to something which it may not be possible to do”.¹¹¹ In a subsequent note, the Treasury provided a fuller account of the difficulties, many of which appear to stem from lack of data as well as methodological difficulties.

Disaggregating the March 2010 and June 2010 Budgets

76. Mr Chote concurred that judged by the Chancellor’s yardstick the Budget was indeed progressive. However, he added a number of caveats to this statement, telling us that the Budget looked progressive when assessing whether the lowest income decile paid less than the highest income decile largely because of the reforms that had been announced by the previous Government in its March 2010 Budget rather than the specific measures announced in the June 2010 Budget.¹¹² When the Chancellor appeared before us, we asked him why he had not separated out the impact of the June 2010 Budget measures from the Budget measures announced by the previous Government. The Chancellor retorted that:

I have included things that I am going to ask the House of Commons to vote on, so I have not unreasonably made the assumption that as Chancellor the things I am going to ask the House of Commons to legislate on are the things that I am

¹⁰⁸ Q 90

¹⁰⁹ Trades Union Congress, Budget briefing: Social security and tax credits

¹¹⁰ Q 201

¹¹¹ Qq 202,203

¹¹² Q 90

responsible for and if you take those as a collective package it is progressive across the income distribution.¹¹³

Treasury analysis beyond 2012–13?

77. The Red Book provides a snapshot income distribution analysis for the year 2012–13. Robert Chote explained to us that the focus on 2012–13 made the Budget measures look more progressive because there were:

further changes, for example, on benefits that go beyond 2012–13 and you would expect those to hit poorer households proportionately more.¹¹⁴

The Chancellor was asked to justify why he had chosen 2012–13, rather than producing similar charts taking us through the whole of the forecast period. He replied that he would be delivering subsequent Budgets in 2011 and 2012 and that as a result “it would not be an accurate table going forward because it would not include potential subsequent announcements in subsequent Budgets.”¹¹⁵

78. Mr Chote concluded that based upon the three factors he had outlined—taking out the measures inherited from the previous Government, looking further into the future than 2012–13 and including some of the other measures which the Treasury had chosen not to model in their analysis of tax and welfare changes on households—the June 2010 Budget was “regressive”.¹¹⁶

79. There is also uncertainty about the extent to which the Comprehensive Spending Review will affect different groups. In his evidence to us the Chancellor told us that he “held open the door to finding further welfare savings as part of the spending review”;¹¹⁷ it is possible that there may be further changes announced this autumn.

80. We share the Chancellor's desire to make sure that the measures are fair, both in absolute terms, and as a proportion of income. Taken together the effects of the measures in the March and June Budgets ensure that the least well off are less affected than richest. We are concerned that, as shown in Chart A2 of the Red Book, the poorest fare slightly less well than middle income groups, as a result of the impact of all measures and when considered as a percentage of net income. We acknowledge though that the June Budget is only the first part of a wider range of measures and there may be changes as a result of the current review of poverty, the Comprehensive Spending Review and future Budgets.

81. Despite the limitations in the data they contain, the charts in Annex A of the Red Book, which show the distributional effects of the Budget measures, are an extremely

¹¹³ Q 205

¹¹⁴ Q 90

¹¹⁵ Qq 286, 287

¹¹⁶ Qq 90,91

¹¹⁷ Q 315

welcome innovation. We applaud the Chancellor for introducing them. We hope that in future years such charts will use a greater range of data, and provide a fuller picture of Budget effects, including the national and regional effects. We note that the Treasury has cited data problems as a reason for its inability to give a more complete analysis. We recommend that Government's data collection is improved to enable these sorts of analyses to be provided in future.¹¹⁸

82. It is likely that the Comprehensive Spending Review will also have different effects on different income groups. We recommend that the Treasury builds on the approach taken in the Budget to give information about the impact of CSR changes on different households. We would like the analysis for both the CSR and future Budgets to take two forms: a narrowly drawn set of figures based on those measures most easily modelled and a wider analysis, using more assumptions, which would allow a fuller set of measures to be included.

VAT rise

83. Our inquiry also touched upon some of the individual tax and benefit measures announced in the June 2010 Budget. The Government has said that VAT will increase from 17.5% to 20% on 4 January 2011.¹¹⁹ We asked our expert witnesses whether the VAT increase was a 'progressive' or a 'regressive' measure. Robert Chote told us that the key issue when assessing this question was whether you looked at the impact of a VAT rise on people "according to their living standards in a particular snapshot as measured by income or over a lifetime period". He explained that VAT looked particularly regressive when compared against income because "the poorest decile spend a relatively high amount relative to their income, you hit high spenders hardest and, therefore, not surprisingly that shows it to be regressive". Mr Chote explained that the alternative expenditure-based approach, dividing people up by the amount they spend, could be "a better indicator, a better proxy for their lifetime living standards". He gave examples of individuals to whom this applied such as people on relatively low incomes consuming past savings or people in self-employment whose incomes were volatile and "who may be at one end of the income distribution one year if you are doing the snapshot and a different point at the other".¹²⁰

84. Mr Chote stated that:

On balance, the consensus would be that total expenditure is probably a better guide to people's lifetime living standards and so that would give you a less regressive or a progressive pattern overall.¹²¹

However, Mr Chote was at pains to stress that the two alternative measurements he had outlined were "alternative views" and that there was "no right answer to this".

¹¹⁸ Ev 58

¹¹⁹ HC Deb, 22 June 2010, col 177

¹²⁰ Q 128

¹²¹ Q 128

5 Business

Industrial policy

85. The Chancellor told us that although the measures to cut the deficit had attracted most public attention, the Budget contained a number of measures designed to assist business:

For example, there is a reduction in the headline rate of corporation tax from 28 pence to 24 pence, a penny a year across the Parliament. There is a reduction in the small companies' tax rate that was set to increase under the plans I inherited and I am reducing it to 20 pence. There is an innovative proposal, which I freely admit has not been tried before by government but we hope it works and will see if it works, and that is to have regional National Insurance rebates for new businesses created in parts of the country outside the south-east and eastern area. There are a series of measures. Alongside those we are publishing a paper on credit conditions later this month. The Green Investment Bank is a very important tool for stimulating investment in a low carbon economy. My colleague, Jeremy Hunt, is looking at increasing the broadband capacity of the United Kingdom. There is a whole suite of policies designed to stimulate investment and send a sign that Britain is open for business.¹²²

86. We draw particular attention to the Chancellor's suggestion that this Government would not only be concerned about the balance between the public and the private sector, but would consider the structure of the wider economy and "be more aggressive about promoting certain parts of the economy and certain skills in the economy":

I think born out of the industrial failure of the 1970s came a view that we could be entirely neutral about the structure of the British economy [...] and now there is a recognition that we cannot be entirely neutral, that we want an economy that is based on more investment and exports and where we move up the value chain. [...] there are big sectors, like pharmaceuticals, aerospace, creative industries, which are really important for this country where we already have a comparative advantage, so we are not starting from scratch, which we should be seeking to promote without doling out large sums of money and getting back to some of those mistakes that were made in the past, but nevertheless taking the appropriate tax and regulatory changes that can help support those sectors.¹²³

We expect our colleagues on the Business, Innovation and Skills Committee will take the lead in assessing the effectiveness of the Government's tax and regulatory measures in supporting strategic industries.

¹²² Q 225

¹²³ Q 239

Credit availability

87. As we noted above witnesses were confident that businesses could fund significant investment from their own resources. Nonetheless in the June pre-Budget forecast the OBR itself identified credit availability as a risk to its forecast.¹²⁴ Mr Dicks assured us that the OBR had highlighted the risk credit availability posed:

both in the pre-Budget and the Budget forecasts. We think that these headwinds, the credit conditions headwinds, will ease slowly through time. The other point I made earlier was that internal finance provides a lot, if not most, of the cash for investment. The problems in the banking sector, as a central guess, would become smaller through time.¹²⁵

88. Mr Barrell, of NIESR, cautioned us though that “part of our problem in the run-up to the crisis is that we were borrowing too much. If we are borrowing too much, that means the banks are lending us too much, so perhaps we should hope to see an economy where banks lend rather less than they have been in the medium to long term.”¹²⁶ On lending to firms, he noted that they “do not report enormous problems with their borrowing and they do have internal resources, but we also have to recognise that this crisis has caused a reassessment of risk and, therefore, a reassessment of the equilibrium capital stock firms want, and they will want to invest less and that will mean they will want to borrow less”.¹²⁷ Mr Clarke also noted that this may be an issue, telling us that “I am a bit worried by the latest Bank of England Credit Conditions Survey which is showing that the availability of lending that lenders expect over the next three months is going down”.¹²⁸ Mr Clarke noted that smaller firms could be particularly affected by restrictive credit conditions: “If the bank levy means that banks try to minimise the size of their balance sheets, they may lend less and it is not the big firms that are going to suffer most, it is the SMEs, so that would be a concern at the back of my mind”.¹²⁹

89. Mr Bootle emphasised that he thought that “there is both a problem of the demand for bank finance and the supply of bank finance” but that “the OBR was surely right to stress that, on the whole, this is not a significant problem for large companies which have substantial internal resources”, due to their access to the bond markets and the equity markets. He thought the problems were “primarily about small- and medium-sized businesses which do not have that access and often do not have internal resources as well.” While he acknowledged Mr Barrell’s point that “[firms] might want to borrow less because the future does not look so good and they should not be wanting to borrow for investment,” he thought “The evidence is too plentiful to ignore, that the banks have tightened their terms extraordinarily and a lot of firms have felt this was very, very

¹²⁴ Office for Budget Responsibility, *Pre-Budget forecast*, June 2010, p 13, para 3.16

¹²⁵ Q 79

¹²⁶ Q 112

¹²⁷ Q 112

¹²⁸ Q 124

¹²⁹ Q 124

destabilising indeed and the reaction has been to say, ‘Well, we’re just going to have to minimise our dependence on the banks because you can’t trust them or depend on them.’¹³⁰

90. The Chancellor thought that there was a need to ensure greater bank lending, but cautioned that “I do not think there is a silver bullet. I do not think there is one thing we can do that is going to suddenly ease up credit conditions.”¹³¹ He went on to outline options that could be taken to support business lending, which the Government will report on in a forthcoming Green Paper on business finance:

First of all there are government schemes that can be expanded. In the Budget I expanded the Enterprise Finance Guarantee Scheme by £200 million that is targeted at small businesses who cannot get access to credit. Second, and I know the Select Committee is going to be looking more broadly at the structure of UK banking, we want to encourage more competition in the UK banking sector which was consolidated and has become a hell of a lot more consolidated as a result of the last two years. I welcome new entrants provided they are appropriate for a banking licence. I think we should be encouraging new entrants. [...] The final point I make is that the regulatory uncertainty at an international level about the kind of capital, liquidity and leverage requirements that the G20 and the Financial Stability Board are going to ask about is not helping matters[...]¹³²

91. The Committee recognises the problems faced by SMEs in raising credit. We will examine these issues as part of our future inquiries.

Bank Levy

92. In the June 2010 Budget the Government announced the introduction of a bank levy starting from 2011. The rationale for this levy is that “banks should make a fair contribution in respect of the potential risks they pose to the UK financial system and wider economy”.¹³³ The levy is also designed to encourage banks to move to less risky funding profiles, since tier 1 capital, insured retail deposits and sovereign repos will be excluded when calculating the levy base. When fully applied, the levy is intended to raise £2.5bn a year. Indeed, in his evidence, the Chancellor told us “we made it clear that we are targeting a revenue sum rather than a particular rate because we think that is an appropriate contribution that balances fairness with the competitiveness of the UK banking sector.”¹³⁴

¹³⁰ Q 112

¹³¹ Q 231

¹³² Q 231; HM Treasury, *Budget 2010*, June 2010, p 28, para 1.74

¹³³ HM Treasury, *Bank Levy: a consultation*, July 2010

¹³⁴ Q 272

93. The Chancellor believes that the bank levy is needed to reflect the implicit price the public has paid in supporting the banking system, and also the fairness to the rest of the society. He said:

The bank levy is designed to do two things. The first is to ensure there is a price paid for the implicit insurance that we all offer as taxpayers for the wholesale funding of banks, which became pretty explicit in the middle of the crisis [...] The other reason, to be absolutely frank, was for reasons of equity. Asking the general population to accept a VAT rise, asking them to accept that there were going to be changes to welfare eligibility and the like, doing these things is a difficult thing for any government to do but I thought it would be totally inappropriate not to ask the banking sector to make a contribution as well.¹³⁵

94. One unintended consequence of the levy is that it may affect banks' ability to lend to the wider economy. There are also concerns that in time banks may be faced with further levies on their business, at European or global level. The Chancellor assured us that proposals for a European Banking Stability Fund financed through direct contributions had not been agreed by Ecofin, but he acknowledged that if such measures were introduced, there could potentially be a conflict if the "prudential regulator here suggests lower capital ratios to encourage more credit into the system but the European Banking Stability Fund is insisting on higher contributions to take cognisance of risk and have two systems effectively working against each other."¹³⁶

95. However the Chancellor insisted that "the most effective tool" for encouraging bank lending "is the capital liquidity requirements. They have a much greater effect on a bank's ability to lend than, say, the bank levy does". Mr Bootle agreed that "the amounts are not huge ... [and that it is] more of a gesture". More importantly, he said, "it is the uncertainty in financial regulation reforms globally that leads to banks' nervousness, hence the hoarding of capital and refusal to lend."¹³⁷ Mr Whiting agreed:

There is, clearly, a lot of worry amongst the international banks that this levy will be matched by similar levies in other countries which then will not offset and it will all be cumulative. [...] There is also a worry that this is also adding to the amount of extra regulation that is on the banks. Also that it is setting a bad atmosphere and it is not giving them the confidence to do the extra lending to, as has been said, the small- and medium-sized sector which, in many ways, is the one that is most wanting finance.¹³⁸

96. The Government has announced a consultation on the bank levy, and we will take evidence on the effect of the bank levy and other proposed changes in the UK and international regulatory system as soon as possible.

¹³⁵ Q 270

¹³⁶ Q 273

¹³⁷ Q 113

¹³⁸ Q 113

Capital Gains Tax

97. One of the headline measures in the Budget was an increase in Capital Gains Tax (CGT) from 18% to 28% for higher and additional rate taxpayers, with an increase in the entrepreneur's relief lifetime limit to £5 million from £2 million.¹³⁹ In evidence, the Chancellor defended this decision with reference to revenue generation and fairness:

I faced a situation when I took office that the capital gains tax regime was being abused, that the 18% rate that I inherited was so much lower than income tax rates of 40% or 50% that a multitude of schemes had been created and were being created to shift income that there was a hole in the tax system that needed to be plugged. I also felt, as indeed did other members of the Government, for reasons of equity an 18% capital gains tax rate was quite difficult to justify when we were going to be asking from other parts of the population, other parts of the income distribution, for people to make a contribution to closing the deficit that it was appropriate to look to increase capital gains.¹⁴⁰

98. We questioned the Chancellor on the impact of this proposal on businesses and entrepreneurs. He argued:

The first point I make is that the entrepreneurial relief is a very considerable one, so it is only people who are going to be making more than £5 million of lifetime gains in creating a business who would face the 28% rate whereas, for example, someone selling a second home will now face the 28% rate. After all, it was 24% just a couple of years ago so I do not think there will be many people whose fundamental life planning would have been thrown entirely off course by this. I accept it is a tax increase and no one likes a tax increase.¹⁴¹

The Treasury has since written to us with more detail about the reasons for choosing the 28% rate and their rejection of indexation and taper relief schemes.¹⁴²

99. We questioned Treasury officials about the impact of the change in CGT rates on members of employee share ownership schemes. Mr Troup said that the Treasury had considered the position of such schemes when drawing up the proposals, including the fact that members of such schemes cannot choose when they realise their assets. However, they had concluded:

If we had settled on a 40% or 50% capital gains tax rate I think the point about employee share schemes would probably have been more of a factor. As it was, at 28% there was no need to make a specific exemption for employee share schemes.¹⁴³

¹³⁹ HM Treasury, *Budget 2010*, June 2010, p 3

¹⁴⁰ Q 227

¹⁴¹ Q 228

¹⁴² Ev 58

¹⁴³ Q 176

Mr Troup also indicated that including members of such schemes in the entrepreneurial relief:

would have made the definitions considerably more difficult and would also have given rise to a significant amount of forestalling because we would not have been able to introduce that straightaway.¹⁴⁴

100. The Chancellor also drew attention to existing tax advantages for members of such schemes, including the annual allowance of up to £10,100. He suggested that the doors to such schemes were “very much”¹⁴⁵ more open than they had been previously:

I am very willing - I would do this anyway off my own bat—if the mood of some Members of this Committee is to go away and look at this and perhaps come back with further thoughts on how to encourage employee share ownership schemes.¹⁴⁶

101. We recognise the Chancellor’s willingness to reconsider the effect of his proposals in encouraging existing and potential share ownership schemes. We look forward to hearing from him on this before next year’s Budget.

¹⁴⁴ Q 177

¹⁴⁵ Q 281

¹⁴⁶ Q 320

6 Conclusion

102. There is political and economic disagreement about what response to the economic crisis would be most prudent. Policymakers have to choose a response, knowing that any response will bring its own set of risks and uncertainties. The Chancellor has chosen a more radical set of Budget measures than his predecessor in tackling the deficit. This Report only begins to explore some of the risks and uncertainties that that has entailed. Some commentators have suggested that this Budget has raised the near-term risk of a period of negative growth; whether or not this is the case, the global economic situation is fluid and fragile, and it is possible that the Chancellor may need to alter his current plans to compensate for external events.

103. We asked the Chancellor whether there was a Plan B. He replied that:

The plan is to have confidence in the British economy and its ability to pay its way in the world. Of course, if you look at the fiscal mandate that I have set it is based on an assessment of the structural deficit to allow automatic stabilisers to operate. I have also built a degree of caution into the fiscal mandate by seeking to achieve it a year earlier. I was absolutely clear, and indeed this was the external advice I was receiving as well and the British public were receiving from the Governor of the Bank, that the first and most pressing issue to deal with was to produce a credible plan for the budget deficit. I would also draw the Committee's attention to the fact that the measures I announced are staggered over three or four years. I think people have assumed they all come into effect in July 2010 and of course they do not, the VAT rise is next year and some of the welfare measures take effect in 2012 and 2013, so it is also a plan not just for this year but a plan for this Parliament.¹⁴⁷

104. As the Chancellor has noted, the fiscal tightening is staggered over several years. In addition, should the economic forecast of the OBR prove to be optimistic, the fiscal mandate is set so as to allow the automatic stabilisers to operate. We hope that this will be sufficient. However, some of the tax and benefit changes adopted to tackle the structural deficit may reduce the force of the automatic stabilisers. **The Chancellor told us that he had built a degree of caution into the fiscal mandate by seeking to achieve it a year early. We welcome this as a signal that if economic conditions demand it he may be prepared to take measures to stimulate the economy, even if these delay the current plans for cutting the deficit.**

¹⁴⁷ Q 221

Conclusions and recommendations

1. This is the central and most difficult decision any Chancellor has to take. We have not attempted to challenge the Chancellor's judgement on the Budget as a whole. There are risks on either side of the Budget judgement. The Chancellor has chosen a somewhat more radical path than his predecessor. Furthermore, he has been explicit that his aim is not only to reduce debt, but to rebalance the economy away from the public and toward the private sector. In this Report, we examine some of the risks and uncertainties in this approach. We expect that the consequences of the Chancellor's decision will be the subject of many of our future inquiries. (Paragraph 8)

Macroeconomy

2. Although there are problems in comparing the OBR's two forecasts, it appears that there has been a slight increase in the chance of near-term negative growth and an increased likelihood of positive growth in the outer years. We will continue to monitor the macroeconomic environment, through our regular hearings with the Bank of England and the Office for Budget Responsibility. (Paragraph 15)
3. We note that despite a significant sterling devaluation, net trade is currently not expected to contribute positively to GDP growth in 2010. The OBR forecasts a significant increase on the path of net trade but there are differences about the speed of change. (Paragraph 23)
4. It is unfortunate that the independence of the OBR has been called into question. This makes it all the more important to get the structure and the statutory basis of the permanent organisation right, as the both the OBR and Chancellor recognise. We will consider in our inquiry into the OBR what further steps need to be taken to ensure its independence. (Paragraph 28)
5. The OBR's publication of forecasts for employment is new and welcome. We note the forecast of both considerable public sector job losses, and strong private sector hiring. This forecast depends on the assumptions in the wider forecasts, and is subject to the same risks. We will continue to monitor the impact of reforms on the labour market. (Paragraph 31)
6. The economic recovery in the OBR forecast will depend, in part, on supportive monetary policy. However, in the short term, Budget measures such as the VAT increase will affect inflation. We look forward to discussing this in more detail with the Monetary Policy Committee very soon. (Paragraph 37)
7. We note the OBR's assumption that the June Budget had no impact on trend output. We also note that the Budget did not set out a policy for improving trend growth. The Treasury recognises the need to do more work on assessing the impact of Budget measures on trend growth and we look forward to seeing it. (Paragraph 41)
8. There are precedents for successful fiscal consolidations which were focussed on spending cuts rather than raising taxes. We also note more recent work on the

impacts of varying ratios of spending cuts to tax rises. We recommend the Treasury revisit recent literature. We understand that the 77:23 split will not be reached until the final year of the forecast period. (Paragraph 49)

9. Gilt yields have fallen in the last few months. This appears in part in response to the Budget. It must be borne in mind that other factors than the Budget may also affect the demand for gilts. (Paragraph 53)
10. The financial crisis has shown the credit rating agencies can be wildly wrong. Excessive reliance on credit rating agencies for an assessment of credit risk is now recognised as having been a mistake. We welcome the positive comments from the agencies following the June Budget, but also acknowledge the Chief Economic Adviser's recognition that agencies tend to follow rather than lead the markets. (Paragraph 56)

Welfare

11. The proposals to reduce Housing Benefit to JSA claimants after a year are designed both to sharpen work incentives and to cut the cost of Housing Benefit. These changes to JSA will require primary legislation. The information provided by the Treasury shows that up to 300,000 individuals may be affected by this measure. However, those scrutinising the legislation would be helped by fuller information, such as the extent to which the changes affect households with children, and a projection of the numbers expected to move into employment as a result of this measure, given the Treasury's assertion that some claimants may not be fully considering certain vacancies when looking for work. (Paragraph 64)
12. We share the Chancellor's desire to make sure that the measures are fair, both in absolute terms, and as a proportion of income. Taken together the effects of the measures in the March and June Budgets ensure that the least well off are less affected than richest. We are concerned that, as shown in Chart A2 of the Red Book, the poorest fare slightly less well than middle income groups, as a result of the impact of all measures and when considered as a percentage of net income. We acknowledge though that the June Budget is only the first part of a wider range of measures and there may be changes as a result of the current review of poverty, the Comprehensive Spending Review and future Budgets. (Paragraph 80)
13. Despite the limitations in the data they contain, the charts in Annex A of the Red Book, which show the distributional effects of the Budget measures, are an extremely welcome innovation. We applaud the Chancellor for introducing them. We hope that in future years such charts will use a greater range of data, and provide a fuller picture of Budget effects, including the national and regional effects. We note that the Treasury has cited data problems as a reason for its inability to give a more complete analysis. We recommend that Government's data collection is improved to enable these sorts of analyses to be provided in future. (Paragraph 81)
14. It is likely that the Comprehensive Spending Review will also have different effects on different income groups. We recommend that the Treasury builds on the approach taken in the Budget to give information about the impact of CSR changes

on different households. We would like the analysis for both the CSR and future Budgets to take two forms: a narrowly drawn set of figures based on those measures most easily modelled and a wider analysis, using more assumptions, which would allow a fuller set of measures to be included. (Paragraph 82)

Business

15. The Committee recognises the problems faced by SMEs in raising credit. We will examine these issues as part of our future inquiries. (Paragraph 91)
16. The Government has announced a consultation on the bank levy, and we will take evidence on the effect of the bank levy and other proposed changes in the UK and international regulatory system as soon as possible. (Paragraph 96)
17. We recognise the Chancellor's willingness to reconsider the effect of his proposals in encouraging existing and potential share ownership schemes. We look forward to hearing from him on this before next year's Budget. (Paragraph 101)

Conclusion

18. The Chancellor told us that he had built a degree of caution into the fiscal mandate by seeking to achieve it a year early. We welcome this as a signal that if economic conditions demand it he may be prepared to take measures to stimulate the economy, even if these delay the current plans for cutting the deficit. (Paragraph 104)

Formal Minutes

Tuesday 20 July 2010

Members present:

Mr Andrew Tyrie, in the Chair

John Cryer	Jesse Norman
Michael Fallon	David Rutley
Mark Garnier	Mr Andrew Love
Stewart Hosie	John Thurso
Andrea Leadsom	Mr Chuka Umunna

Draft Report (*June 2010 Budget*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 104 read and agreed to.

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

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

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

Papers were ordered to be reported to the House for placing in the Library and Parliamentary Archives.

[Adjourned till Thursday 22 July at 9.30 am

Witnesses

Tuesday 13 July 2010

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Sir Alan Budd, Chairman, **Mr Geoffrey Dicks**, Member, **Mr Graham Parker** CBE, Member, Office for Budget Responsibility Ev 1

Mr Roger Bootle, Managing Director, Capital Economics, **Mr Robert Chote**, Director, Institute for Fiscal Studies, **Mr Ray Barrell**, Director of Macroeconomic Research and Forecasting, National Institute of Economic and Social Research, **Mr John Whiting**, Tax Policy Director, Chartered Institute of Taxation, and Member, Low Incomes Tax Reform Group, **Mr Alan Clarke**, Economist, BNP Paribas Ev 11

Mr Dave Ramsden, Chief Economic Adviser, **Mr Andrew Hudson**, Managing Director, Public Services Growth, and **Mr Edward Troup**, Managing Director, Budget, Tax and Welfare, HM Treasury Ev 20

Thursday 15 July 2010

Rt Hon George Osborne MP, Chancellor of the Exchequer, **Sir Nicholas Macpherson**, Permanent Secretary and **Mr Mark Bowman**, Director, Budget and Tax, HM Treasury Ev 29

List of written evidence

1	National Institute of Economic and Social Research	Ev 47
2	Professor David Blanchflower	Ev 48
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Oral evidence

Taken before the Treasury Committee on Tuesday 13 July 2010

Members present

Mr Andrew Tyrie, in the Chair

Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love

John Mann
Jesse Norman
David Rutley
John Thurso
Mr Chuka Umunna

Witnesses: **Sir Alan Budd**, Chairman, **Mr Geoffrey Dicks**, Member and **Mr Graham Parker**, Member, Office of Budget Responsibility, gave evidence.

Q1 Chair: Sir Alan, welcome to this the first hearing of the Treasury Select Committee, and the first Treasury Select Committee ever to be elected. It is a particular welcome because we have before us a new institution. You have very kindly agreed to give us two lots of evidence, and we are looking forward to seeing you next week to discuss the structure of the OBR and its statutory basis, and your thoughts on that. Today we are going to concentrate on the forecast. I gather that you have some opening remarks you would like to put on to the record. I have to say, on the whole, the Committee rather deprecates opening remarks, except where they are essential, on market sensitive grounds. I do not think this fits that bill, but in this case, having come briefly and now going quickly, I think we should allow you these opening remarks.

Sir Alan Budd: That is extremely good of you, Chairman, and I do appreciate your indulgence in this regard. May I introduce Geoffrey Dicks, on my right, and Graham Parker, on my left. It is a great honour to have been invited to appear before you. As you have said, we are your first victims, so that is a particular privilege, and we hope the fact that you are seeing us first symbolises the importance that you attach to the OBR and its work. We were pleased by the domestic and international response to the establishment of the OBR and welcome this opportunity to give evidence about it. We are proud of the fact that starting from scratch and with the essential help of the Treasury, HMRC and the Department for Work and Pensions, we did produce in a matter of weeks a fully documented pre-Budget forecast and then a Budget forecast. Apart from the remarkable fact that the Chancellor bound himself to accept our forecasts without any interference, there was also a significant move to greater transparency. The forecasts contained more detail than had ever been the case before, including forecasts of wages and salaries, profits, average earnings, ILO unemployment and ILO employment, and a number of variables specifically related to the public finances. That was certainly a first, and we hope you will welcome that as an aid to scrutiny of the forecasts, particularly by this Committee. We have also sent you, Chairman, our

terms of reference—the terms agreed with the Chancellor—in the hope that this will provide a guide to the areas on which we are able to comment. We have also, as you know, published our advice to the Chancellor on the permanent OBR, though I assume, as you say, that you will want to leave detailed discussion of that to a later meeting. As we say in our covering letter, we have not been prescriptive on all the questions since we do not want to pre-empt your Committee's views on them. More importantly, perhaps, you have also received a note on the forecasts of general government employment, and I am sorry that it has only just reached the Committee. We are publishing it on our website at 9.30. I realise it will take time for the Committee to absorb but, in brief, it suggests that modelling changes between the pre-Budget and Budget forecasts raised the forecast of general government employment by about 140,000 (these were modelling changes) and an approximate—and it must be approximate—measure of the net effect of the Budget measures on general government employment was to reduce it by 160,000. In the course of the forecasting round, as we explain in the note, there was a change in the way that average employment costs for general government employees were predicted. Given the forecasts for total general government pay costs within departmental expenditure limits, the consequences for the path of employment followed automatically. As we promised in our pre-Budget forecast, we have, as far as possible, met requests for further background information. That was why we published our forecasts of general government employment, in response to a request. We did not publish it as part of our initial forecasts because, despite its obvious interest, it is not a key determinant of our economic and fiscal forecasts. The decision to bring forward publication by one day was completely ours. We did it because a Treasury document with misleading numbers had been leaked and was giving rise to misinformed comment. Given our concern with transparency, we thought it correct to release the numbers which correctly represented the OBR's forecasts. The numbers we released on 30 June were not an

13 July 2010 Sir Alan Budd, Mr Geoffrey Dicks and Mr Graham Parker

appropriate basis for attempting to estimate the effects of the June Budget on general government employment; they simply showed the forecasts. The release pointed out that there were modelling changes which affected the Budget numbers. In retrospect, I wish that we had provided more information and a specific warning against using the numbers to estimate Budget effects. There was no conspiracy or pressure on us to change the numbers and no pressure on us to bring forward publication. That is all I want to say, at this stage. Perhaps I could conclude by saying that we shall practise a division of labour in which Geoffrey Dicks will mainly answer questions about the economy forecasts and Graham Parker will mainly answer questions about the fiscal forecasts. Thank you very much.

Q2 Chair: Thank you, Sir Alan. Could you answer a few questions straightaway on these employment numbers? When you decided to put out a corrective statement (the statement that came out on 30 June), how did you come to take that decision? Did you take it personally? Did you take it on the basis of advice?

Sir Alan Budd: Yes. We published the numbers that were due to be published the following day. We published them in the form in which they would have been published on the following day.

Q3 Chair: So they were already fully prepared?

Sir Alan Budd: Yes, and a whole lot of other numbers, the publication of those, was also brought forward by a day. So there was a pack of numbers due to be released on the Thursday and we released them on the Wednesday. The question of whether or not to bring forward the publication was discussed with my colleagues, and we agreed that this was the correct thing to do. It was our decision, and taken for the reasons that I have given.

Q4 Chair: Why did you release them at five-to-twelve on Wednesday?

Sir Alan Budd: I believe that they were released at 11am. That is the information that I have—that they were released at 11 o'clock.

Q5 Chair: You are putting out material today at 9.30 am.

Sir Alan Budd: Yes.

Q6 Chair: Which seems a reasonable and sensible time for material already prepared. Why did you pick on 11 for these OBR figures? Incidentally, those who keep an eye on these things said they were first available on your website at five-to-twelve.

Sir Alan Budd: I am sorry if that is true. That must be checked. We have not yet quite decided our full procedures for releasing numbers or the time at which it should occur. This is a matter still for discussion, though I think frequently the time of 11 am will be chosen, but that is a matter of policy. The reason they were not released until 11 is as follows: I normally arrive in the office very early in the morning, and sometimes have to ring the bell on the front of the building in order to be allowed in.

However, on that particular morning, for personal reasons, I was unable to reach the office until about half-past 10 in the morning. Since the decision could not be taken until I arrived, that was why the decision was taken at that moment, and then the numbers was released as soon after that as could be reasonably done. Again, there was nothing sinister about the time; it was probably the only time while I have been working for the OBR that I was not there very early in the morning.

Q7 Chair: Did you think there would be a huge fracas about the fact this was being released minutes—perhaps 60, perhaps five—before Prime Minister's Questions?

Sir Alan Budd: I did not notice and did not realise. I was, of course, quite taken aback by the response that our action received. It is always difficult to remember what one remembered or knew at a time. In taking our decision it was not at all part of my decision—or our decision—that there was Prime Ministers' Questions that day.

Q8 Chair: Was there any contact between your Office and the Prime Minister's Office with respect to these numbers prior to their publication?

Sir Alan Budd: As far as the Prime Minister's Office is concerned, I am not sure. We do have the practice, rather like the ONS, of releasing within the Treasury numbers that are going to be put out by us, so that they have prior warning of that. Those numbers had been circulated in the Treasury—I believe they were circulated—on the previous Friday.

Q9 Chair: So the Government had these figures from the previous Friday but they were made available to the press sometime between 11 and 12 on Wednesday?

Sir Alan Budd: Yes, yes.

Q10 Chair: I am sure you can understand the sensitivity now, retrospectively, of the decision you took, and I am sure you understand that this has led many to query the independence of the OBR.

Sir Alan Budd: Yes, of course, that consequence I most sincerely regret, and I have spent a great deal of the time subsequently trying to work out whether this was a mistake. One makes mistakes all the time. I still believe that it was the correct thing to do to release those numbers in response to the leaked document.

Q11 Chair: If these documents had already been prepared and are ready to go, why was it not until 1.50 that they were deposited, as you are normally required to do, with the House of Commons Library?

Sir Alan Budd: It is difficult for me to answer that precise question, Chairman, but, again, I think we would have followed the normal procedures. If there was some delay I would have to investigate why that was the case.

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Q12 Chair: So that was an exceptional circumstance for which you have no explanation. Have you looked carefully into the timing of the publication of these documents?

Sir Alan Budd: I thought I had satisfied myself that they were published at 11 am. So I am surprised by the comment that you have made.

Q13 Chair: That they did not arrive there until 1.50?

Sir Alan Budd: The question I have not specifically answered when they were deposited in the House of Commons Library, and I honestly do not know the answer to that question.

Q14 Chair: You do understand, though, Sir Alan, do you not, that this has done quite a bit of damage to the early reputation of the OBR?

Sir Alan Budd: And, as I have said, I regret that enormously, Chairman.

Q15 Mr Umunna: Just a follow-up, actually. When did you first become aware of *The Guardian* article where these leaked Treasury figures appeared?

Sir Alan Budd: I think I can tell you almost precisely: at 9am on that morning.

Q16 Mr Umunna: Just for the record, did anyone connected to the office of the Chancellor and/or the Prime Minister suggest, in light of that leak, that it might be wise to put forward and publish the OBR employment forecasts?

Sir Alan Budd: Not as far as I am concerned, and they certainly did not make that suggestion to me.

Q17 Mr Umunna: So the decision to release your forecasts that day was a unilateral one, made by you alone?

Sir Alan Budd: By the three of us, yes.

Q18 Mr Umunna: By the three of you. Did you not think that it might be wise, given that you knew that your forecasts were going to be circulated within the Treasury, to, perhaps, as a courtesy, notify the Opposition Treasury team and/or the Leader of the Opposition's office, given there was going to be Prime Minister's Questions later that day?

Sir Alan Budd: I am not sure that that would be the normal practice with any release. What was important to us is that they would be released to everybody at the same time, and I had assumed that that was 11 am on that day.

Q19 Mr Umunna: Would you say that simply posting something on a website without really giving proper notice to the media and other interested parties counts as a proper release of information?

Sir Alan Budd: I think we have a process, which we are still developing, for release, and I think the normal process would be that we would release it at a pre-announced time—normally, it is a pre-announced time—on our website.

Q20 Mr Umunna: Was it released by people within your secretariat, or was it released by people in the Treasury?

Sir Alan Budd: It was released by people within my secretariat. We are responsible for the content of our website.

Q21 Michael Fallon: Just to clear this up, in relation to your reference to “pressure”, no Minister asked you to accelerate the publication of this material?

Sir Alan Budd: No.

Q22 Michael Fallon: Could you also just clear up the question of your own departure? When did the Chancellor first know that you were going to leave?

Sir Alan Budd: Yes. It is hard for me to know what the Chancellor knew when, but it has always been completely clear—I made it completely clear—to the Chancellor that I had only taken on this job for the emergency Budget and for any work associated with it, including of course appearing before this Committee. The Chancellor knew that I had a three-month contract as did my colleagues, and the only matter that was not known was precisely when I would leave the job, and that was not known because it had not been decided. I have now agreed with the Permanent Secretary to the Treasury that I shall leave the job when my contract ends on 13 August.

Q23 Michael Fallon: The Chancellor always knew it was a three-month contract?

Sir Alan Budd: Yes.

Q24 Michael Fallon: Can we turn to your growth forecasts on page 80 of the Budget? Why is the OBR so confident that we can or will avoid a double-dip recession?

Sir Alan Budd: Can I, at this stage, use my—

Q25 Michael Fallon: May I have your answer first?

Sir Alan Budd: Okay. You have used the expression “so confident”. No forecaster is ever so confident about anything, and that is why we have provided the fan charts to illustrate the uncertainty about our central forecasts. As we say, for example, if we look at the forecast for next year, there is only a 40% chance that the outcome will lie 1% either side of our central forecast. So this is a matter of extreme uncertainty, and the possibilities certainly include a double-dip recession. They also include a stronger recovery. So we have done our best to provide our central forecast, given the information and judgments that have been made, but we are not more confident than the fan charts suggest we should be.

Q26 Michael Fallon: Let me ask Geoffrey Dicks then: has anything happened since the Budget that would make you revisit that forecast?

Mr Dicks: I would not have said so. Most of the numbers that are coming out have been in line with the numbers we were looking for. The point we were really trying to emphasise is that all of forecasting is extremely uncertain. These are innovations, these fan charts that we have for GDP and public sector net borrowing. As Sir Alan has said, the range of uncertainty, as you can see from that chart on page 80, is really quite large.

Q27 Michael Fallon: In your view, does the Budget make the possibility of a double-dip recession more or less likely?

Mr Dicks: When you say “a double-dip recession”, is this a sort of two quarters of negative growth—the standard definition of a recession? It is always possible under any scenario to have a couple of quarters where output slips back, but it is not a part of our central forecast; it is not something we are looking for.

Q28 Michael Fallon: I understand it is a possibility. What I want to know is whether you think the Budget made it more likely or less likely.

Mr Dicks: You have seen the revisions we have made to our forecasts as a result of the Budget. We discourage, you will see in the Red Book, from making these direct comparisons but there are some Budget measures which will have reduced demand and, in aggregate, between our pre-Budget and post-Budget forecasts, we have taken 0.5% off GDP. So the near-term outlook for GDP is not as good as it was before the Budget. I still do not think that will mean a double-dip, but logically the chances of that happening have increased.

Q29 Chair: Sir Alan, a moment ago, in answer to questions about your departure, a couple of other points briefly crossed my mind. What are you going on to do?

Sir Alan Budd: My main ambition is to return to the semi-retirement from which I emerged in order to take on this job.

Q30 Chair: What remunerated employment?

Sir Alan Budd: Remunerated employment. As the press release which accompanied the original launch of the OBR stated, I do have three part-time consultancies. I have suspended those while I have been Chairman of the OBR, and I shall, in due course, return to them at a date still to be agreed with those three organisations.

Q31 Chair: You would agree, would you not, that you have had access to a great deal of market-sensitive information in the course of your brief spell as the first Chairman of the OBR? Do you think that in principle there should be an interval between resuming those jobs and your departure from the OBR?

Sir Alan Budd: Certainly the propriety of my conduct is supremely important to me. I think, at the moment, I have no access to market-sensitive information at all, because everything I did know came out with the Budget, but I shall take steps to ensure that any risk of this is avoided or, if it happens, it extends the period between my being involved with the OBR and restarting my employment.

Q32 Chair: With that in mind, do you think it might help avoid any impression of impropriety and bolster public confidence if you referred yourself to the Advisory Committee on Business

Appointments, chaired by Lord Laing, even though under the terms of your contract I understand you are not required to do so?

Sir Alan Budd: That is the first time that has been suggested to me, so it will take me time—

Q33 Chair: I am surprised by that.

Sir Alan Budd: I discussed this matter with the Permanent Secretary to the Treasury, and I think we had reached an agreement that the principles surrounding my departure and re-employment were perfectly fair and honest.

Q34 Mr Umunna: When you were appointed why was it not mentioned that you were going to be in position for three months? I will tell you why I ask this: if you look at the announcements that were made when you were appointed, the impression is very much given that you were going to be in position for some time. In his lecture on 24 February the Chancellor said, in reference to what you may do in-post, that whether he thanks you in a couple of years' time is another matter, but that is the whole point of your appointment. Actually, in the press notice that was released when it was formally announced that the OBR was going to be established, you said: “It is quite remarkable that the Chancellor has given us the authority to produce independent forecasts for the Budget and the Pre-Budget Report, and to provide a public assessment of the action needed to achieve his fiscal mandate. I consider it the most exciting challenge of my professional life.” So the impression given by those comments is certainly that you were going to be in position through to the autumn. I have actually looked at your consultancy agreement, and it does have provision in there that allows for the extension of your term. Could you, perhaps, just expand, for our benefit, on the reasons why you decided to leave, and perhaps clear up any speculation there may be that it has anything to do with there being a big disagreement between yourself and the Chancellor?

Sir Alan Budd: Yes, certainly. I think the comments that other people have made you must ask them about why they made them. You have reasonably referred to my own comments, and I think that on the day on which that announcement was made our contracts were available to anybody who wished to see them, and it was certainly no intention of mine to mislead anybody about the time which I would spend on the job. As I say, what I was not clear about was how long it would take to perform the tasks which were allocated to the interim OBR. Although this does not answer your question, there is not a single person who knows me who was not aware that I was only doing this for the emergency Budget. I regret that there has been a misunderstanding of this matter.

Q35 Mr Umunna: So you did not intend to be in-situ for the Pre-Budget Report later this year?

Sir Alan Budd: No. (Conferred with Mr Dicks) Mr Dicks has made a helpful comment to me, because of the way in which various comments are made and

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maybe a quote from me would explain this. We refer to the pre-Budget forecast. That was the first forecast we produced. That was the pre-Budget forecast. There is, of course, an exercise carried out by the previous government called the Pre-Budget Report which is normally in November. I was not referring to that at all. It is very helpful that Mr Dicks has pointed that out. If I could just answer the question you have asked me, I am absolutely not leaving because of any disagreement I have had with the Chancellor. That is absolutely not the case, and I am simply leaving when I have completed the task that I had been set.

Q36 Mr Love: Sir Alan, all three of you, if I may say so, are seasoned public servants, yet you are asking this Committee to accept, first of all, that it never occurred to you that when you released this information it was just as Prime Minister's question time was about to occur. You are also suggesting that it should be released to everybody at the same time, but you must have understood that that would be in the hands of government or Treasury officials. Do you think you have been a little naïve in the way that this whole debacle has been handled?

Sir Alan Budd: What I have said is I certainly did not anticipate the furore that this action caused, and if that is evidence of naivety then I absolutely accept the charge. I have been a public official at various stages of my life. It so happens they have never particularly been of the private office type and answering Prime Minister's questions type; I have just been a dull and boring economist doing his best to produce forecasts and matters like that. This is not the sort of area which has fallen to my responsibility.

Q37 Mr Love: The point I was making was that it is not just yourself but there are three of you who are also seasoned public servants and, as I think you said earlier on, you did consult between the three of you and these decisions were taken collectively.

Sir Alan Budd: Mr Dicks, I am not even sure you have ever set foot in the Treasury building before. Maybe you have. Mr Dicks has had a wholly innocent life of any public sector employment of any sort. Mr Parker might wish to speak for himself on this matter.

Mr Parker: My public service is very much the same type as Sir Alan's; again, no private office experience, etc—even more boring statistics, economics and public finances, etc. So pretty much the same applies to me.

Q38 Mr Love: If I may say so, in politics innocence is no excuse.

Sir Alan Budd: I am not making an excuse.

Q39 Mr Love: Can I ask you about the modelling changes that you mentioned in your statement? Of course, this has come under some criticism with particular modelling changes that anticipate things that may have happened rather than government policy. How do you respond to that?

Sir Alan Budd: Yes, I think we can all speak to this, and it may be better if Graham Parker does so. These modelling changes do not anticipate any policy changes of any sort. If anything, they move slightly away from that to being stylised assumptions about such matters as pension contributions as we move into the future. There are no policy assumptions. There is always a policy implication in any forecast, but there are no policy assumptions built into those projections at all.

Q40 Mr Love: Unfortunately, we only received this document at 9.30, and that does not breed confidence amongst Committee Members. Let me just ask specifically: the reports in the newspapers suggest that you were anticipating judgments and decisions that may have been made by the Hutton Committee in relation to it. Are you rejecting those assertions?

Sir Alan Budd: Completely.

Q41 Mr Love: Can I move on to your forecasting and, in particular, in relation to the contribution that you are suggesting net trade will make to growth in the economy? We have seen a significant devaluation of the pound yet, as yet, not much in the way of an improvement in net trade. Why are you so optimistic that net trade will contribute to growth in the future?

Mr Dicks: I agree it is disappointing so far. Exporters seem to have taken the depreciation of sterling on their profit margins, but that is always—and has been in the past—the first stage under which you get a supply side response. Profitability of exports has improved; we are more competitive overseas. The article that I wrote for *The Sunday Times* earlier this year pointed out that in the recovery of the 1990s exports rose by 50%. Obviously, you can never have history repeat itself, but the point, again, in this article was that things always take longer to appear than anyone expects and then, when the price signals and the supply side response is in place, it happens much more than anyone expects. We have looked in detail at the recovery of the 1990s and 1980s, trying to draw comparisons, and the forecast that we have this time round, generally, is a pale shadow of the recoveries we saw in the 1990s and 1980s. We are quite comfortable, given the headwinds, given problems in the financial sector, that the outlook is weaker, but only in degree. I would expect the shape of this recovery, including a strong contribution from net trade, which was your question, to be of an order of magnitude similar to what we have had before.

Q42 Mr Love: You have just given us the classical economic theory, but there are some reasons to be somewhat sceptical about that. From recent figures from the United States, one of our biggest trading partners, and the continuing fiscal consolidation and other problems that exist in the EU area, our biggest trading partner, it does seem, looking out there internationally, it is quite difficult to be optimistic that, somehow, trade will take off in these circumstances.

Mr Dicks: Our forecasts for the euro area are below the consensus, so I agree with you there that—well, we are not getting a lot of help in terms of our export markets from our largest export market, but that is part of our central forecast.

Q43 Mr Love: Can I just say, it is not just the Greeks, the Portugals and the Spains of this world who are retrenching; it is also that Germany is retrenching at this time, which I think is a little more surprising considering the international climate of opinion in relation to that matter. How can you be optimistic on trade?

Mr Dicks: I think the ingredients are there, as I have said, for a strong recovery on trade. There are two sides to trade, of course: one is imports, and we have a pretty downbeat forecast for domestic demand—and particularly consumer spending—so we are not going to be sucking in imports, and then I think I have talked about the export side. It will take time.

Q44 Mr Love: Let me ask you one final question, because I think we need to move on: there is quite a lot of evidence in company surveys that they are not looking to increase export markets in the next six months. You would go further head than that, but, again, it would appear that confidence is not there amongst the people that we would be looking to export. Again, does it not cause you concern that the trading part of the way out of this recession back into growth will not be there in the foreseeable future?

Mr Dicks: One is always worried about a forecast. That is the perpetual life of the forecaster; you produce a forecast and then you check it against what is happening. The most recent purchasing managers' survey on exports was a bit downbeat. The previous CBI quarterly survey showed manufacturers' export confidence at its highest level since 1995. So, yes, of course we are watching the evolution of the data, but we are at that difficult phase, I think, in the economic cycle where you get conflicting evidence. Some surveys are positive—the PMI for manufacturing, as a whole, has been extremely robust over the last several months. Yes, I agree there are downside possibilities on the export front, and we will be monitoring them.

Q45 Stewart Hosie: Just before I ask a specific question on business investment forecasts, can I pick up on that? Even yesterday currency strategists at BNP Paribas were suggesting that: “The euro rebound we have seen over the course of the past month is coming to an end, providing a renewed selling opportunity”, and UBS Investment Bank were commenting on the stress tests, if they were viewed to have unrealistic assumptions. You have set your “below consensus” estimates on exports but does this information coming out about the euro even in the last couple of days not worry you further?

Mr Dicks: I do not think I am more worried about the euro area than I was, no. The sovereign debt problems have been there for a long time. As I said, our forecasts are fairly downbeat. On the investment front, yesterday's data revised the whole economy

investment up to 4.5% in the first quarter (you will never put too much emphasis on one quarter's data), at which business investment was rising—I think it was 7.5%—

Q46 Stewart Hosie: In that case, let me look to the long and medium term, and this 8–11% increase in business investment forecast, which many people believe to be extremely high indeed. That is obviously going to require capital for investment. The Bank officially tell us that the unused sterling credit facilities have 27 consecutive quarters of negative growth, the most recent being a year-on-year 11.6% shortfall in available credit. That was at the end of May this year. Where is the confidence the OBR has that the cash will be available to meet these investment growth forecasts or expectations?

Mr Dicks: Well, it is a well-known statistic that something like 80% of all investment is done by 20% of the largest companies who, typically, finance it from internal resources. You could say exactly the same question to me about the first quarter: how come business investment was up 7.5% at a time when the banks are not lending? I think that is part and parcel of the internal financing investment argument, and the private non-financial corporate sector has built up £100 billion of net assets over the last two years; they are not cash-poor. We think, and the Budget will have helped here with its cuts in corporation tax, the fact that it fell such a long way means it has got a long way to come back relative to GDP before you get to a normal investment to GDP ratio. The recovery we saw in the 1990s showed investment up again, and this was in my *Sunday Times* article, by about the same as exports, 10% a year. Okay, I am not putting all my faith in saying that this recovery will match *pari passu* the previous one, but it has happened before and I think that conditions are in place with the tax reforms, the cash they have got and a supply-side response that we will see a strong—

Q47 Stewart Hosie: In a very short yes or no, you have remained confident on this 8–11% business investment growth over the medium term?

Mr Dicks: It is our forecast, yes. It is our best guess. As the Governor has said on many occasions, all forecasts go wrong, but that, as of now, is our best guess.

Q48 John Thurso: Can I just go back to the follow-up to the question that Andy Love asked you regarding net trade. Between your Pre-Budget Report forecasts and the forecasts actually with the Budget, you raised the forecast for net trade, not by a huge amount, but it goes up. What were the other factors which led you to that conclusion?

Mr Dicks: Simple crowding in, crowding out. If the public sector is demanding fewer resources, there are more resources available to the private sector. If your home markets are a bit more difficult and your profits in exports are that much better, you will try harder and, if you are facing weaker demand at

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home and demand overseas or your pricing is right, then it makes sense to try and channel resources into the export sector.

Q49 John Thurso: Help me here as somebody who is not an economist. This Budget will be judged by history in some years to come almost entirely on whether the growth side of it has been successful because, without that drive in growth, then we will just have had a lot of pain for not a lot of gain. It relies on quite a growth in the private sector to counter, if you like, the contraction in the public sector. Please tell me that is not entirely on a whim and a prayer, but there is actually something that is going to make that happen other than economic theory.

Mr Dicks: Well, we have had fiscal consolidations before, a relatively minor one in the 1980s and a stronger one in the 1990s. If you look at our employment forecast as an example, we are forecasting 5% employment growth over the next six years. In the fiscal consolidation of the 1990s, which was similar in magnitude, the deficit went from 7.7% of GDP to a small surplus, so a similar sort of deficit reduction programme, we had employment growth of 7%, and in the 1980s we had 13%. Now, I am sorry to keep coming back to what has happened before, but it is the best guide. We are in a big fiscal consolidation and previous fiscal consolidations have not derailed the recovery, and I do not think this one will either.

Q50 John Thurso: One could argue we have to go back to 1931 to find a fiscal consolidation of the same size, but, leaving that aside, what I think I need to understand is that the forecasts that you are putting out are not saying, "As a consequence of action being taken, this result will happen", but they are in fact saying, "Based on the probability of outcomes based on previous experience, the likelihood is . . ." so there are actually no particular measures or suite of measures that get to your conclusion; it is your best guess as to what the economy will do given the circumstances, because there is quite a distinction between the two. I see you nodding, Sir Alan. I do not know if you would like to comment.

Sir Alan Budd: I will let Geoffrey as he is doing so well.

Mr Dicks: Well, economic policy has a monetary arm as well and the Bank of England has taken extraordinary measures to try and keep the economy moving ahead, and one would imagine that, as long as inflation remains under control, the Bank of England will be supportive, the exchange rate is competitive and the private sector, typically, once it gets going, takes up the reins. Our forecasts at least for this year and next are in line with the consensus, bang in line with the consensus, 1.2 this year and 2.3 next year, and I think the consensus is either 1.3 and 2.2 or something like that. In the medium term, we are a little bit more optimistic than some forecasters, but by then the recovery, we believe, will have got

some momentum, not just in the UK, but elsewhere, and we do think that the forces of recovery will gather strength.

Q51 John Thurso: Obviously, public spending and government are going to be a drag on growth; it is an inevitable consequence of the policies. Do you think there are any aspects of government spending which should in fact be protected to help facilitate a recovery in the private sector? In other words, should the Government be thinking through which items of expenditure are genuinely helpful to investment in a recovery, and what might they be?

Mr Dicks: Well, I think they should be, but that is not one for the OBR. We have been charged with producing a forecast, not with commenting on the sort of mix of policy.

Q52 John Mann: The definition of "general government employment", could you send us one because I cannot find the precise one—

Mr Dicks: Central Government and local authorities, excluding public corporations.

Q53 John Mann:—including a list of what is excluded by it.

Mr Dicks: It is anyone who works for central Government or a local authority.

Mr Parker: And/or the central Government associated bodies, including the OBR, for instance.

Q54 John Mann: So any public servant is excluded?
Mr Parker: Public corporations.

Q55 John Mann: Just public corporations?

Mr Parker: Yes, they are trading, so any body who is actually trading cannot be part of Government in the national accounts.

Q56 John Mann: But, in terms of the employment projections you have made, how many of the new employees will be migrant workers from elsewhere in Europe?

Mr Parker: We have no information on that at all. As I think Alan suggested in his introductory remarks, although it is obviously of prime interest to people, the government employment forecast is not a key part of our forecasts.

Q57 John Mann: But you have forecasted a claimant count and you have forecasted employment.

Mr Parker: Sorry, yes, I understand what you are talking about.

Q58 John Mann: So how many migrant workers?

Mr Dicks: In our assessment of trend growth, which we published in our Pre-Budget Report, Annex B on trend growth, we had an assumption of net migration of 140,000 a year, and we cannot say which particular countries that might come from—

Q59 John Mann: Obviously not.

Mr Dicks:—but that was the assumption.

Q60 John Mann: So 140,000 a year?

Mr Dicks: Yes.

Q61 John Mann: What is the basis for determining that? What assumptions are you using?

Mr Dicks: I think these are based on the ONS's best migration projection statistics. It was as high as 190,000 before, so we are assuming that the overall economic environment will not be so conducive to inward migration, but 140,000 or thereabouts will still be coming.

Q62 John Mann: But you are projecting growth as, what, approaching two million new jobs?

Mr Dicks: Yes.

Q63 John Mann: So on what basis are you assuming that, of those, only a maximum 140,000 will be taken by migrant workers each year?

Mr Dicks: Well, the demography. There are more people entering the labour market, there are the unemployed and there will be some small net inward migration, but it is more demographic than anything.

Q64 John Mann: It is a fundamental assumption that you are making there.

Mr Dicks: Well, demography is demography, is it not?

Q65 John Mann: How have you accounted for the actual statistics over the last 10 years and compared them?

Mr Dicks: Well, I think the one statistic that really impresses me is that job losses in this recession were, peak to trough, 740,000, in the recession of the 1990s, 1.7 million, an extra million, and in the recession of the 1980s, 1.7 million, an extra million. This tells me—

Q66 John Mann: But the free movement of labour has not existed in the European Union in the sense of the 1980s.

Mr Dicks: This tells me that we have a labour market these days which, for one reason or another, works. You have seen how.

Q67 John Mann: I am not interested in your view on whether it works. What I am interested in is the projections that you have put in, and the projections that you have put in increases employment and you have got a figure for the claimant count which reduces it. I am asking: how many of those are going to be migrant labour from elsewhere in the European Union and on what basis have you made that assumption? Is it based on a historic analysis of what has happened in the last 10 years or not?

Mr Dicks: Well, plus or minus a little, and we are not expecting the same.

Q68 John Mann: So it is based on a historic analysis of the last 10 years?

Mr Dicks: Well, we have seen large-scale inward migration, particularly from Eastern Europe after they gained accession to our labour markets, the A8 countries. We are not expecting something like that to happen again, but we have projections of the population of working age based on the demography that we all know about. We think, and this was the point I was trying to make, that our labour market works pretty well these days and, as evidence for that, I would cite the freezes and the cuts in private sector pay that we have seen over the last couple of years as people price themselves into work or accept lower pay so that they are not priced out of work in a recession, but we think the labour market will continue to do that. We have falling real wages for the next three years, earnings rising less than the CPI and rather less over the next four years, I think it is, than the RPI, so workers will price themselves into work and the population of working age is rising—

Q69 John Mann: I understand that, apart from in the last two years of your projections when the increase in wages and salaries is double inflation.

Mr Dicks: We think that by that time, as the output gap is nearly being closed, you will get normal sorts of increases in earnings.

Q70 John Mann: So double inflation?

Mr Dicks: No, not double inflation, but of the order of 2–2.5% a year in line with the underlying productivity growth in the economy.

Q71 John Mann: In your projections between the average earnings of the public sector jobs that go and the private sector jobs that are created, what is the differential?

Mr Dicks: I do not think I know the answer to that question. We published on 30 June that release that we have talked about. We published our forecasts for public sector earnings growth both in our Pre-Budget Report and our post-Budget assessment.

Q72 John Mann: I am interested in the average earnings of the jobs that go compared with the jobs that are created.

Mr Dicks: Well, that is not ever a part of anyone's forecasting.

Q73 John Mann: So how do you forecast it? It is a key political assumption and I am not asking you to make political assumptions, but the key political assumption repeatedly made is that the more expensive public sector jobs will go, and you said yourself that flexibility in the labour market and cheaper private sector jobs will come in. The reason for asking is in relation to your forecasts on income tax, which of course are critical to your forecasts on the budget deficit and reduction in that, that you have to have an assumption on that because, if a significant number of public sector jobs are going to go, unless they are pretty much the average of the earnings of the private sector jobs, there is a differential loss in income tax based on your projections, so there must be assumptions made in

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relation to that, and I am asking what they are. You are saying there are not, which worries me, statistically.

Mr Parker: There are assumptions made about the overall growth in average earnings in both the private and public sectors. That is the assumption we make. We are not making—

Q74 John Mann: I understand that, but that is not my question. It is an important issue, and I can see that in there and that is very clear. What is not clear is that public sector jobs go, a significant number, you are projecting, will go. They earn X amount of money and they pay Y amount of income tax. New jobs are created and those new jobs are going to be created in a range of sectors. I put it to you that, going on the last 10 years, significant numbers of those jobs will be in the flexible labour market and very low-paid jobs and, therefore, the net income tax take from those jobs is lower, so I am asking where that is in your assumptions on income tax revenue, which you have increasing significantly and from 2011 onwards you are boosting that up, so the boost-up must be based on some assumptions?

Mr Parker: The income tax forecasts will be based on the overall forecast of wages and salaries, which is a mixture of the overall numbers in employment and the average earnings increases in both the public and private sectors so, in a sense, we are making that kind of assumption, but what we are not doing is kind of separating out the actual flow from the public sector to the private sector. We are just looking at the overall averages for each sector and that drives the income tax forecast.

Q75 Mark Garnier: You talked about the fact that the job peak/job trough was 700,000 jobs, but to what extent is that hiding people who have gone from full-time work to part-time work who are working for the same employer, but who are now perhaps unemployed for maybe one or two days a week?

Mr Dicks: I have not got the numbers in my head, the change in employment between full- and part-time over the last twelve months or so. There will have been some of that and, no doubt, in the recovery some of the people who are working part-time will be sucked back into longer working hours. Beyond that, we think the private sector will be a net creator of jobs.

Q76 Mark Garnier: Including taking people back on to full-time work?

Mr Dicks: Yes.

Q77 Mark Garnier: So there will be more people in full-time work than there are, if you like, full-time equivalent jobs at the moment?

Mr Dicks: I would have thought so, yes.

Q78 David Rutley: Turning to a different subject and moving on to credit availability, obviously this is going to be important going forward, but just looking at the latest Bank of England Credit Conditions Survey, which sets out a pretty

continuing hesitant picture, I just wondered if you think that the suggested credit availability will improve enough to help the private sector-led recovery that you are forecasting?

Mr Dicks: Well, it is one of the Governor's headwinds, and we highlight it—

Q79 David Rutley: Sorry, I did not hear what you said.

Sir Alan Budd: The sailing analogy.

Mr Dicks: We highlighted it both in the pre-Budget and the Budget forecasts. We think that these headwinds, the credit conditions headwinds, will ease slowly through time. The other point I made earlier was that internal finance provides a lot, if not most, of the cash for investment. The problems in the banking sector, as a central guess, would become smaller through time.

Q80 David Rutley: A different subject again, and I think this is one for Mr Parker or maybe Sir Alan himself, at any time did you discuss with the Treasury the much-talked-about 80:20 rule of thumb ratio on spending cuts to tax?

Sir Alan Budd: You mean the choice?

Q81 David Rutley: The choice, yes.

Sir Alan Budd: No, that is not part of our responsibility; that is entirely for the Chancellor.

Q82 David Rutley: In terms of the position you do hold, do you regard that as a good decision?

Sir Alan Budd: I am not commenting on that because it is not within our terms of reference. We note that that is the choice that the Chancellor has made.

Q83 Mr Love: I want to come back to this issue of your employment forecasts because of course there has been quite a lot of comment in the newspapers, I think you would accept, and I am looking particularly at comments made in *The Financial Times* where they indicated that, according to their research, for every billion pounds' worth of expenditure reductions under the Pre-Budget Report, 20,000 jobs were lost, but, with the change to the Budget Report, for each additional billion pounds' worth of reduction, that was only 2,000 jobs. Now, I note your comments about the changes in terms of the cost of employing people in the public sector and other changes that you touch upon in your document, but that seems a remarkably large difference. How do you explain it?

Sir Alan Budd: That is precisely why we have circulated that note to the Committee, and it has been quite an extraordinarily difficult note to produce to delve into the effects of changing the assumptions, but that mystery arose entirely because of an attempt to use our released document of 30 June to assess the effects of the Budget. It was not an appropriate set of numbers to do that and the reason it was not appropriate was between the pre-Budget forecast and the Budget forecast we made a number of changes to the assumptions which affected the path of average pay in the public sector and, because of that, since employment drops out,

significant though we know it is, employment drops out and, when you start with a forecast of cash expenditure, that is the limit that applies and that is what it is our job to forecast. We add to that a projected path for earnings and you derive a path for employment by simple arithmetic. Since there had been this change, the attempt to make that sort of calculation could not be done, and we have issued this document precisely so that a fair comparison can be made and, as I said in my opening statement, as far as we can judge, the effect of the June Budget on public sector employment is to reduce it by 160,000, and that is more or less proportional to the effects on employment of the measures that had been introduced in the March Budget.

Mr Love: I do not think we can go into this now, but can I ask that perhaps this may be an issue that we would want to touch upon when Sir Alan comes back again?

Chair: We are hoping to do mainly structural issues next week, but we can consider that thought.

Q84 Jesse Norman: Sir Alan, just to pick up on one thing that you said earlier in relation to the briefing that you put out on the Wednesday, does the OBR have a press officer of its own or does it use the Treasury's press office? How does it relate to the press or put information into the public domain?

Sir Alan Budd: It does now have a press officer of its own, though this is a Treasury official. Previously, we had a member of the Treasury press team dedicated to us and we can understand that this created difficulties, so we have changed the arrangement and we now have our very own dedicated press officer. He is a Treasury employee, but he does not work in the Treasury press office, he works wholly and exclusively for us.

Q85 Jesse Norman: And that is a result, as it were, of experience?

Sir Alan Budd: Well, it is what we have learnt from the, to me, quite extraordinary amount of press interest in our activities. I hoped we just produced a very boring forecast that no one would notice and we could just move quietly on in the way that economists normally do!

Q86 Jesse Norman: Just picking up on two earlier questions, you obviously privately resolved to depart after the initial period of the interim OBR.

Sir Alan Budd: Yes.

Q87 Jesse Norman: Does it sadden you that you will not be actually setting up the permanent OBR because obviously it is some way before the institution itself will have come into being and, therefore, it does raise the question as to why again you would have drawn the line where you did?

Sir Alan Budd: Because I am doing everything I can to help with the design of the permanent OBR. I think there will be a lull in the activities of the OBR, but during this period there will be continuity in the sense that both Graham Parker and Geoffrey Dicks

will remain as members of the Budget Responsibility Committee, so there will not be a complete break, but I think my presence will no longer be necessary after 13 August.

Q88 Andrea Leadsom: I am sorry, I am jumping back to the previous conversation. You were talking about the prospects for growth and a turnaround in the economy and I just wonder how sensitive you think it is to continuing loose monetary policy. With the prospects for inflation in the near future, do you think the Monetary Policy Committee will need to respond to that, or do you think we can continue as we are, and how important is that?

Sir Alan Budd: Well, of course it is not for us to try to predict how the Monetary Policy Committee will behave, but what we do know is that the responsibility they are given is to keep inflation at 2%, and they in turn believe that that is best done by keeping the economy fairly close to trend. At the moment, the economy is some way below trend, and we do not completely agree with the MPC about how far below trend we are, but we both agree that the economy is below trend and, therefore, it can safely grow more rapidly without threatening the inflation target. In fact, if it does not move back to trend, inflation will start falling and it will fall and fall and fall, and that is not what the MPC is charged to do, so we assume that they will conduct whatever is the appropriate monetary policy to make sure that the economy does continue to grow until it reaches trend. Now, at the moment, of course interest rates are very low and it has been relying more recently on quantitative easing and it has to judge whether the temporary problems of inflation, how long they will endure, or whether it should look through them and consider where the economy will be in two years' time, and I think they have done an excellent job so far and I hope they will continue to do so.

Q89 Chair: Sir Alan, thank you very much for coming before us this morning, and we are looking forward to seeing you next week. You have been accused of naivety this morning, which is not the most heinous of sins, but perhaps that point is not lost on anybody who might want to succeed you. It has been a learning experience for us this morning, but it sounds as if your brief tenure at the OBR has been a learning experience for you as well.

Sir Alan Budd: Yes, and can I make a brief comment on that, and you have been so indulgent towards me. I can say personally that the events of the past few weeks have been, personally, very painful indeed, but I do not complain about that. I volunteered for the job, and we all know what happened to the young lady of Riga, so I do not complain about that, but I would be deeply sorry if any of the mud that has been thrown at me stuck to the OBR because I do believe it is a brilliant and courageous innovation, and we will come back in due course to discuss that, but that, to me, would be a real pity.

Chair: Well, we will be examining that conclusion of yours in seven days' time. Thank you very much for coming.

Witnesses: **Mr Roger Bootle**, Capital Economics, **Mr Robert Chote**, IFS, **Mr Ray Barrell**, NIESR **Mr John Whiting**, CIOT and LITRG, and **Mr Alan Clarke**, BNP Paribas, gave evidence.

Q90 Chair: Thank you very much, all five of you, for coming today. I am sorry, as those of you who have given evidence before will know, that the evidence you are giving today is somewhat compressed. Can I begin by asking you, Robert Chote, whether you think this is a progressive Budget?

Mr Chote: The Chancellor said in the Budget speech, “This is a progressive Budget”. One issue is: what do you define as being ‘the Budget’, ie, what set of measures do you include in making that judgment? The second question is: what do you mean by “progressive”? The Treasury has presented a set of analyses in the Red Book which is clearly rather more nuanced and precise in its definition in reaching the judgment that the Budget is progressive. It does, as these analyses typically do, look at the effect on the incomes of different households and divides them from the poorest 10th to the richest 10th. Essentially, they do reach the conclusion that it is progressive, it is harder on the richer households than the poorer ones, and a few points are worth bearing in mind here, that, first of all, this is mainly because of the reforms that had been announced by the previous Government that have been stuck to rather than the additional measures that were announced specifically there. It also looks more progressive because the Treasury is focusing on the position in 2012–13 and there are further changes, for example, on benefits that go beyond 2012–13 and you would expect those to hit poorer households proportionately more. In addition, the Treasury does not take account, and neither would we in an analysis because it is very difficult to allocate them to specific households, of the impact of things like cuts to housing benefit, disability living allowance and the in-year changes to tax credits, all of which, you might assume, would hit the poorer half of households harder than the rich. On the other hand, the Treasury analysis does not include capital gains tax changes, which you would expect to hit the rich harder than the poor, but those are relatively small. I think, taking all of that lot together, you would say that the overall impact of the additional measures that were announced in the Budget Statement are regressive if you look at—

Q91 Chair: Are regressive?

Mr Chote: Regressive, that is right.

Q92 Chair: I am sure other colleagues will want to come back to this point in a moment, but I would like to go on to ask Roger Bootle one question, which comes out of a previous evidence session, which is: do you think that this Budget increased the risk of a double-dip recession?

Mr Bootle: I think the answer is yes, but I would caution against overuse of this expression “double-dip”. We heard Geoffrey Dicks say, “Are you assuming that this means two consecutive quarters of negative growth?” in which case it is not really particularly significant, it seems to me. It is possible to imagine an outturn in which there were two consecutive quarters of negative growth, but for the rest of the forecast period the economy is actually

pretty strong. I think that media comment has focused excessively on this technical issue of: is it a double dip? I think the more meaningful thing is: is growth going to be significantly weaker or stronger than the forecasts over the period? I think the Budget has increased the chance that growth will be significantly weaker over the forecast period.

Q93 Chair: By how much?

Mr Bootle: You know there is no certainty in this, but, for the sake of argument, the emergency Budget forecast for next year suggests that the economy will grow by about 2.3%. My own forecast is more like 1.5%. It is difficult to be precise about how much the Budget itself has reduced growth prospects, not least because so much depends upon what happens to monetary policy and bond yields, and on that of course there can be umpteen different views.

Q94 Chair: Just before we move on, what are your views on the long bond yield effect of these measures?

Mr Bootle: This is a sense in which I think, although I adhere to the traditional Keynesian view of how the Budget will impact the economy, the Budget has gone down pretty well and, without a tough Budget, we would be looking at a more difficult situation. We reached a remarkable position under which the UK is regarded as something of a safe haven, or at least it has been recently. Government bond yields are really very low with a 10-year yield of the order of about 3.4% and at the beginning of the year not many people would give them much chance of that happening so, so far, that is looking good. Indeed, I think if short-term interest rates remain low for an extended period, there is even a significant chance that the 10-year yield will fall to 3% or below.

Q95 Chair: Before I bring in John Mann, is there anybody else who wants to add anything to what has been said so far on that double dip point?

Mr Clarke: I would agree with that as well. I shared Roger’s pessimism on growth for this year and for 2011 particularly. Just to keep this in context, I am forecasting 1% growth, the OBR 2.3, and the most optimistic person in the consensus is looking for 3.2, so the OBR is in the middle of the road. The quarter on quarter path that the OBR is assuming barely has a bump in the road at the start of next year; it goes from 0.6 to 0.5 and then at 0.6 for ever. Now, for the economy to go about 2.3% and then almost 3% the year after that, the newspapers said this was going to be the most painful Budget in living memory. Well, 2.3% and then 3% is not painful at all. I think a quarter on quarter growth could get down to about zero, but then we recover from there. That is not a double dip, that is a soft patch.

Q96 Chair: A soft patch?

Mr Clarke: Yes.

Q97 Chair: Mr Barrell?

Mr Barrell: It is relatively clear that, if you look at the OBR forecasts, they think the world is uncertain. They are saying that there is 80% chance that next year growth will be somewhere between minus 0.5% and plus 5%, if you look at their chart. That seems to be a reasonable enough distribution, in my view.

Q98 Chair: It is also reasonably wide enough to make sure you do not make a mistake! Why not make it minus 2 and plus 10?

Mr Barrell: Well, it could be, but, if you look at forecast errors, which is what they have done, those are the sorts of numbers you get out of forecast errors from the past. In other words, it is a very uncertain process. If, in 2011, this Budget slows growth by 0.4 or 0.5, it means we are 80% certain growth will be somewhere between minus 1 and plus 4.5, so the distribution is very wide indeed, so the probability of a double-dip recession has risen by 4%, or some such number.

Q99 Chair: So the width of the fan chart has increased, is what you are saying?

Mr Barrell: No, not the width. The centre of the fan chart has shifted. If we had not had the Budget, the fan chart would have been higher and, therefore, less of it would have been below zero and more of it above 5%, so the whole thing is moving up and down. It is a terribly uncertain world we live in and it has got worse, I am afraid.

Q100 John Mann: One certainty that the OBR is remarkably independently projecting is that inflation will be for three years, 2012 to 2015, 2%, 2% and 2%, that is, 2.0%, each year, which is a remarkably precise projection. The average earnings growth is 2.6, 3.8, 4.3 at the same time. How do those two figures marry together?

Mr Clarke: Historically, the average earnings growth rate, to be consistent with the Bank of England's 2% inflation target, has been 4.5–4.75%, so I would not be too surprised if there is that gap, so you have got productivity growth which will account for that gap.

Mr Barrell: The OBR's forecast obviously is different from other people's, but we can say that in the recent past about a third of the shock to labour input has been taken up on hours, that is, hours have dropped. Hours will rise again, so average earnings, which are not per hour but by person, will rise and we will also find the normal addition over the next few years of productivity growth, so average earnings growing at a bit over 2% in real terms from about three years' time is reasonable, maybe a bit high, but it is a reasonable assumption.

Q101 John Mann: Growing by 2%?

Mr Barrell: Yes, 2% or a bit more. My personal view is that the OBR is perhaps a little optimistic about the growth of real earnings three or four years out, but, if one thinks that the uncertainty bounds around our output forecast are as high as they are, the uncertainty bounds around the real income growth forecasts three years out are quite wide.

Mr Bootle: Just briefly on the inflation part of your question, you comment on the fact that the inflation forecast is very precise and I can see that it does seem that way. In fact, this is just a convention that most forecasters would follow, that is to say, the Bank of England has got a target for inflation, we assume they are trying to hit it and over a run of years it seems, on average, that they will hit it. There is, however, an underlying uncertainty about how co-operative, as it were, the economy will be in producing that sort of inflation rate. I think the point is that, if it is not very co-operative, the implicit assumption in the OBR's document is that the Bank of England will take monetary policy action to bring inflation to the target, and that of course could make things very uncomfortable for the growth environment.

Q102 John Mann: With a big increase in productivity, therefore, projected at a time of labour market flexibility, these new jobs that are coming in, what sectors would you expect them to be in?

Mr Clarke: You are right to address that point, but I was talking about the gap, and 4% or so wage inflation does look a bit "go-ey" in the sense that demand for workers relative to supply, and my own view is that wage inflation should be lower. In what sectors will the jobs be coming? Manufacturing has done quite well for now, but a lot of the upstream indicators are turning down, so I do not think they will have such a good run over the next 12 months or so. The services sector has fared a little bit better, but I do not think there is going to be as much hiring as the OBR assumes because I do not think we will be growing in excess of the economy's trend growth and, when that is the case, you tend to have job losses.

Q103 John Mann: So you think the projections on private sector job growth are overstated, the OBR's projections?

Mr Clarke: They are fairly internally consistent given their optimistic growth forecast. Relative to my own view of where the economy is going to be, I am not as optimistic on hiring.

Q104 John Mann: Any other comments?

Mr Barrell: A similar comment, that in five years' time they have the output gap nearly closed and we might suggest it is not quite so closed as they think. The output gap closed means that unemployment is around about back to normal. Employment might be slightly slower than the OBR think, but again it is a very uncertain matter. We are liable to see employment growth, but we cannot always predict which sectors are going to grow because it depends upon who invents what where and who demands what where. One thing we can be reasonably clear on is that some of the growth will be export-related.

Q105 John Mann: Mr Chote, on job losses in the public sector and the average earnings and average income tax take from those jobs and new growth in the private sector, what I have suggested earlier is a potential differential between the two, and that

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would have a negative impact on the forecasts on income tax take, possibly significantly so. In your Institute for Fiscal Studies, are these figures here on income tax take overly optimistic?

Mr Chote: Well, I think that depends very much on the overall path of spending in the economy. The breakdown between the two is important, but essentially they are basing, and in a similar position other forecasters are basing, their income tax revenue forecasts on the overall wage bill in the economy. Now, you are assuming that there is obviously fiscal action taking place which takes demand out of the economy which takes workers out of the public sector, but essentially, as Roger was saying, we have an environment in which the Bank of England is essentially tasked with achieving an inflation target and, therefore, keeping the overall amount of nominal spending and activity in the economy where they think it should be in order to deliver the inflation target. Unless you think you are skewing the mix of that total nominal spending in the economy or total nominal income in the economy between the total amount that goes to wages and to other sources of income, it is not necessarily unrealistic that they should base the forecast off the aggregate wage bill.

Q106 John Mann: If I am an employer of new employees, who am I going to employ if I am in one of the growth sectors, let us say, distribution or in retail, let us say, supermarkets, which has been a consistent growth sector in the economy in terms of jobs? If I am opening up a new supermarket, who am I going to employ? Am I going to employ a 45-year-old redundant public sector worker earning average public sector pay before, or am I going to employ a keen 20-year-old who is looking for work and just turned up from somewhere else within the European Union?

Mr Chote: Well, we have not exhausted the supply of labour outside those being released from the public sector, so there will still be some people to go for there. Clearly, there is an issue about the people coming out of the public sector and some of those are going to be coming out with more transferable skills than others and that is presumably going to affect their relative employment chances, but, given the size of the output gap we have at the moment, the idea that there is no spare capacity in the labour market other than that which is going to be released as a result of the public spending cuts is probably not correct.

Q107 John Mann: My final question is on this question of spare capacity because spare capacity in the labour market of course incorporates anybody who wishes to come here from within the European Union. Looking at what has happened over the last 10 years, is it not probable that a very large growth in private sector jobs in the short term in the economy in the UK will lead to, as we saw before, significant numbers of those jobs being taken up by young, relatively cheap, migrant workers coming from elsewhere in the European Union?

Mr Barrell: Some of the work that people quote on migration and the Pre-Budget OBR Report quoted as well comes from the Department of Communities and Local Government's report on the effects of the recession on migration. I am probably one of the few people that has read it because I wrote it, so that is why I can give you a specific answer. We judge that perhaps the recession and the scar on output will reduce the stock of migrants in the UK by about 350,000, and that is a permanent shock and there are two reasons for that. Countries such as Poland, Australia and the Indian Sub-Continent have actually suffered less in this crisis than we have and people are less willing to come. Secondly, the Poles who have gone back, and it is the Poles in particular who are interesting, came here because we, the Irish and the Swedes were the only people who allowed them to work. When they start to come back as the whole of the European economy recovers, they will have the German, the French, the Italian and the other markets open to them, so they will not all come back here, so we are unlikely to see such a large rise in the number of migrants after the recession as we have seen beforehand, so I suspect a lot of those jobs will not be taken by Poles because they can earn more in Germany than they can in the UK and five years ago they were not allowed to go to Germany, so yes, there will be some inevitably, but we can say something about the numbers that there may be. There have obviously been changes in policy since then which would also change the number of migrants who come here, so I personally would revise my projection downwards and, if downwards, that is a larger impact on the stock of migrants than we previously thought.

Q108 Stewart Hosie: You said that part of employment growth will be driven by exports, the export sector, and much of the growth forecasts are driven by an expectation of higher exports, but we have gone, since 1977, from a balance of trade effectively in balance, £1 billion surplus, to a £30-plus billion total deficit, an 80-plus deficit in the traded goods and a million lost manufacturing jobs associated with much of that before the recession. That is an incredibly deep trough to start from, so are you confident in terms of the Budget, the Finance Bill and forecasts that we can actually deliver this export-led growth that is intended?

Mr Barrell: Well, over the next five years, probably yes. Over the next year or two, there are serious risks from our major market, the European Community. We have seen a major decline in the value of sterling against our competitors in the last two years and that will eventually feed through into stronger volumes, and I base that not on comparisons with previous recessions, but just on the standard statistical work we do all the time on the relationship between relative prices, the level of demand and the level of exports. Exports at some point or other will take off, but it could take two or three years for the effects to feed through, so it will happen slowly, we think.

Q109 Stewart Hosie: I appreciate that there is a lag in these things, there always is, which is why we why we went from a £93 billion deficit in the traded goods up to a fantastic £82 billion deficit in the traded goods, but that was with a 25% reduction in sterling against the dollar and a 15% reduction in sterling against the euro over a pretty prolonged period. Now, if the forecasts from the eurozone are not great, if there are shocks to the euro which may be anticipated, if the stress-testing is adequate or if there is a loss of confidence there, then does that not damage those forecaster hopes even further?

Mr Barrell: Any shocks on the downside would damage the prospects even further, but we have to remember that shocks can be on both sides. The stress test may, for instance, discover that there are no banks at risk in the euro area and suddenly we get a rebound in activity. I think that is rather unlikely, although normally the risks are distributed.

Q110 Chair: Usual probability functions!

Mr Barrell: That would be to discuss things I discuss with the FSA and the BIS in Basel, so I do not think I am in a position to do that!

Q111 Stewart Hosie: Finally, in terms of the demand side, let us suppose the euro booms and people buy our goods and all that kind of good stuff, but in terms of the supply side, is there enough being done to ensure we have the service capacity and manufacturing capacity in order to meet the things we might want to sell, assuming we can design them properly and price them properly?

Mr Barrell: One of the things that is clear in the UK is that over the last 10 to 15 years the economy has actually become more flexible, we have actually made the economy more efficient, and I think the conditions for that sort of growth are there. They have been put in place, not just by the previous Government, but by the last few years of the previous Conservative administration. That comment comes from a paper I did on accounting for UK growth for the European Commission and it was presented a few weeks ago, so it is not just a random thought, but there is a serious piece of research behind that. I think the UK economy's flexibility is sufficiently great that the market will work to produce those jobs and that capacity.

Q112 Andrea Leadsom: I would like to talk to you a bit about the banks and the impact of, particularly, the bank levy, but also on the effect of the health of the banking system in terms of supporting our economic recovery. First of all, on bank lending, the OBR representatives earlier were suggesting that there is a lot of internal funding of expansion going on and that companies are actually now carrying a lot of cash in their balance sheets, so were not so dependent on bank lending to recover. Would you, as a panel, agree with those assumptions, or do you think that bank lending is absolutely key?

Mr Barrell: There are two parts to the answer. It is relatively commonly agreed, and it is commented on in the Budget, that part of our problem in the run-up to the crisis is that we were borrowing too much. If

we are borrowing too much, that means the banks are lending us too much, so perhaps we should hope to see an economy where banks lend rather less than they have been in the medium to long term. Now, in the short term, there can be some problems from the fact that banks are not lending enough, but one has to be very careful about that. Lending to consumers might stoke another house price boom and that would not necessarily be good. Lending to firms, well, firms do not report enormous problems with their borrowing and they do have internal resources, but we also have to recognise that this crisis has caused a reassessment of risk and, therefore, a reassessment of the equilibrium capital stock firms want, and they will want to invest less and that will mean they will want to borrow less, and that is part of what was in the forecast, that everybody's forecast has weak investment because of that scar and, therefore, weak borrowing because of that scar. I think we would be advised to worry less about the amount the banks are lending and worry more about what is happening in the real economy.

Mr Bootle: I take a rather different view on that, I have to say. I think there is both a problem of the demand for bank finance and the supply of bank finance, and the OBR was surely right to stress that, on the whole, this is not a significant problem for large companies which have substantial internal resources. Also, of course large companies have access, in principle, to the bond markets and the equity markets. I think we are talking primarily about small- and medium-sized businesses which do not have that access and often do not have internal resources as well, and what I think has happened as a result of the crisis partly, as Ray Barrell was suggesting, may be that in equilibrium, as it were, they might want to borrow less because the future does not look so good and they should not be wanting to borrow for investment, but a lot of it, I think, is actually uncertainty and worry about continued access to finance and they have been frightened by what has happened in the crisis. The evidence is too plentiful to ignore, that the banks have tightened their terms extraordinarily and a lot of firms have felt this was very, very destabilising indeed and the reaction has been to say, "Well, we're just going to have to minimise our dependence on the banks because you can't trust them or depend on them". Equally, at the same time, it is not all a demand-side problem, but the banks, for reasons which I think are understandable under the pressures they are under, have become more risk-averse and, therefore, they have tightened the terms on which they are prepared to lend, and this is a factor, I think, which makes one, or me anyway, inclined to the view that investment, in particular, is going to struggle to recover at quite the pace that the OBR suggests.

Q113 Andrea Leadsom: So, just turning to the bank levy, do you think that the banks have had an easy ride with this bank levy combined with the reduction in corporation tax, or do you think that this has

done more damage to banks' ability to lend particularly to SMEs, which I think is the area that we are most concerned about?

Mr Bootle: Well, it does not help in terms of taking resources from the banks, and it is very difficult, I think, to argue that banks should be lending more and at the same time asking them to hold more capital and/or imposing some sort of levy on them; these things are actually in contradiction. However, the amounts are not huge, I have to say, and I would regard this as more of a gesture, but in relation to the reaction of the banks, it is a gesture that does not help because all the time of course the banks are fearful of how the climate is developing with regard to their own activities, so many of them are worried that we are moving into a regime in which the political environment is very unfriendly to the activities that they wish to undertake, so they think about reducing the scale of those activities or even moving them elsewhere.

Mr Whiting: As a comment from a tax point of view, you are absolutely right to link the bank levy with the reduction in corporation tax rates, because there is an element here for the profitable banks that the levy will claw back what would have otherwise been a bit of a bonus for the profitable banks with the reduction in corporation tax rates. There is, clearly, a lot of worry amongst the international banks that this levy will be matched by similar levies in other countries which then will not offset and it will all be cumulative. As Roger has alluded to, there is also a worry that this is also adding to the amount of extra regulation that is on the banks. Also that it is setting a bad atmosphere and it is not giving them the confidence to do the extra lending to, as has been said, the small- and medium-sized sector which, in many ways, is the one that is most wanting finance, so there is quite a lot of things swirling around. The good thing about the levy is that there is active discussion with the banking sector about its design to try to minimise the burdens, but what actually comes out remains to be seen.

Q114 Andrea Leadsom: So do you think that it might push banks overseas? Obviously, banks are pretty international anyway, but do you think it might make them change their headquarters?

Mr Bootle: I do not think the levy, as such, is significant enough to have that effect, would be my judgment. I think the way to see it is as just one of a whole series of things both already in place and mooted or threatened in the future which banks find uncomfortable. That is not to say of course that they should not necessarily be done, but, from the banks' point of view, the idea that they have got hanging over them a possible enforced break-up is, in my view, much more significant than this bank levy.

Mr Whiting: I would agree with Roger. I do not think this is going to push banks overseas, particularly because they are looking and seeing a lot of other countries contemplating something similar. I think one of the things that this Government should be doing is actively engaging with other countries to try and co-ordinate the levies rather than have sort of everybody try and pick off their

own. That is why we have double tax treaties to try and control interactions with general taxes; we want to make sure that there is not a significant doubling up of bank taxes.

Q115 Mr Umunna: I would just like to probe a bit about the public spending cuts being imposed by the current coalition Government, and actually I will direct this to maybe Mr Bootle, given it was you, I think, who said a little earlier that the UK was being seen as somewhat of a safe haven now. Do you think it is absolutely necessary to be making the degree of cuts envisaged by the coalition Government within the four to five-year timeframe? Do you think there is any possibility that this could be done over maybe six to seven or seven to eight years? Do you think it is absolutely necessary for it to be done over four to five years?

Mr Bootle: I do not think in this subject area that the word "necessary" is particularly helpful. I think of it as there being a spectrum essentially of possibilities.

Q116 Mr Umunna: Well, maybe I should rephrase it. If it were to be done over a slightly longer period, do you think that would have a significant material impact on market confidence in the UK?

Mr Bootle: I think this is where the political process intervenes because what the Government wanted to do was to eliminate the structural deficit within a Parliament. In straightforward economic terms, I am not sure it would make a great deal of difference if the adjustment were over a longer period, but we have to face the political reality of when parliaments change. Where, I think, there would be scope for the burden to have been distributed differently without adverse effect, I suspect, on the market is if more of the burden fell later in the period rather than earlier. As it is, I think that the programme is pretty good in this way because it does build up, the tightening builds up gradually over time, so the full thrust of the tightening comes later in the period. That is good, but it would have been possible to have designed it so that that happened even more so, but there are no free lunches in this area. To the extent that you do that, you also, to some extent, lessen the credibility because we all know, having observed governments over many, many years, that actually words are cheap and it is quite easy to make promises about what is going to happen in several years' time.

Q117 Mr Umunna: In that regard actually, can I put this to you and also to Mr Chote. How plausible do you think it is that the Government, leaving aside the ring-fenced areas, leaving aside education and defence, are actually going to be able to make these spending cuts in the other departments of what we are talking, 33% and maybe more? Do you actually think it is feasible for them to be able to do that?

Mr Chote: It is feasible if you are willing to take the consequences for the quality and quantity of public services you are able to deliver. Now, clearly, an additional choice before you get to the 33%, which, as you say, sort of falls out from assumptions you make about the areas you are protecting, is on what, if any, additional savings will be made on the welfare

and social security budget because that is the other part of public spending where you can make savings in that way and loosen the restriction of public services, but that has different consequences.

Q118 Mr Umunna: Realistically, what is the consensus amongst people in your industry as to what they are going to be able to do in terms of cuts in the non-ring-fenced, non-education and non-defence departments?

Mr Chote: Well, I think you only have to look at the fact that, ignoring the ring-fencing, you are looking at a six-year period which implies the largest and most sustained real cut in public services spending at least since the Second World War, so it is not as though we have a great deal of historical precedent to say, "Well, the last time we tried spending cuts of this magnitude, it was able to be achieved there", so, in some senses, we are in the unknown there. As the previous session pointed out, we have had a fiscal consolidation of roughly this size before in the early 1990s, but, if you look at, for example, the Clarke and the Lamont budgets of 1993, the split between tax and spending, and it is hard to be precise about it because there was less information available then, it was roughly 50:50 between taxation and spending, whereas now you are looking at an overall consolidation that is roughly 75:25 by the end of the process, so more is being done on spending within a consolidation that is, arguably, not of unprecedented size.

Q119 Mr Umunna: If they cannot achieve what they want in terms of cuts and they look towards reducing welfare expenditure, what is that actually going to look and feel like for my constituents?

Mr Chote: Well, very painful for those affected and, for example, we had roughly, depending on which year you look at, an £11–12 billion discretionary cut in social security spending announced in the Budget. If you were to implement the same amount again at the time of the Spending Review, that would allow you to reduce the 33% squeeze in the unprotected departments to something like 25, so it is not as though doing the same amount again on welfare completely removes your need for tough decisions on the public services side either and, as you have seen with some of the consequences of the welfare decisions that were made in the Budget, making more of them would mean that more sacred cows would potentially be there for slaughter if you were to try to raise similar sums again.

Q120 Mr Umunna: So the bottom line is that, if they are not able to achieve the spending cuts they want, they are going to have to slash welfare and, if they want to avoid doing that, they are going to have to look again at the period over which they look to make the reduction and wipe out the structural deficit. That is the bottom line and it seems to be one Mr Bootle and indeed yourself are telling me.

Mr Chote: Yes, if you extend the period, you may still end up with the same eventual percentage cut in public services spending, but it is just going to be taking longer to do it. The other margin of course is

that you can revisit the split between taxation and spending, so, if it looks unachievable on the spending side and you do not want to relax the fiscal targets, it is tax that has to move.

Q121 Jesse Norman: Just to pick up on some of those issues for a second, Robert Chote. The IFS have done some excellent work in pointing out that you can view VAT either from an income or an expenditure standpoint, and each gives a different view as to whether you consider it to be progressive or not. Do you think it is a bit niggardly to call the Budget "regressive" on the back of assumptions already made, and accepting Labour's existing plans? Would not the fairer thing be to say that the whole package is progressive, in part, because of the original inheritance that has been taken over and adapted?

Mr Chote: I think what we have done is pointed out that those are true and it depends on, as I say, what definition of "the Budget" you are using as to whether you are including the pre-announced measures. The Chancellor, in his Budget speech, said, "This Budget is progressive, I think", and I think most people would read that statement in isolation as meaning the newer measures announced in this Budget, rather than this Budget plus what was inherited from previous budgets, were progressive, but, if you look at the analysis that is in the Red Book, the Treasury is very clear and precise about what it means there in, as I say, focusing on 2012–13, focusing on a subset of the tax and benefit measures and those things which it has included and excluded, so the question in the Red Book is posed more precisely and answered correctly, whereas, inevitably, in a speech you cannot go into all of those details, but it is just worth pointing out why the pictures look different depending on how you are going to ask the question.

Q122 Jesse Norman: In reference to the 80:20 balance that the Chancellor is expecting, I would just like to ask the panel where they come out on the wisdom of that balance, bearing in mind two things. One is, from an economic perspective, is it true that 80:20, as was suggested, was, as it were, the best economic balance to be struck between the two sides of spending cuts and tax rises, and the second is what about the glide path to 80:20. Because we end up with 77:23, I think it is, but we start at 60:40, much closer to the Lamont/Clarke era. Maybe other members of the panel could contribute as well?

Mr Chote: It is clearly true that the total tax increase builds up pretty quick and is then static and you are doing more on spending in the longer term. I think that, given the way in which you plan public expenditure, that is not entirely surprising. Clearly, if you are looking to take the sorts of dramatic reductions in public services spending that you are talking about there, the idea of being able to do that very rapidly, clearly, it is very difficult doing it slowly and it is even more difficult doing it rapidly. With

taxation, you are able to move more quickly and to get some of the job done earlier so, as Roger says, you are persuading people that you are on a relatively stable path with the consolidation as a whole. I think again though, if you go back to the early 1990s' consolidation, you had more pre-announcement and phasing in of the tax measures as well as the spending, so the tax measures took longer to build up in that consolidation than they do in this one, but that partly again comes down to the fact that you were looking at a very different mix of tax and spending in aggregate, so more of the job was being done on taxation in the early 1990s than it is now.

Q123 Jesse Norman: Right, but the Chancellor is saying there is a specific technical point which was that the best economic advice available, in this kind of situation, recognising that they were very rare, was in favour of that kind of balance, that level of balance. Other economists went on about the technical point, but the question is what economic evidence supports that view.

Mr Barrell: As I wrote something on it just before the Budget, may I comment. There are three things you can do when you have got a very large deficit that is caused by something. One is to cut public sector wages, and there is a strong case for doing that because private sector wages are adjusting to the scar to the economy we have got, so you can get rid of some of the deficit by adjusting public sector wages. Then you have got the options of either closing the problem that you might have with large deficits and a large debt stock by either raising taxes or cutting spending. It is quite clear that in the 1970s and 1980s and maybe even the early 1990s cutting spending was more effective than raising taxes because it involved more commitment. The recent research by the European Commission, who are very much spending-cutters rather than tax-risers, suggests that that balance of advantage has actually changed and that, although there may be some advantage to cutting spending, raising taxes with the right institutions in place, such as the Office for Budget Responsibility, might well be equally effective as cutting taxes, so there is a decision to be made. Does the economic evidence support the 80:20? If you look at the last 50 years, yes. If you look at the last 15 years, less so, although there might be a bias in that direction, but we also have to remember that things like ring-fencing certain types of spending and deciding on the size of the public sector can be a political decision as much as an economic decision. It is not for me, as an economist, to say what the optimal size of the public sector is; that is for the voters and the politicians to decide. Therefore, 80:20, there is some evidence for it, and 60:40, there is also some evidence for that.

Mr Bootle: I do not think it is possible to defend, as it were, precisely 80:20 or 75:25 on the basis of the evidence, but there is quite a lot of evidence from a range of fiscal consolidations in the past ranging across Canada in the 1990s, Sweden, Finland, a whole series of examples which have been examined

by a number of international bodies, and there were papers published in the UK on this to suggest that it is more likely that your fiscal consolidation could be accompanied by sustained economic growth and it is preponderantly done with regard to spending cuts rather than taxation. I have to say, I do not find this altogether conclusive or persuasive and there is a considerable room here, I think, for political discussion and debate which, as an economist, I have got no role in. However, one point I would like to make is that one ought to make some reference to what has been happening recently before this fiscal crisis. Did we get to this position because taxes were cut to a considerable extent, or did we get to it because expenditure was increased to a considerable extent? When you think about what measures should be taken to address the fiscal crisis, you ought to look at the balance of the things that changed, and I think the evidence is pretty clear that in this country we have not been suffering from excessively low taxation and we perhaps have been suffering from excessively high public spending.

Q124 David Rutley: The need for a stronger private sector-led recovery is implicit in the Budget, but I have been interested in your views particularly on the strength of the package of measures in the Budget that will help SMEs generate jobs, particularly in the regions.

Mr Clarke: One particularly encouraging measure, I think, was the tax incentive to hire outside of the South East. If it is successful, yes, that was a very good idea. In terms of small- and medium-sized businesses, it is just coming back to the question of the banks and their lending. I am a bit worried by the latest Bank of England Credit Conditions Survey which is showing that the availability of lending that lenders expect over the next three months is going down. If the bank levy means that banks try to minimise the size of their balance sheets, they may lend less and it is not the big firms that are going to suffer most, it is the SMEs, so that would be a concern at the back of my mind.

Mr Whiting: The national insurance holiday idea is certainly a worthwhile experiment for the small, new business with new employees. There are other things, no doubt, which could be done. There is a certain amount of concern about the reduction in the annual investment allowance, the 100% allowance, which is obviously of particular significance to small- and medium-sized businesses, although the proposed £25,000 limit will certainly cover an awful lot of small businesses. It is the medium business that perhaps falls into the potential £25,000–100,000 investment level in that there will be less allowances for them.

Mr Chote: On the NICs holiday, it will obviously be interesting to see how that performs, an exemption from one year to the next, first 10 employees hired, first year of trading by businesses that have been set up in the last three years outside three particular regions of the country, up to a maximum of £5,000. I remember reading about simpler, flatter tax systems a while ago and that is not, I think, a move in that direction.

Q125 David Rutley: So your concern is about complexity.

Mr Chote: It is complex and it is estimated to cost less than £1 billion. If you are trying to protect employment, the case for providing support for start-ups relative to existing businesses that are feeling under pressure to let people go, it is not necessarily the best allocation of support.

Q126 David Rutley: Do you think that it should have been capped to businesses of a certain size? What would your preference have been to take it forward?

Mr Chote: You can push it in different areas if you want to make it more or less expensive. To what extent that sort of measure in terms of its size and magnitude is going to make a large material difference is unclear and depends a bit on what your actual objectives are for the policy to achieve. This may be a little too complicated to offer the best value for money.

Mr Whiting: Yes. I view it as a bit of an experiment that needs evaluating after it has been in place for a little while.

Q127 John Thurso: A quick question first to Roger Bootle, if I may. Did you hear the last session by any chance when I was asking about growth and pointing out that the historical judgment on this Budget will be if the growth is attained and the rebalancing happens? Geoffrey Dicks replied that the OBR merely applied the economic formula to what they saw and came out with a result and they did not look at any measures particularly. Do you think there are sufficient in the way of measures either being taken through the Budget or through the Business Department to actually achieve that or can we just rely on the application of the maths to arrive at those growth levels?

Mr Bootle: I am not sure that there is a very great deal that can be done in an overall financial constraint to boost growth. After all, if you take some particular measures to boost growth then you are taking money within that constraint from some other area which prima facie you would imagine would reduce growth. There might be particular things that intelligently can be done which might boost growth. I do not think one could just pick these off the shelf, but there is a legitimate role here for Government to investigate these. Let us take, for instance, road pricing, which is an area that the Government has said it is not going to proceed with. If it were to embark on a policy of road pricing I think the structural consequences to the economy would be so big that I could imagine a whole series of private investment decisions that might follow from that. Another is the regime with regard to planning permission on residential property. If the planning regime were easier, and of course there are objections to this, this would not cost the Government any money but it could potentially lead to much greater private spending on residential investment. There

are a series of things like that which the Budget does not seem to address or discuss where I think there is legitimate room for debate and discussion.

Q128 John Thurso: Can I turn to the vexed subject of VAT. I am genuinely trying to decide for myself what the impact is on people and there seems to be a massive debate going on which sheds more dark than anything else. In your Green Budget in 2009 you had a wonderful section “Debunking Myth 2: VAT is a regressive form of taxation”. It is obviously regressive on income and nobody is going to argue with that. In your analysis of the emergency Budget you had two slides which caught my eye, one as a proportion of income and the other as a proportion of expenditure, and the following slide which talks about hitting those with high expenditure the hardest, and so on. Can you give me a factual explanation? Is VAT ghastly and regressive and absolutely whacks the least well-off or is it actually, as others put it, a good way of raising money that does not impact on growth as much and therefore is fair? What is the real story?

Mr Chote: If we take the regressive/progressive argument to begin with, it depends really on whether you are looking at its impact on people according to their living standards in a particular snapshot as measured by income or over a lifetime period. The reason that VAT looks particularly regressive if you do the standard comparison against income is that the poorest decile spend a relatively high amount relative to their income, you hit high spenders hardest and, therefore, not surprisingly that shows it to be regressive. If you take the alternative view, and as I say these are alternative views, there is not a right answer to this, and divide people up by the amount they spend, arguably what people are spending is a better indication, a better proxy for their lifetime living standards. For example, there will be some people on relatively low incomes who are consuming past savings. There will be some people in self-employment whose incomes are volatile and who may be at one end of the income distribution one year if you are doing the snapshot and a different point at the other. On balance, the consensus would be that total expenditure is probably a better guide to people’s lifetime living standards and so that would give you a less regressive or a progressive pattern overall. In terms of whether it is the most efficient way to do it for the economy, there is an argument that says that increasing VAT you are taxing both incomes and past saving because it is on what people are spending and taxing past saving is less inefficient as you are taxing decisions people have already made rather than distorting decisions they are going to. That said, the way that VAT here is being increased by increasing the standard rate is widening the differential between the tax treatment of those items to which the standard rate is applied and the zero and reduced rates and to that extent it further distorts people’s spending choices in a way that means they are getting fewer of the goods and services they want for every pound they are

spending. In that efficiency sense there are arguments for saying that VAT is a relatively efficient way of raising money but this way of raising VAT actually makes the VAT system as a whole more distorting rather than less so. As ever there are arguments pointing in both directions on both the distribution and the efficiency side.

Mr Clarke: Can I just add something quickly on timing. We thought it was quite skilful that the timing comes in early next year because if it is the low income groups that are hurt most by it it is coming very close to the time at which the personal allowance is starting to increase, so that does soften the blow somewhat. It is also skilful from a second standpoint, which is we saw from the June MPC Bank of England minutes some members of the Committee are sensitive to elevated inflation right now, so myself and a number of other forecasters thought it was perfectly plausible that could have gone up imminently which would have fanned those flames and maybe caused more people on the MPC to vote for interest rate hikes sooner rather than later. By doing it in January you are coinciding with base effects, ie the VAT hike a year ago, so you have minimised the impact on inflation, so the timing is quite good.

Mr Chote: If you are concerned about double-dip in the short-term it does bring some spending forward from next year into this year but that depends on where you are worried about the double-dip.

Mr Whiting: There is also a benefit for the lower income people with the increase in child tax credits. I was slightly surprised that the Chancellor did not explicitly make the point that the increase in child tax credits, which is above inflation, is not some sort of compensation for the VAT increase because, again along with the personal allowance increase, it is obviously geared at the lower paid and is some compensation for the general reduction in the tax credits. Coming back to Mr Umunna's point, there are already some quite significant reductions in tax credits around. VAT is an efficient tax and it is at least a tax we know and quite easy to collect—

Q129 John Thurso: If you looked at a balanced comment on it, it is not that fair but it is not screamingly unfair and taken in the round with everything else it all comes out in the wash. That seems to be what you are saying.

Mr Whiting: If you want to raise the money from somewhere it is at least known. It is in line with European rates. Our rate will still be relatively modest but, as people have said, it does highlight even more the differentials between 20% and the 5% or 0% rates. There are arguments that it gives a boost to the hidden economy rather than anything else because it increases that incentive. As the Low Incomes Tax Reform Group has said, it exposes many of the anomalies around things like the disabled welfare bits where there are some very odd boundary issues between what is taxed and what is not.

Chair: Andy Love, you wanted to ask one quick question.

Q130 Mr Love: It is one question in two parts. I want to ask the economists amongst the panel whether they accept that lower growth than forecast will increase the proportion of the Budget deficit that we could call structural?

Mr Chote: It is not so much lower growth but lower potential growth. The main reason why the hole in the public finances looks a bit bigger than it did in Alistair Darling's final Budget is the fact that the OBR has taken a more pessimistic view of the future path of trend GDP, ie how far the economy can grow to get back to a Goldilocks state. If there is less scope for it to grow then there is less scope for the deficit to come down automatically so more of it looks structural.

Q131 Mr Love: I am talking where trend growth stays the same. If growth going forward is lower does that increase the structural deficit? I am not getting much response from our economists.

Mr Barrell: If we look at the structural deficit at this point in time or in 2011 if fiscal policy has slowed growth, which it probably has, that has not changed the structural deficit. If growth which in the long run will be driven by the trend rate of growth in the economy is slower then again the structural deficit may look bigger. Judging the structural deficit now, which is much more important than going forward, we have to make the judgment on how much this crisis has caused the scar to output. There are different estimates of the structural deficit at the minute that range from 10% to 0% of GDP depending on how much we think the crisis has caused a permanent loss of output and a temporary loss of one. There are delicate judgments to be made. Slower growth next year does not change the structural deficit. Slower growth over the medium term with no change in spending plans would worsen the structural deficit.

Q132 Mr Love: I should have known that. Let me pose what I was trying to get at. If trend growth stays the same then growth going forward reduces and the structural deficit increases. On the basis that we have got to wipe out that structural deficit within a fixed timescale, does that then force us into a straitjacket of tax increases or cuts in expenditure? That is the question. What is the answer? Mr Bootle is being very coy about responding to this.

Mr Chote: The fact you have a target for what you want to do, the structural part of the current Budget balance is not affected by how strong actual growth is over that period, so the contrast will be with the previous government which had a target for the actual level of the deficit in 2013–14, as I recall, which did have the odd characteristic that despite its espousal of Keynesian policy if you took it literally and you had weaker growth and the cyclical component and the deficit was higher you would have had to cut spending or increase taxes to do that. This is less perversely anti-Keynesian than the rule that was in the Fiscal Responsibility Act.

Chair: I am going to bring this session to an end for the time being and you can pursue it informally. We have got another group of witnesses about to come

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before us. Thank you very much all five of you for coming in. I hope this will not be the last time that we have the opportunity to hear what you have to

say. What you have said will no doubt be reflected in our report on the Budget which is going to be produced as soon as possible. Thank you very much.

Witnesses: **Mr Dave Ramsden**, Chief Economic Adviser, **Mr Andrew Hudson**, Managing Director, Public Services Growth and **Mr Edward Troup**, Managing Director, Budget, Tax and Welfare, HM Treasury officials, gave evidence.

Q133 Chair: Thank you very much for coming in. We do not have very much time. It is all rather curtailed compared to previous years. We would like to finish as near as possible to 12.30 although we might run on just a little. I would like to begin by asking you, Mr Ramsden, what measures, if any, in this Budget enhance the supply side of the economy and overall trend growth?

Mr Ramsden: Thank you for that question. I will not go through the usual introductions for the shorthand writer.

Q134 Chair: I have never understood the purpose of those. Maybe I will be told off but they have always seemed a waste of time to me since your names are up in front of you.

Mr Ramsden: So long as you know what we do that is fine. To answer your first question, the OBR has made an assumption that there will be no impact of the Budget on trend output. It sets that out in its chapter of the Budget document. This was something we thought about quite seriously, as you would expect us to, in advising the Chancellor on the Budget measures, whether it be on the tax side with Edward or the spending side with Andrew. There was some discussion of this in the document. The reductions in the main rate of corporation tax over a sustained period will have potential implications for the supply side. The increase in VAT, moving VAT to 20%, will contribute to rebalancing the economy, and you see that indeed in the OBR's forecast. Whilst the OBR's assumption is that there is no impact, overall this is an assumption. I think this is an area that over the months ahead requires a lot more work from within the Treasury and with the OBR as they become more established to assess both the individual impacts of these measures and the overall impact on the UK economy. As you are probably aware, the OBR has made the decision to revise down the estimates of trend growth compared with the estimates that were decided on by the previous government, so it is 2.35% out to the medium term and then I think it comes down further in the final year for demographic reasons. That is quite a significant revision down. As policy is implemented and as the economy evolves that is a judgment that the OBR will want to return to and it is also a judgment that the Treasury as an economics ministry will want to do more work on.

Q135 Chair: Do you agree with Robert Chote's conclusion that the NICs changes are complex and may be too complicated to offer best value for money?

Mr Ramsden: If I may I will ask Edward, who led on those measures, to answer that question.

Mr Troup: I was interested in Mr Chote's comments. Inevitably any measure which attempts to target has a degree of complexity about it. Although we have not published the details of these they are going to be designed in a light-touch way, it is going to be fairly straightforward, effectively self-certification, and it is going to operate quite simply by new businesses not having to pay the NICs for their first 10 employees for the first year. It is not as straightforward as a simple NICs cut but I think it will work quite smoothly.

Q136 Chair: Do you think it is going to have any supply side impact?

Mr Troup: What is clear and if you look at what is said in the Budget is that it is going to encourage new businesses. It is £5,000. Talking in the billions that we normally talk about here it is easy to regard anything less than a few million as insignificant but for small new businesses it is a significant amount of money. We do hear from businesses going from the stage of being the self-employed individual to taking on employees that the burden of PAYE and NICs is a significant threshold, so we do expect businesses to be encouraged and respond.

Q137 Chair: Is this more than a gesture then?

Mr Troup: Definitely so.

Q138 Chair: Robert Chote is wrong on that as well?

Mr Troup: I am not quite sure what the word "gesture" means. It is certainly something which gives effect to a commitment made in the coalition agreement and in the manifesto and it will benefit 400,000 businesses and about 800,000 employees.

Q139 Andrea Leadsom: I just wanted to ask a particular question about that. I have met a number of small business people who say that this measure will simply encourage them to keep recycling their business to take advantage of it. What consideration have you given to the unintended consequences of this type of gaming?

Mr Troup: I am afraid my excellent colleagues in HMRC are on to that one. There will be provisions in the legislation to stop simply recycling, so stopping your business, packing up for a week and then pretending you have got a new business. I cannot say there will not be any avoidance because unfortunately there seems to be avoidance of absolutely every tax there is, but I think we are fairly confident that it will go to the businesses who are genuinely new businesses and this will not be

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something where people spend their time closing down their businesses and reopening them to get the benefit.

Q140 Chair: For those of us who have been on the circuit a while it sounds like another case of triumph of hope over experience if I may say so.

Mr Troup: I look forward to sitting here in a year or two's time and seeing how it has gone.

Q141 Mr Love: Mr Ramsden, the OBR has made some heroic forecasts about improvements in net trade. What work is the Department doing to help that process to rebalance the economy? I am thinking here in particular about improving exports to those areas of the world economy where perhaps we are not as well represented as we should be.

Mr Ramsden: Just on the OBR, it is worth stressing that what underlies all the OBR's forecasts is its commitment to transparency. I have been working on forecasting in the Treasury and the economy for 20 years and I think the OBR has made more progress on transparency in the last eight weeks than in my experience of 20 years working on forecasting and the transparency that goes with it. They have set out very clearly their assumptions and their judgments on the forecast and on the degree of rebalancing that they judge there will be. If you compare it with the last forecast that I was responsible for, the March Budget forecast, where I was responsible for advising the Chancellor on the decisions he made on that forecast, there was quite a lot of rebalancing already in that forecast. I remember we had discussions then and it is good to be back to have discussions with you again now. All forecasters when looking at the big picture of what is going on in the global economy are very conscious of the fact that the UK experienced a very significant depreciation in sterling through to the beginning of last year, 2009. Sterling has been more stable since then. Also, the kind of big trends in the world economy, which the UK is very open and exposed to, has been a fact that in the recovery phase since this time last year it is the emerging markets that have been growing more strongly than the developed world. Obviously the UK has a trade pattern which is very significantly determined by history. For example, that means one of our biggest trading partners is Ireland given our very close links with Ireland over centuries. It is a feature of the UK economy, which was something I was quite struck by when I was analysing the data, that in terms of shares of trade our share of trade with the rapidly growing and emerging economies, the BRICs—Brazil, Russia, India and China—is about 5% or 6% whereas it is about three times that with the euro periphery economies. I have mentioned Ireland but we also have strong trade links with others. That share with the emerging market economies has grown very significantly in recent years. I think it has doubled compared with 2000 when it was 2.5% and it is now just over 5%. Government policy is very much focused on looking for the opportunities, and this is something that the Treasury as an economics ministry is very focused on thinking about, how can

we encourage stronger growth both in terms of macro policy settings but also whether there are any micro policy interventions.

Q142 Mr Love: Do you accept that you need to do more? You mentioned the previous work that was done under the last government at the beginning of the year, but since that time the economy in the United States, if I can put it this way, seems to have tailed off and there have been some quite negative figures emerging recently in terms of employment and other factors. Of course we have also had the emergence of the debt crisis in most of the southern European countries and the widespread austerity programmes that have been introduced, particularly in Ireland if I may say so. Does that lead you to question the assumptions on which the OBR have delivered their figures? Is there anything we can do with those other Third World, BRIC countries that you were talking about that could give us an opportunity to at least improve our export performance?

Mr Ramsden: On your point about the OBR's forecast, I am very comfortable with the forecast and that was why I was making the point about the last Budget forecast I was responsible for, a forecast that does assume a significant rebalancing. I think that is the experience of the UK. For example, in the 1990s it took time to come through after the very significant depreciation of sterling that we saw after the UK left the ERM but net trade started to make a significant positive contribution and made a marginally positive one in 1993 and a significantly positive one in 1994. As Geoffrey Dicks was saying to you this morning, it can take time for these effects to come through for the supply side, for the rebalancing to respond to the signals in terms of price. I have no issues at all with the OBR's assumptions and they have been very clear about the uncertainties around their forecast. Just on the policy point, if I may, the Foreign Secretary stressed very recently how we saw the UK's diplomatic effort very much through an economic prism and that is something the Treasury would strongly support. That explains our engagement in the G20.

Chair: We have to move on in a moment because we have a lot of people who want to come in on this section.

Q143 Mr Love: Just a final question. I would have to say that is not the first speech by a Foreign Secretary to highlight the need for the economy to be central to our operations in other countries. Are there any discussions ongoing about the fiscal consolidation occurring worldwide and whether or not that is in the best interests of growth in the world economy?

Mr Ramsden: It is very clear that the world economy needs to rebalance. If you look at G20 communications from June in South Korea and other communications there is a recognition by international policymakers, including in the UK, that countries with serious fiscal challenges have to go through a serious fiscal consolidation. That applies to Ireland and it applies to the UK, but it is also a recognition that does not apply to all

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economies. The IMF has done analysis that shows if the world economy can go through this adjustment and can rebalance it can reach a higher growth path. I think that would be very positive for the UK. You were asking are there doubts that we are going to see this export performance. This is something that we monitor, as we have been doing, from one month to the next and one year to the next. Experience in the UK shows that it takes time for the volumes to adjust, but they do adjust and the UK has adjusted in the past and moved on to a stronger export trajectory.

Q144 John Thurso: I was going to ask you whether you thought the OBR was an irritating imposition but you have clearly fallen in love with it because they have done in eight weeks what you could not do in 20 years. Are they really that good?

Mr Ramsden: You have to go back to the principles underlying effective fiscal policymaking and quite a few people in this Committee past and present, and also a lot of commentators, have put an emphasis on transparency. It is also mentioned when you look in the context of countries that have had problems with sovereign debt or you look at the banking areas where concerns are raised. Often it comes back to transparency. The overriding commitment of the OBR to transparency is a hugely powerful force for good. It is something that successive governments did make some incremental progress on, but I remember this Committee putting me through the wringer because I was not able to give you figures of AME forecasts beyond 2010–11 that you knew were available. Also in the early 1990s when I was working for a different government there were issues around the transparency of the forecasts. This is an issue that has been going on for 20 years. This is a step change in transparency. I am a strong champion of it and certainly do not see it as an imposition. It has changed my job but we all have to deal with change.

Q145 John Thurso: What I want to ask you about is their suggestion that business investment will be a positive component of growth and particularly their statement that they expect it to be between 8% and 11%. When I was asking them about growth basically they said there were not particular factors it was just the application of the formulae. Surely there need to be some factors. What is in this Budget that will actually help increase business investment by those levels?

Mr Ramsden: Just look at what is in the economic environment that once there is less uncertainty and once confidence returns will help business investment. We have very, very low interest rates both at the short end and the long end which businesses can borrow at. As I think you heard earlier, large businesses have rebuilt their cash positions and they are in a good position financially. I must stress that this is not to underplay the significance of the issues for small businesses, which I am very conscious about, but it tends to be larger businesses that contribute to the macro aggregates of business investment that the OBR is forecasting.

There is a supportive economic environment with the surveys suggesting that quite a lot of investment is being held back because of lack of confidence about the future. That is not surprising when you think of the crisis that the UK and world economies have been through. It was a crisis of confidence through the winter of 2008 and early 2009 and businesses have been affected by that. When you look against that kind of backdrop and those kinds of drivers in 1995 UK business investment grew by 7.8%, in 1996 by 10.4% and in 1997 by 10%. You get significant growth rates in business investment for a number of years because after a shock like we have had, and which the economy saw to a lesser extent in the early 1990s, there is a need to rebuild the capital stock, there is a need to invest and if the environment is there to do it with low cost of capital it can do it. Also the Budget on top of that with the certainty it provided about the business investment regime over the whole period of this Parliament and four years of cuts in the main rate of corporation tax. One thing we get back very strongly from businesses when we discuss with them is that they want stability and certainty in this kind of regime. I think that the corporation tax reforms are strategic, have given them that certainty and macro conditions stay supportive. The OBR's business investment forecasts could well be borne out. They look to me like a fair best estimate.

Q146 John Thurso: One of the risks to that must be if you look at the Coalition Government's programme a lot of it is around investment in green technologies, renewable energy and so forth, and a great many of those are still at the stage that requires quite substantial government commitment or investment to actually get them going. To what extent is investment of that kind, and it is quite a big chunk of growth, at risk from the current programme of cuts, or is there government spending that must be preserved in order to achieve that growth?

Mr Ramsden: At the macro level the Government has committed itself on public sector net investment very much to maintaining the levels that were assumed by the previous government, so as a share of GDP. Obviously the issue will be when it comes to the Spending Review going through individual public spending. We have made clear that economic returns will be a key driver. I do not know if Andrew wants to come in on more detail on that and Edward might want to say something more about the environment.

John Thurso: We are a little short of time unless it is very small.

Q147 Chair: If you have something you want to add could you put it on a piece of paper and come back.

Mr Hudson: Very briefly, Chairman, I would add that the creation of Infrastructure UK as a body—which looks at infrastructure needs—and is spending quite a bit of time on the issues you are talking about is looking not just at public sector

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investment but how to leverage and how best to work with the private sector on all this, adds to our effort in this area.

Chair: We have seven people wanting to chip in and rather less than half an hour.

Q148 John Mann: What are the significant differences in assumptions that you have made in setting the Budget and the OBR has made?

Mr Ramsden: This may help you and the Committee, Mr Mann. One thing which is clear, and which surprised a number of commentators when the Government announced the setting up of the OBR, is that the OBR is responsible for the official forecast and all the judgments that go into that forecast. I think a lot of people expected that the OBR might have more of a monitoring role of Treasury forecasts, but there are not two forecasts or two sets of assumptions about the forecasts, there is one official forecast. I think this is why the OBR has been so widely welcomed internationally because it is quite a radical departure.

Q149 John Mann: So there are no differences?

Mr Ramsden: Sorry, I am conscious of time. I just wanted you to understand that because I was at a Commission seminar last week and there was some misunderstanding of that. When it comes to the detailed assumptions that go into policy costings the OBR have set out in their chapter of the Budget that they have been able to certify the Treasury's policy costings. A whole process was run under my and Edward's teams whereby we would say to the OBR this was what we had assumed were going to be the economic and other impacts of policies and the OBR had to decide as part of factoring those into their forecasts whether they were comfortable with those. The outcome of this was they said in their document that they had certified them. I do not know if Edward can throw more light on the detail.

Mr Troup: Only to say that if you have not had a chance to look at the policy costings document, picking up on one of Dave's previous points, this is very much about the transparency of what we have done and what Dave has described in terms of the way the costings themselves are drawn and that is set out very clearly.

Q150 John Mann: I have read them. I am asking are there any significant differences in assumptions?

Mr Ramsden: Given that the OBR has certified all our analysis on the detailed policy costings and given that the OBR is responsible for all the key assumptions that go into the forecasts, I am not aware of any. We can go through every single moving part in the Budget, of which there are a lot. All I can tell you is I am not aware of any.

Q151 John Mann: How many public sector jobs over this Parliament are going to be net lost and how many private sector jobs net created?

Mr Ramsden: The OBR published forecasts for total employment at the time of the Budget.

Q152 John Mann: I am asking you as the Chief Economist to the Treasury.

Mr Ramsden: I am the Chief Economist to the Treasury but I am no longer responsible for forecasting. I can elucidate on what the OBR's judgments and forecasts are if that would be helpful.

Q153 John Mann: So you do not have a view then of how many new public sector jobs there are going to be or how many new private sector jobs?

Mr Ramsden: I had a responsibility for advising the Chancellor on this up until the new Government, but now what I have is responsibility for my analysts, just as Andrew does for his analysts, who help the OBR reach their judgments.

Q154 John Mann: Let me make it easier. You collect income tax. Are the OBR's assumptions in relation to the income tax take accurate? Is that how much income tax you project will be coming in to the Exchequer?

Mr Ramsden: They are now the official forecasts for income tax.

Q155 John Mann: Yes, but do you agree with them?

Mr Ramsden: They have very similar drivers to them as in the last forecasts I was responsible for for the March Budget. They assume, for example, an element of fiscal drag because earnings tend to go up more quickly than inflation so they will have, I imagine, a rising profile for the income tax to GDP ratio and also because of the measures that have been introduced. I have not got the numbers in front of me but I would imagine that is what they show.

Q156 John Mann: Does the Treasury agree with those forecasts on income tax take that you are taking in as the Exchequer?

Mr Ramsden: The Treasury very much agrees with them because the Chancellor has said that he is using them as his official forecasts.

Q157 John Mann: So this is what we can expect to come in?

Mr Ramsden: These are the forecasts which are the basis for the Budget judgments and the Budget policy decisions.

Q158 John Mann: That is what we can expect to come in?

Mr Ramsden: Yes.

Q159 John Mann: What are the average earnings in the public sector and private sector at the moment, approximately?

Mr Ramsden: If you will let me look at some data I can tell you. If you will not I will have to guess.

Q160 John Mann: As a reasonably accurate guess.

Mr Ramsden: I am just getting the statistics that came out last month. Average earnings at the moment, total pay including bonuses, in the whole economy 4.2% and excluding bonuses 1.9%. Private sector was 1.2% and public sector excluding

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financial institutions, for obvious reasons, was 2.7%. That may be just for the month of April so they may not be comparable with the previous numbers.

Q161 John Mann: Average public sector earnings are higher than average private sector across the economy and in most regions.

Mr Ramsden: If you take out bonuses.

Q162 John Mann: There are bigger regional disparities in some regions. The new private sector jobs that are created, how many are going to be migrant workers?

Mr Ramsden: The OBR produces a macroeconomic forecast and it has produced a huge amount of detail to underpin that including, for the first time last Wednesday, details of—

Q163 John Mann: I am asking you, not the OBR. I am interested in how much you as the Exchequer are getting in income tax.

Mr Ramsden: If I can find the table of income tax I can tell you what we are forecasting to get for income tax and that is the forecast.

Q164 John Mann: 145 billion this year up to 199 billion in 2014–15.

Mr Ramsden: 195.2 billion. Table C11.

John Mann: What I am asking is—

Chair: John, this will have to be your last question.

Q165 John Mann: I am trying to get an answer and I have not got one yet. How many of these new jobs are going to be migrant workers?

Mr Ramsden: When I was doing the forecast and when the OBR is now doing the forecast, a macro level forecast, you would never have a detailed forecast within there of gross flows in and out of the labour force and how many were migrant workers. As you may know, we always run our forecasts off stylised projections on migration which are produced by the ONS. We had one when we produced forecasts up until the March Budget and the OBR has one for now. We do not have detail in our macro forecasts. However, I am very confident that as part of the Spending Review the implications of population projections and changes in the composition of the population will be one of the economic factors that will be taken into account.

John Mann: This is about income tax that you are responsible for.

Q166 Chair: Come back to us in writing if you have more you want to say on this subject, but I do not think you do.

Mr Ramsden: I am very comfortable to be responsible for the macro level income tax forecast which has framed the Government's fiscal policy decisions.

Q167 David Rutley: I just wanted to come on to an issue that I know Jesse raised in the earlier session and I raised with Sir Alan Budd, and that is the 80/

20 rule of thumb which is a vital part of the philosophy and the direction of the Budget. Why do you believe that is the optimal ratio?

Mr Ramsden: One should not get over precise about these things. What is clear from the empirical evidence of successful fiscal consolidations in the past, and when I say successful I mean consolidations that both achieve sustainable public finances and also growth, is that those more successful fiscal consolidations have had a proportion which is a much higher proportion of the consolidation that is spending than tax. In some of the literature it is 80/20, but if it is 75/25 or 80/20 the big picture is that you want a high proportion of it to be spending reductions because typically tax driven consolidations, depending on the choice of tax instrument, the empirical literature, the experience of other countries, shows that it tends to not be growth enhancing. We set out in the Budget document what were the previous government's plans in terms of our assumptions about those and then the current Government's plans and for the current Government the ratio gets up to 80/20 by the end of the consolidation period because although the tax measures are quite early on in the consolidation, particularly the increase in VAT, spending builds up over time in a phased way with spending reductions.

Q168 David Rutley: So why is that ratio more relevant now than when we were working on these issues in the 1990s?

Mr Ramsden: A lot of the literature relates to consolidations in the 1990s. The Scandinavian countries did their consolidation in the 1990s. The empirical literature by people like Alesina and others draws on that experience as well as drawing on the UK in the 1990s where on those criteria of achieving fiscal sustainability and also seeing significant growth outcomes, because there was a strong recovery through the 1990s, the UK would also have been a feature of that analysis.

Q169 Mark Garnier: Can I turn to borrowing now and obviously we have a requirement to continue to borrow through the gilt market. There is a huge amount of emphasis that is put on credit rating agencies and obviously in the past they have had a somewhat chequered track record. Those people who invested in Iceland, for example, will obviously have a dubious view on what they have to say. Given their flawed business models and bad record, why do you put so much emphasis on the credit ratings themselves?

Mr Ramsden: As I have said to this Committee before, the credit rating agencies tend overall to follow rather than lead the markets. In the vast majority of cases a rating agency action will reflect what the markets have already concluded. However, where I think rating agencies can be useful, along with international organisations, is in the surveillance that they provide on an economy. For example, when we were looking at the UK's profile for debt interest payments we took seriously when Moody's said that debt interest payments as a

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percentage of receipts risked going above 10% as a share into the territory where your AAA rating might be at risk. I personally found that a useful metric. For me, the fact that under the current Budget that metric peaks at something around 9% suggests that we have moved to a more sustainable fiscal position where debt interest payments are less of a share of the economy or of receipts. Different rating agencies have different approaches. Standard and Poors, who made some commentary on the UK yesterday, analysed what they thought were the gross costs of our financial interventions last May when they put us on negative outlook and they concluded that the gross fiscal costs might be in the region of £100 billion to £140 billion. That was one of the factors that added to their gross debt ratio forecast going up to 100%. Personally I thought that was a less useful piece of analysis because our analysis was that the fiscal cost of financial interventions was going to be much lower than that. I have discussed these issues with both Standard and Poors and Moody's, so I think they can make a contribution in terms of their analysis, but overall their rating actions in most cases follow developments which are already in the markets. When you look at the UK now we have got 10 year bond yields down at 3.35% and they have come down significantly through this year. That has been recognised in Moody's and Fitch's and to some extent Standard and Poors' reactions to our numbers.

Q170 Mark Garnier: That is quite a fascinating thing to say because the whole point about the rating agencies is to predict what the problems are going to be rather than assess them in retrospect. That is the tail wagging the dog at this point. The other point which the markets are going to be looking at, and this is incredibly important going forward depending on what is going to happen to gilt yields, is whether the proposed Budget cuts are going to be implemented in a strong way or in the way they have been suggested in the Budget. If that does not happen then the likelihood is that the markets are going to turn round and start charging a greater amount for UK debt and so as we are issuing more debt it is going to cost us more and more. Can you comment on that?

Mr Ramsden: My experience is that the markets do tend to judge governments on their actions rather than on their words. I think the markets have responded. If you look at the differential over German Bunds, the UK gilts differential over Bunds, it has narrowed since the March Budget. In a sense we have moved towards one of the benchmark economies which is seen in the AAA space as being very, very strong. As long as the policies that have been announced are implemented, whether that is the increase in VAT or the announcements that will be in the Spending Review on 20 October, that keep us on that consolidation path I would expect the markets would take that into account, but what they do not like, and Greece last year is relevant on lack of transparency. Greece had to revise its numbers for 2009 four times in-year and that can really affect your credibility. Similarly, a lack of follow-through,

having said you are going to do something on policy and not doing it, usually undermines your credibility.

Mr Hudson: I would just add on the spending side that the £6.2 billion of in-year savings which were implemented very early in the life of the Government were an example of the sort of action that Dave Ramsden has been talking about saying that this will take place and then following through in very short order to announce and implement it.

Q171 Stewart Hosie: Can I move on to the bank levy. It is not a one-off cost to banks, it is part of a package of costs they have or burdens they bear, if you like, additional capital requirements, paid for external lending insurance, paid for intra-banking insurance and some of the banks are contributing to the Asset Protection Scheme. Is it sensible to take an extra 2.5 billion a year from the banks in the form of this levy just now when we are looking to get economic growth and lending is a driver to that?

Mr Ramsden: I will make a macro point and then hand over to Edward. I think for any government you have to balance the different risks and a key lesson from the crisis is the need to find a way of curbing the potentially very strong pro-cyclicality of the financial sector. The kind of levy and the way it has been designed does contribute. All policy is about risk management, whether it is macro or micro, and that is a specific policy intervention which will contribute. You mentioned a lot of other factors that are in the landscape and that comes back to a point about the OBR's forecasts, if you like. The OBR is forecasting what is a pretty modest recovery by historical standards. As the Budget document highlights, coming out of this recession there is a lot of indebtedness about still and there is a lot of adjustment that has to be gone through, a lot of rebalancing, including in the financial sector. That is why in the OBR's forecasts you are not seeing any growth rates of 3%, which is typically what you see in UK recoveries.

Q172 Stewart Hosie: I agree with you in terms of the dangers of pro-cyclicality, I absolutely agree, but we have the potential of the EBA Stability Fund and the European Consumer Protection Fund in addition to the levy and in addition to the other insurances. Does there come a time in terms of banking when we are doing so much to protect and mitigate against risk that really we are beginning to squeeze the potential for all of this cash to underpin lending?

Mr Ramsden: I think we have to see how these various things that you are talking about both domestically and internationally are implemented both in terms of the tax regime and also the regulatory regime.

Mr Troup: I really echo Dave's point about balance. First of all, we do think that so far as the banks are concerned this is affordable. It is set broadly at £2.5 billion a year. As you will have seen, this is broadly being used to fund the corporation tax package which itself has, as Dave has explained, positive effects on investment through lowering the cost of capital to businesses. There is a balance here. The

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other thing to note about the bank levy is because it is based on short-term funding it is hopefully going to encourage the banks to move to a less risky funding profile. There are a number of things which have been balanced out.

Q173 Stewart Hosie: I understand that. The reason I have gone down this route of questioning is because it is not just about banks, it is about the financial sector generally. When you add into that mix Solvency II for the insurance sector and in this Budget the addition of the insurance premium tax, I am trying to get an understanding from the Treasury as to when enough would be enough and the draws on capital would be so great that they would have to ease up in that counter-cyclical manner. I just wonder if you could comment on the whole package and where we might end up. When will enough be enough in that regard?

Mr Ramsden: What I can comment on is that the crisis has revealed just how many risks were latent in banking, in shadow banking and in the financial system more generally as the excellent work of this Committee in this past has drawn attention to. What the Budget set out is a set of measures which, along with measures which are not the responsibility directly of the Treasury, are a kind of coherent approach to managing these risks in a way which will get us a steady recovery but also over time we will have to remain very vigilant to this risk. One thing we have not talked about today is the announcement the Chancellor made in the Mansion House speech as to the new environment for thinking about some of these risks, macro prudential and beyond. That is all going to have to be put in place and implemented led by the Bank but working with the Treasury and with the FSA in the years to come.

Q174 Michael Fallon: Mr Troup, if we can turn to capital gains tax. In reforming capital gains tax why did you choose to penalise people who were in employee share ownership schemes by excluding them from the entrepreneurial relief regime?

Mr Troup: I do not think I would describe it as penalising.

Q175 Michael Fallon: The tax has gone up.

Mr Troup: The tax has gone up from 18% to 28% for higher-rate taxpayers in employee schemes as for all capital gains holders. This was part of the package to arrive at a simple, straightforward capital gains tax system which imposed a sensible and fair rate across the piece with some relief, as you know, for entrepreneurs through the entrepreneurial relief.

Q176 Michael Fallon: These are people who cannot control when they realise their assets. They cannot sell at a time to reduce their CGT liability. Did you not consider the position of employee share ownership?

Mr Troup: We did consider the position. As you will have been aware from the debate in the public, consideration was given to a wide range of rates from 40/50% down to a lower rate. If we had settled on a 40% or 50% capital gains tax rate I think the

point about employee share schemes would probably have been more of a factor. As it was, at 28% there was no need to make a specific exemption for employee share schemes.

Q177 Michael Fallon: So they have got to take the hit. What would have been the cost of including them in the entrepreneurial relief regime?

Mr Troup: I do not have a figure for that, but if we had sought to include them in the entrepreneurial relief it would have made the definitions considerably more difficult and would also have given rise to a significant amount of forestalling because we would not have been able to introduce that straightaway. The advantage of using the existing relief is that we are able to piggyback straight on to the same definition and introduce the changes immediately.

Q178 Michael Fallon: Given that they cannot control when they sell their assets how could they have forestalled the tax increase?

Mr Troup: Probably fairly limited, but that is where we have got to.

Q179 Michael Fallon: Can you let me have a note of the amount?

Mr Troup: Can I just be clear what you would like a note of.

Q180 Michael Fallon: I asked you about the cost. Had they been included what would the cost have been? Just on the National Insurance Contribution, I think you described a system of self-certification. If a business does split or somebody leaves a particular small business and sets up next door, his or her employees are then free for the whole of the next period. Have you measured the anti-competitive effect of that?

Mr Troup: Sorry, can you describe the facts again?

Q181 Michael Fallon: If you are running a print shop or a wine bar, whatever it is, in one of these particular areas and you happen to fire one of your senior colleagues, he is then able to set up completely next door and have all his employees free for the next period.

Mr Troup: He does not get his employees for free, he has to pay for the employees. He will have to pay income tax and other costs.

Q182 Michael Fallon: But he gets a subsidy.

Mr Troup: He gets a subsidy for a new business, yes, and it would be a genuinely new business and it is right that it should apply to him. I do not think we could go back and look and say, "Actually you were in the business next door" if it is a genuinely new business. The point I made earlier was we have got to be very careful to avoid just straightforward recycling where the same person sets up, but there is no reason why if someone leaves a business and sets up a new enterprise they should not benefit.

Q183 Michael Fallon: You do not see this as anti-competitive?

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Mr Troup: I certainly do not agree with the comment the Chairman made that this was a gesture. You have to recognise that £5,000 is a significant amount for a small business but it is unlikely to determine the viability of a given business except in the most extreme cases.

Q184 Mr Umunna: One of the things that we have not really touched on is the raft of changes to housing benefit in the Budget. One thing that caught my eye was the provision that said that if you have been on JSA for more than a year you would see a 10% cut in your housing benefit. If you have done everything that you need to do to comply with the JSA requirement for finding a job, what is the rationale for applying what can only be described as a pretty inhumane sanction with this 10% cut?

Mr Troup: The first thing to say is this particular feature of the housing benefit reforms is about sharpening work incentives and that is about creating greater incentives to get out and find a job. To describe it as “pretty inhumane” is quite strong because—

Q185 Mr Umunna: Let me put it this way: Mr Troup, have you ever been on housing benefit? Have you ever lived on housing benefit?

Mr Troup: No, I have not.

Q186 Mr Umunna: I accept what you are saying, we want people to try and find work, but if somebody in my constituency, or any constituency, is doing absolutely everything they can to find work but for whatever reason, and there are many cases where I live, are unable to find work, what is the justification for applying this sanction if they have done everything? They are making their best effort to find a job.

Mr Troup: I think it goes to the wider question of what is the right package of support for those people who are out of work and how long should that support continue. It goes to the point that the cost of housing benefit has increased by 50% over the last 10 years and there is a need to impose some degree of control over it. I think it goes to the point that even at the end of these reforms, and we recognise that there are some quite difficult aspects of these reforms, we are still going to see in real terms housing benefit running at the same level that it was in 2008–09.

Q187 Mr Umunna: So this is actually less to do with incentivising people who have been out of work and are struggling to find work after 12 months and more about reducing the housing benefit bill?

Mr Troup: The housing benefit package is about making housing benefit more affordable to make sure that those people who do need support for their housing are not significantly advantaged compared to their working peers. It is about trying to do the reforms in ways which actually sharpen work incentives and are fairer to everybody.

Q188 Mr Umunna: Mr Troup, let me just repeat my question. This is more to do with reducing the housing benefit bill than it is about incentivising people to find work when looking at people who are doing absolutely everything they can do already to find work.

Mr Troup: No, this specific element is more about work incentives. The package as a whole is quite clearly trying to make sure that—

Q189 Mr Umunna: I am not talking about the package as a whole, I am looking at this particular measure. What I do not understand is how reducing housing benefit by 10% for people in my constituency who have been struggling to find work for more than 12 months is going to incentivise them when they are doing absolutely everything they can already.

Mr Troup: I am not sure what I can say in response to that point. I can give you some facts about the number of vacancies that exist and that there are jobs available.

Q190 Mr Umunna: You do not buy any story which says that people who are out of work for more than 12 months are actually doing a hell of a lot already to try and find work and because of economic circumstances or whatever their personal circumstances may be it is all about them?

Mr Troup: I do accept there are people who try extremely hard to find work and I do accept that individually there are some difficult cases but overall this will improve work incentives, this will encourage people to get back to work and it will ultimately ensure that the savings on the housing benefit bill and the package of welfare reforms, of which this is part, are encouraging people to take responsibility to get jobs and make sure the housing benefit costs themselves are not significantly advantaging people who are on housing benefit compared to their working peers.

Chair: We have two very quick questions. The first one is from Jesse Norman.

Jesse Norman: I should disclose that I am Chair of the All-Party Parliamentary Group on Employee Ownership so I would like to associate myself very much with Michael Fallon’s comments on ESOPs. I think that was a bad decision by the Treasury. I would like to ask that in future work there will be some scope for including a geographic analysis alongside the income based analysis of the distributional effects you have. But my question is actually about long-term growth. Obviously the key part of that is productivity, and what is so staggering about UK productivity is just how bad it has been in many ways over the last 15 years, at a time when we were supposed to be enjoying an extraordinary economic boom and then a bust. What is interesting about productivity is that it has not been as bad in other countries, for example in the US. One cannot help thinking that part of this is because of the way in which resources are being expended across the economy. I just wonder if you have got any comments on that or whether there is anything that

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the Treasury specifically is looking to do now to assist the process of rebuilding what is an absolutely foundational block?

Chair: I think we need a question.

Q191 Jesse Norman: The question is what are you doing? I note how low the OBR's current prediction of long-term growth is.

Mr Ramsden: I must admit I do not fully recognise your description of UK productivity developments up until the crisis because I think most international comparisons show that there was some convergence of UK productivity towards our peers. That is not to say, and this is recognised by the current Government just as it was by the previous government, there are not significant challenges to raising UK productivity. Where I think your question is going is how does that play into this kind of assessment of degree of rebalancing that we did. This is something that the Committee were interested in back in March, how much were the productivity improvements that we saw sustainable or how much did they rely on high productivity sectors such as the financial sector which the crisis showed was carrying a lot of latent risks even if that was not apparent in the headline data. What I was trying to stress at the outset, and what is very much an organising way of thinking for the Treasury with the Budget but also thinking about the UK economy over the next five to 10 years, is how do we go through this adjustment to this rebalanced economy in a way that can strengthen long-term growth. There are macro and micro elements to this. You want to be able to build up your adaptability as an economy. Because of policies going back 25 years under successive governments the UK is very flexible, is very adaptable, but has not always combined that with high productivity. How do you build up resilience? We have seen under this crisis the UK was hit quite hard because of our reliance on the financial sector. We want to carry on having a very strong financial sector, it is very important to the UK economy, it is a global comparative advantage sector for us, but we need to build resilience. There is a really important agenda around both micro policy interventions that might stop growth being held back, but also at the macro level what is the structure of your economy, can it adapt through time, is it resilient to shock so that it can move to a higher long-term growth path. Where we are at the moment is the OBR assumption which is that we are on a pretty muted growth path compared to what we have seen in the last decade or so. I think the challenge for policy is through the implementation

of the Spending Review, other policy interventions, what we do on the financial sector more generally, can we move to a higher potential growth path.

Q192 Chair: Thank you very much. I have got one last question. Earlier you said, almost it seemed with a sense of relief, that part of your previous responsibility had now passed to the OBR, that is the task of drawing up forecasts, which had been a central task of the Chief Economic Adviser. Does this mean that your post with its diminished responsibility will carry a lower grade and a lower salary?

Mr Ramsden: We will have to see what the reviews are like on today's hearing, I suspect. Seriously—

Q193 Chair: I was asking a serious question.

Mr Ramsden: I know you were.

Chair: We are looking for savings right across the public sector.

Q194 Mr Love: Sacrifice!

Mr Ramsden: The Treasury, like the whole of the public sector, is going to go through a very significant adjustment in the coming period. The Treasury is going to shrink in terms of the number of staff to meet the kind of administrative savings that Andrew with his policy hat on will ask of the Treasury. My responsibilities have changed. All the issues that we have been talking about today relate to the Treasury as a finance and economics ministry, so what the Treasury is actually engaged in at the moment is a contribution to deciding what will be the Spending Review outcome for us, a review of all of our functions, taking stock of the lessons that we learnt through the crisis. If you recall, the Treasury pre-crisis was about 1,100. We had taken on tax policy responsibility as a result of the O'Donnell review and we had taken on a lot more resources through the crisis, some of which we definitely should have had before the crisis, so as well as shrinking we will have to think about what things the Treasury should be doing.

Q195 Chair: You have not had pay increases for all this extra work you have had over the last three years?

Mr Ramsden: We have got frozen pay this year. It is going to be a challenging time. We are all going to have to be adaptable, like the UK economy is going to have to be adaptable.

Chair: Thank you very much for your evidence today. Apologies to the two people flanking you, Mr Ramsden, that you did not get in quite as much airtime as you might otherwise have done. It has been very helpful. Thank you very much.

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Members present

Mr Andrew Tyrie, in the Chair

Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love

John Mann
Jesse Norman
David Rutley
John Thurso
Mr Chuka Umunna

Witnesses: **Rt Hon George Osborne MP**, Chancellor of the Exchequer, **Sir Nicholas Macpherson**, Permanent Secretary and **Mr Mark Bowman**, Budget and Tax, HM Treasury, gave evidence.

Q196 Chair: Chancellor, thank you very much for coming. You have brought Mark Bowman and the Permanent Secretary, Sir Nicholas, along as well. This is our first opportunity to cross-examine the Chancellor. As I say, we are grateful to you for coming along. I would like to get straight into the questions. We are intending to run this until 12.20, if that is agreeable to you, so that you have time to get away to business of the House this afternoon. I would like to ask you about the fairness agenda aspect to the Budget. In constructing this why were you content to allow your measures to hit the bottom 10% harder than most of the rest of the income scale, apart from the top 20%?

Mr Osborne: My overall objective, of course, was to create a set of measures that were broadly progressive. The challenge when you are doing fiscal consolidation is that there is inevitably a focus of public expenditure, like welfare spending, towards lower deciles. I did everything I could to mitigate the impact of that by increasing, for example, the child tax credit. The bottom 10% of incomes includes groups of people such as students who have irregular income patterns so the figures for the bottom 10% are somewhat distorted.

Q197 Chair: Are you saying they are dodgy and we cannot rely on them?

Mr Osborne: No, I am just saying that in any income distribution in the bottom 10% there are always going to be categories of people who have low incomes but, for example, relatively high expenditure. That is why among the tables we produced we also produced the impact of the changes in indirect taxes on incomes as assessed by expenditure.

Q198 Chair: Chancellor, there is a group here between 16,900 net income and 38,400, that is the middle seven deciles, they are paying proportionately less than the bottom decile. Is that fair?

Mr Osborne: First of all I would make a broader point which is the thing that is most unfair to the lowest paid in our society and the most vulnerable in our society is when a country loses control of its public finances. The whole purpose of the Budget is to get back control of the public finances. It has been a point made by politicians across the political spectrum in Britain over the last 15 years that a loss

of control of the public finances impacts those at the lowest end highest. I have sought to mitigate the impact of that by taking specific measures. Obviously certain measures that I was able to take, for example increasing the income tax thresholds for people on the basic rate, do not impact on the bottom 10% because these tend to be people who are not paying direct taxes. That is why deciles two, three, four, five and so on benefit from the income tax changes.

Q199 Chair: The point that I am making, Chancellor, and I am very grateful to you for publishing chart A2 and that is a great step forward, is the fact is that on the basis of your own data you are forcing the poorest decile to take the strain more than the middle seven deciles and the whole of the middle income band in Britain. That does not strike me as fair. That strikes me as unfair. Does it not to you? These are people in work with reasonably good jobs, many of them, and they are finding they are taking less of the strain than the bottom decile, than the poorest, who you said you were going to protect.

Mr Osborne: As I say, Chairman, the bottom 10% includes categories of people who have low incomes but would not necessarily be regarded generally as the poorest in our society, such as students who have relatively high expenditure but low incomes and, therefore, they feature in that bottom decile and the impact of the indirect taxes is clearly relatively high on them because of their propensity to spend more. That is why we have included another table over the page. If you break the population up by expenditure distribution you can see that the impact of indirect taxes is very clearly progressive and the lowest decile pay the lowest.

Q200 Chair: Is it not also the case that table A2 excludes a lot of things that are going on in the Budget, such as cuts in housing benefit, cuts in disability living allowance and in-year changes to tax credits? All of those will also hit lower income groups hardest will they not, Chancellor, and therefore does not chart A2 understate the impact on the poorest?

Mr Osborne: It does not include a number of things, I accept that, for example measures to freeze the council tax, measures on the pensions tax, which hit people at the top end of the income distribution. There are a number of measures not included. What

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we have sought to do, and this is the first time any Chancellor has ever published a table like this, is to the best of our ability use the measures that can be modelled most effectively across the income distribution to produce this table. I accept it does not include every measure but there are measures, as I say, that affect people right at the top end of the income distribution that I have not included as well. Of course, there might have been a political temptation for me to do so in order to advance my argument but I resisted that temptation.

Q201 Chair: I hope you agree it would be helpful, although it would be difficult and I agree it is not an easy piece of work to do, if you could come back to us with that chart amended as best you can with a number of assumptions to take account of the effects of HB, disability living allowance, tax credits and any other area that you think needs to be taken account of so we can get a more considered view about what the impact of these measures really is. Would you be prepared to do that? At the same time would you be prepared to tell us what proportion of the bottom decile—not now but in writing—are students in that category where you said that bottom decile was a distorted figure?

Mr Osborne: Of course I am very happy to consider these things. I would make the observation that I did consider them in quite some detail before the publication of the Budget. Mr Bowman has drawn my attention to the evidence that Mr Chote gave to your Committee in which he said: “It is very difficult to allocate to specific households the impact of things like cuts to housing benefit, disability living allowance and in-year changes to tax credits”. Our approach has been almost identical to the approach of the Institute for Fiscal Studies. Really what I have been seeking to do anyway is get the Government to a place where it is publishing the kind of information which is available the very next day for the Institute of Fiscal Studies. This was already considered but I am very happy to consider it again.

Q202 Chair: Thank you. Is that a commitment to have another go at sending us another table, Chancellor?

Mr Osborne: I am making a commitment to consider again whether it is possible to allocate to specific households some of the benefit changes and, indeed, what the impact of—

Q203 Chair: Consideration is something short of a commitment.

Mr Osborne: I do not want to commit to something which it may not be possible to do.

Q204 Chair: Okay. If it is not possible you can write to us and explain why. I have in front of me Mr Chote’s evidence, the evidence you have just referred to. He goes on to say as a matter of fact that the measures taking all of these facts into account are regressive, not progressive as you suggested in your evidence just now and as you have said repeatedly.

Mr Osborne: Mr Chote—

Q205 Chair: In fact, he emphasised. I said, “Just to clarify, are they regressive?” and he replied, “Regressive, that is right”.

Mr Osborne: There is a difference of opinion here. I have included things that I am going to ask the House of Commons to vote on, so I have not unreasonably made the assumption that as Chancellor the things I am going to ask the House of Commons to legislate on are the things that I am responsible for and if you take those as a collective package it is progressive across the income distribution.

Q206 Chair: Could I ask you briefly about the row over the OBR. Do you agree with Sir Alan Budd that the Prime Minister’s use of these employment statistics at Prime Minister’s Questions was inappropriate?

Mr Osborne: I am not exactly clear that Alan Budd put it like that.

Q207 Chair: I have got what he said in front of me here if you want me to read it out. Anyway, do carry on.

Mr Osborne: The point I would make is that the Prime Minister was, like everyone else that day, reading out the information produced by the Office for Budget Responsibility and, of course, subsequently they produced further information this week. I do not think you can fault the Prime Minister for reading out published statistics.

Q208 Chair: When did he get them?

Mr Osborne: He received them when they were published, when they were made public.

Q209 Chair: Did you or the Treasury have any contact with Number 10 about these statistics since we now know they were in the Treasury five days earlier?

Mr Osborne: First of all, on Friday I was aware that the OBR wanted to publish these numbers. I made absolutely clear to my officials that it was up to the OBR to publish what they wanted to publish and up to the OBR to determine the timing of the publication. I note that, again, Sir Alan in his evidence to you absolutely refutes any suggestion that there was any pressure put on him over the publication of these numbers. I might further add that the very idea that a government publishes these numbers is in itself pretty revolutionary. These numbers existed for the previous government but are not publishable unless members of the previous administration would like them to be published. No pressure was put on him, it was entirely his decision when to publish them. Once we were aware of Sir Alan Budd’s decision of course we informed Number 10 that there was going to be information coming out.

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Q210 Chair: Did the Prime Minister have that information beforehand? Had you briefed him of it or had the Treasury briefed him of it, or had officials briefed Number 10 of it?

Mr Osborne: To my recollection he did not have the information as published until it was published.

Q211 Chair: Did he have the substance of that information in order to prepare for Prime Minister's Questions?

Mr Osborne: He was aware once the OBR had made their decision that they were going to be releasing this data that they were going to be releasing this data. At the time there was a lot of speculation, I remember, because of the leak of inaccurate Treasury material.

Q212 Chair: The reason I ask these questions is this has thrown into question the independence of the OBR which has been drawn into what has been perceived to be a party political dispute at a time when perhaps you should have been bolstering its credibility.

Mr Osborne: Can I just say something about that? First of all, of course it is a matter of regret to me that anyone has questioned the independence of the Office for Budget Responsibility. The evidence that Sir Alan gave to this Committee I hope goes some way to putting to rest the conspiracy theories that some people have wanted to cook up in this area. If one takes a step back and asks oneself is it likely that a government would want this kind of information to be produced for its own political benefit the answer is no, we are doing this in the interests of transparency and there is a reason why the previous government kept this information secret. For me, the whole purpose of creating the Office for Budget Responsibility has been to give confidence in the statistics produced by the Government and for the Office for Budget Responsibility to have complete independence about what numbers it publishes and when it publishes them. My purpose now is to put this on a statutory footing. I do not know if it is appropriate for me to say something about my thoughts in this direction, or would you like me to do that later?

Q213 Chair: It would be helpful if you put that in writing, Chancellor, because we are taking evidence on that subject next week.

Mr Osborne: There is one time sensitive issue which I would just like to draw to the Committee's attention which is that tomorrow we will be advertising for a permanent head of the Office for Budget Responsibility, and indeed from now the job application will go up on the Treasury's website and will appear in *The Economist* magazine tomorrow and we hope to have applications by the middle of August. What I would propose to do, of course subject to your approval, is to give this Select Committee a veto on the person nominated by the Chancellor of the day. I think this will be the first time that any select committee has ever had a veto on an appointment. Obviously it is entirely up to you whether you will want to take up that offer, and if

you deem it appropriate it will be put in the statute which I propose to present to Parliament later this autumn because I want there to be absolutely no doubt that this is an independent body, that this person has the support and approval of the Treasury Select Committee in undertaking that work, that they come here to give evidence. I also agree with Sir Alan's recommendations that the Office, now it is going to be put on a permanent footing, moves out of the Treasury—it was simply not possible to do that in the first couple of weeks of a new government—and has a core secretariat that enables it to question any figure put to it by the Treasury.

Q214 Chair: That is a very helpful announcement and we will consider it carefully. I would expect my Committee to treat it favourably.

Mr Osborne: I would be rather disappointed if you did not.

Chair: We will do our best, Chancellor.

Q215 Mr Love: You have just ruined the first three questions I was about to ask you!

Mr Osborne: You can ask them anyway!

Q216 Mr Love: Chancellor, are you a gambler? On Tuesday the OBR confirmed that it was more likely rather than less likely that your Budget would cause a double-dip recession. Do you acknowledge that you are taking an enormous risk with the British economy?

Mr Osborne: No, I do not acknowledge that. I would say I am reducing the risk faced by the British economy. When I became Chancellor of the Exchequer the country had the highest budget deficit in the G20, the second highest in the European Union after Ireland, the credit rating agencies of the world had raised serious questions about Britain's credit rating and our market interest rates were similar to those of Spain. In the last eight or nine weeks there has been a general view around the world that Britain has taken decisive action to deal with its budget deficit. Of course, some people are now waiting to see whether these measures actually take effect, and it is perfectly reasonable for people to ask that question but the fact that we passed the VAT measure through Parliament this week is a strong sign that we can deliver on this. I think it is worth drawing the Committee's attention to what has happened to market interest rates for the United Kingdom since the March Budget. Ours have fallen by half a per cent and Spain's have increased by half a per cent. That is a very significant monetary stimulus to the economy and also has helped to deal with the tail risk which the OBR draws everyone's attention to in its report but says it is not possible to put in its growth forecast.

Q217 Mr Love: There has been a great deal of concern that you are going too far and too fast, especially since you are trying to rebalance the economy from the public sector to the private sector. Do you accept those concerns? Are you not worried that the private sector will not take up the challenge as quickly as necessary?

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Mr Osborne: The first point I make, Mr Love, is that the growth forecast that I have published, the OBR's growth forecast, is significantly less optimistic than the one produced in the March Budget. The OBR is forecasting a sustained and stable recovery. It is forecasting a rebalancing of this economy away from the public sector more towards the private sector and I think that is very necessary when the public sector is currently consuming almost half of national income. We also want to create over the longer term an economy that is not so dependent on household debt, overleveraged banks, over indebted government, but where we invest more and we export more, and I think that is going to be a more stable economic model for this country going forward.

Q218 Mr Love: I do not think anyone is arguing against the need to rebalance the economy for the private sector to take up, I think the question is the heroic assumptions that the OBR are making first of all about the increase in net exports but also about the increase in business investment. It would seem that as the economy and certainly the international environment in which we are operating gets more and more gloomy by the day it gets harder and harder to deliver on these assumptions.

Mr Osborne: As I say, first of all I think we have reflected the economic realities of the world better, and indeed the economic realities of the UK better in the growth forecast that this new Government has published rather than the 3¼% growth that the previous government was forecasting. Indeed, there have been some issues raised today about whether that was indeed the previous Chancellor's forecast at all. Second, on investment and exports, and these are the OBR's forecasts so ultimately it is for them to justify them—my responsibility is to make sure that I believe they are a credible and appropriate basis upon which to base a Budget, and I believe they are—the export growth is in fact forecast to be less than was the case coming out of the previous recession in the early 1990s and the investment growth was certainly exceeded in some of the middle years of the last decade. It is also the case that plenty of companies in the UK, and this is a good thing, have built up strong reserves on their balance sheet, so I think there could be some domestically driven export growth.

Q219 Mr Love: Let me probe into that a little. Recent figures from the United States' economy, one of our biggest trading partners, have become more gloomy and employment and various other issues show the American economy appears to be slowing down at the present time. We all know and have talked at great length about the difficulties in the euro economy and the devaluation of the pound that we hoped would lead to increased exports may not be as great as once assumed. Are you not concerned not just that we will not get the increase in exports but more importantly, perhaps, that we will not get the increase in exports in time for the very strict Budget that you have imposed today?

Mr Osborne: I would say that the biggest external factor out there has been concern about sovereign debt sustainability. Again, I am very conscious that the United Kingdom has the second largest budget deficit in the EU and that when I go with the Prime Minister to the G20 we represent a country with the largest budget deficit around the table. The Budget has gone quite a long way to reassuring people that we are serious about dealing with this very large budget deficit and I think that has been reflected in the market interest rates that the United Kingdom and, more to the point, United Kingdom businesses enjoy. It has always been my view that monetary stimulus is the most powerful tool available to stimulating growth. It is striking, and I am sorry to repeat myself, that the interest rates for UK businesses are a full 1% lower than they are for Spanish businesses and that was not the case at the time of the March Budget. There is a stimulating effect that is driven by confidence that the UK is able to deal with its fiscal problems.

Q220 Mr Love: Will that be quick enough is the real question that we are asking. Let us take the issue of fiscal consolidation. We have seen fiscal consolidation not just in those countries where it is absolutely necessary in southern Europe but we have also seen it in Germany, one of our major trading partners. Is there not a real danger that these combined fiscal consolidations will lead to a slump in demand that will inevitably lead to slowing in growth worldwide and there will be an impact on the United Kingdom? In those circumstances, should that happen, do you have a Plan B?

Mr Osborne: The first thing I would say is that surplus countries, of course, can do more to contribute to global demand and we welcome the decision that China has made on its currency. To be fair to Germany, particularly given the long history of that country and its concern for its fiscal sustainability, they have a relatively moderate pace of fiscal consolidation. Ours is broadly similar for the first few years to the pace of consolidation being undertaken in the United States. I would say that there are other potential stimulating forces out there in the world that we could draw on. For example, further progress on a trade deal would be enormously helpful. I come back to what is the biggest risk sitting out there at the moment and it is the sovereign debt risk, a concern that people previously had about the liquidity and solvency of banks transferred to a concern about some of the countries that stand behind those banks. In the United Kingdom we have taken the measures necessary to reassure people that we can deal with these problems. I would also draw people's attention, indeed it was on the radio this morning talking to the Secretary General of the OECD, who has that broader picture that looks at all the different countries, Mr Gurría was making the point that the response in different countries is different and the growth forecast for the UK produced by the OBR is pretty consistent with the forecast produced by the IMF, the European Union and various others for the UK, which was not the case when I came into office,

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there was quite a considerable difference between the growth forecast which the Treasury was adhering to and the one that most people thought was appropriate for the UK.

Q221 Mr Love: But you do not have a Plan B?

Mr Osborne: The plan is to have confidence in the British economy and its ability to pay its way in the world. Of course, if you look at the fiscal mandate that I have set it is based on an assessment of the structural deficit to allow automatic stabilisers to operate. I have also built a degree of caution into the fiscal mandate by seeking to achieve it a year earlier. I was absolutely clear, and indeed this was the external advice I was receiving as well and the British public were receiving from the Governor of the Bank, that the first and most pressing issue to deal with was to produce a credible plan for the budget deficit. I would also draw the Committee's attention to the fact that the measures I announced are staggered over three or four years. I think people have assumed they all come into effect in July 2010 and of course they do not, the VAT rise is next year and some of the welfare measures take effect in 2012 and 2013, so it is also a plan not just for this year but a plan for this Parliament.

Q222 John Thurso: I want to follow on from Andy Love's question regarding investment and growth, but can I first ask you a more parochial question. The Red Book on page 26 at paragraph 122 contains the welcome news that the Government are going to look at a fuel duty discount, which you may recall I have been pressing for nine years. My question is what confidence can I have that the same officials who had been advising the last government that was not possible for nine years will now advise you it is possible?

Mr Osborne: I think the confidence could perhaps stem from the fact that my Chief Secretary represents a seat, and I do not know whether it neighbours yours—

Q223 John Thurso: Nearly.

Mr Osborne: —which is a very large rural seat in Scotland and so also has his own particular interests in this direction to make sure that the work is properly carried through and there is a proper analysis of the options.

Q224 John Thurso: Can I urge that that happen quickly because with the VAT increase of 2.6p per litre, which will come through as a result of VAT and we are already paying a premium, this measure is about the only thing that can alleviate that.

Mr Osborne: We absolutely take this commitment seriously. It was mentioned in the coalition agreement and it is mentioned here in the Red Book. We will return, no doubt, to this Committee to explain our decision.

Q225 John Thurso: Coming back to the Budget, history will judge the success or failure of this Budget on whether or not the growth comes in from the private sector which has already been touched on.

What measures are there in the Budget that will bring about that increase in the private sector and what measures in other departments that will aid growth in the private sector?

Mr Osborne: There are a whole series of measures which for perfectly understandable reasons did not get the same amount of public attention as some of the measures designed to reduce the deficit. There are a whole string of measures. For example, there is a reduction in the headline rate of corporation tax from 28 pence to 24 pence, a penny a year across the Parliament. There is a reduction in the small companies' tax rate that was set to increase under the plans I inherited and I am reducing it to 20 pence. There is an innovative proposal, which I freely admit has not been tried before by government but we hope it works and will see if it works, and that is to have regional National Insurance rebates for new businesses created in parts of the country outside the south-east and eastern area. There are a series of measures. Alongside those we are publishing a paper on credit conditions later this month. The Green Investment Bank is a very important tool for stimulating investment in a low carbon economy. My colleague, Jeremy Hunt, is looking at increasing the broadband capacity of the United Kingdom. There is a whole suite of policies designed to stimulate investment and send a sign that Britain is open for business. That headline reduction of corporation tax, which would give us the fifth lowest corporation tax rate in the G20 and maintain our position as having the lowest rate in the G7 as other countries reduce theirs, which would not have been the case if we had stood still, those things have been noticed and picked up around the world and I hope they encourage investment into this country.

Q226 John Thurso: In his evidence to us on Tuesday Mr Dicks made the point that 80% of investment will come from 20% of companies—the other 80% of companies, of course, being largely SMEs—yet any study of lasting growth suggests that it is the SMEs that need to grow and invest. Ultimately the projections for net investment, private sector investment, are based on the mathematical application of the formula by the economists, which is that if you take it away from the public side the resource will go to the private side. My concern is that we need the SMEs to grow and that will only happen with affirmative action through BIS. Have we really got sufficient resource available to BIS to make that happen?

Mr Osborne: We have taken the measures on the small companies' tax rate, which I think were helpful. As I have already said, we have taken measures to say to any new business setting up outside the greater south-east of England that the first 10 jobs they create will have up to £5,000 less National Insurance paid on them. We are taking some measures through the tax system but my and your colleague, Vince Cable, is also working on further supply side reforms, for example on the regulatory burden, that will precisely encourage the small business sector. I certainly agree with the premise of your question which is that a strong and

vibrant and innovative and growing small business sector is a very important part of the economic model we want to create for the future. Whilst it is the case that the largest companies are going to undertake the largest investment projects for employment and the stability of the economy going forward, we also want a vibrant entrepreneurial small business sector.

Q227 Andrea Leadsom: Chancellor, just following on from what John has been asking you, capital gains tax is obviously an optional tax in that people can take steps to avoid it by not selling or whatever. Since we do need a recovery primarily in the SME sector in order to rebuild our economy, CGT is now completely changed again and businesses are saying to me that they desperately need clarity, security of tenure and certainty for the future. These are long-term investment decisions. Could you talk to us a bit about how you came to the conclusion that 28% was the right rate? Secondly, is this now going to be a permanent feature or is there going to be some sort of review and, if so, when and what will trigger that?

Mr Osborne: I certainly regard it as permanent as any tax change a Chancellor can make. I am not planning to revisit this decision in this Parliament. I faced a situation when I took office that the capital gains tax regime was being abused, that the 18% rate that I inherited was so much lower than income tax rates of 40% or 50% that a multitude of schemes had been created and were being created to shift income that there was a hole in the tax system that needed to be plugged. I also felt, as indeed did other members of the Government, for reasons of equity an 18% capital gains tax rate was quite difficult to justify when we were going to be asking from other parts of the population, other parts of the income distribution, for people to make a contribution to closing the deficit that it was appropriate to look to increase capital gains. I then faced a series of options which were do I completely redesign the system, do I try and introduce indexation, do I try and introduce the taper again, and I took the view for precisely the reasons you talk of in order to give a greater sense of stability to take the existing system and make some changes to the rates. For example, of course, the 18% rate for higher rate taxpayers went up to 28% and I kept the 18% rate for basic rate taxpayers, and that is about half the people who pay CGT. I also increased the entrepreneurial allowance to £5 million which, in answer to Mr Thurso's questions, encourages entrepreneurial activity, and I kept the annual allowance. I kept the shape of the regime but I changed the rates and I thought that was the best approach to the problem that I inherited.

Q228 Andrea Leadsom: Do you feel that it will be necessary to measure the impact on new entrepreneurial activity because clearly that is a disincentive to some people in their consideration about where to take their business and so on? There have been a lot of representations that 28% is already a big disincentive to do just what we are trying to achieve.

Mr Osborne: The first point I make is that the entrepreneurial relief is a very considerable one, so it is only people who are going to be making more than £5 million of lifetime gains in creating a business who would face the 28% rate whereas, for example, someone selling a second home will now face the 28% rate. After all, it was 24% just a couple of years ago so I do not think there will be many people whose fundamental life planning would have been thrown entirely off course by this. I accept it is a tax increase and no one likes a tax increase. With the higher entrepreneurial relief I have taken into account the concerns that you have expressed.

Q229 Andrea Leadsom: What about short-term gains? Surely there would have been an argument to introduce a 12 month or even longer rate similar to the marginal tax rate for the individual?

Mr Osborne: I looked at a taper and, of course, the last but one Chancellor of the Exchequer introduced a taper and, to be frank, it was abused. From memory, but I am happy to correct this if I have got this wrong, around 80% of the tax ended up being paid at the taper because people just rolled forward their gains. Of course the policy objective of stopping people shifting their income in the short-term is a good one. When I actually looked at the practicalities of reintroducing the taper, which the previous government had introduced and then abolished, it struck me as (a) introducing a degree of complexity which was unnecessary and (b) not likely to achieve the policy objective which you express.

Q230 Andrea Leadsom: Thank you. Would the Committee be able to see the work that supported the decision to stick at a 28% capital gains tax rate? You said in your Budget speech that was the magic figure at which revenues were maximised. Would it be possible to see that research?

Mr Osborne: I can certainly provide the Committee with a note and also in greater detail my explanation for why I decided not to proceed with indexation allowances or with taper.

Q231 Andrea Leadsom: Very quickly coming on to bank credit, which again is another area that is incredibly important to SMEs and the area where credit is not getting through, could you tell us quickly what more can you do to encourage bank lending to SMEs specifically? Secondly, would you be considering doing something with the state-owned, currently taxpayer-owned banks to force through better credit for SMEs?

Mr Osborne: You are absolutely right that this is a very considerable concern, not just in this country but in a number of Western democracies at the moment. I do not think there is a silver bullet. I do not think there is one thing we can do that is going to suddenly ease up credit conditions. There are a number of measures we can take and I will be setting these out in more detail and other proposals we have in this Green Paper. First of all there are government schemes that can be expanded. In the Budget I expanded the Enterprise Finance Guarantee Scheme by £200 million that is targeted at small businesses

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who cannot get access to credit. Second, and I know the Select Committee is going to be looking more broadly at the structure of UK banking, we want to encourage more competition in the UK banking sector which was consolidated and has become a hell of a lot more consolidated as a result of the last two years. I welcome new entrants provided they are appropriate for a banking licence. I think we should be encouraging new entrants. I have said that when we come to dispose of the government shares in the Royal Bank of Scotland and Lloyds that we should have broader considerations, and I think this is a point that the Chairman of the Select Committee has made as well, and that is why I have established the Independent Banking Commission, which is also looking at competition issues in the sector. The final point I make is that the regulatory uncertainty at an international level about the kind of capital, liquidity and leverage requirements that the G20 and the Financial Stability Board are going to ask about is not helping matters, which is why the UK has worked very hard in the G20 to say, "Let's tell the world what these requirements are going to be this autumn" even though there is quite a long transition to those requirements so that banks have no excuse for hoarding capital.

Q232 Andrea Leadsom: How important is global coordination of changes to bank regulation?

Mr Osborne: I think it is incredibly important to avoid regulatory arbitrage. In other words, people moving banks to different jurisdictions to try and avoid these capital requirements which I regard as the most important but also the liquidity and leverage requirements. Having made a decision in the G20 last year to produce these things what we have tried to do at the G20 meetings I have attended in South Korea and in Canada is get a move on, get an agreement at the Seoul Summit for what they should be and then have an appropriate transition but understanding that you cannot expect everyone to meet those requirements overnight.

Andrea Leadsom: Thank you.

Q233 David Rutley: Unemployment is one of the key areas of focus in the Budget and what we can do to create jobs. Sir Nicholas, I am keen to understand what is the basis for your confidence in achieving the growth in employment that has been set out in the coalition plans.

Sir Nicholas Macpherson: I think it has been set out in the Budget document and by the OBR. The economy is now recovering and employment, as the figures released yesterday confirmed, is rising and the conditions look pretty good for the labour market. There are good grounds for confidence.

Q234 David Rutley: If you start looking at the figures in more detail, and maybe the Chancellor can comment on this as well, and you look at the shape of it you will see that the growth in employment is very much focused on part-time jobs. If I am not mistaken the number of part-time workers who would like a full-time job has now increased by 39% in Q4. What confidence can we have from the

proposals that have been set out in the Budget that are going to address that so that we have long lasting, enduring and sustainable jobs that are created?

Mr Osborne: I will allow Sir Nicholas to comment. By the way, to the day it is the 25th anniversary of his arrival in the Treasury so we should congratulate the Permanent Secretary.

Q235 David Rutley: I remember working with him!

Mr Osborne: He has seen quite a lot of things. A feature of any recession is that people move on to part-time work and partly that is a reflection of labour market flexibility. Of course, coming out of recession into recovery you want people who are working part-time who want to be able to work full-time, and of course there are people who want to stay working part-time, to have the opportunity to do that. One of the measures which I have not mentioned so far, but essentially one of the largest items that we had in the budget, is an increase in the employers' National Insurance threshold by £21 which will make it cheaper to employ people earning less than £20,000 than it is today and, indeed, cheaper across the income spectrum compared to the plans that I inherited from the previous government. We are making it easier for employers to take people on and reducing the burdens on employment and as we come out of recession into recovery we want to see people who want to move into full-time work. Again, the Office for Budget Responsibility does forecast falling unemployment from 8% to 6% over the period, which is a welcome forecast.

Sir Nicholas Macpherson: I think one of the really striking things looking back over the last 25 years is how under successive governments the labour market has become more flexible and with each passing recession the speed of adjustment in the labour market has increased. As I say, that reflects measures under successive governments.

Q236 David Rutley: I suppose the challenge now is one of the segments of the employment market that has been most hard-hit through the recession into this fragile recovery is the young men and women in the country. As you have had a chance to reflect since the Budget took place, and having viewed the comments from various external commentators, are there any other steps that you think should be taken to tackle the particular issue of youth unemployment?

Mr Osborne: Yes, I do, Mr Rutley. The big policy change here is a more effective welfare system. My colleagues in the Department for Work and Pensions are working on the Work Programme which we believe will provide more effective help than existing schemes have to help in particular young people get into sustainable jobs, in other words not to find themselves constantly recycled through government training programmes and possibly hold work for 13 weeks only to drop back into unemployment in the 14th or 15th week. Using the plan that was originally developed by Lord Freud for the previous government, but not implemented, and being less theological about the division between DEL and

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AME, and by increasing the diversity of providers for Welfare to Work schemes and increasing the incentives on them, I think we will have better targeted and more effective support for younger people who are currently unemployed. You are quite right to draw everyone's attention to them because we have one of the highest youth unemployment rates in Europe.

Q237 David Rutley: Just picking them more strategically and building on some of the comments from other colleagues about what we can do on the supply side and focusing on the open for business element of the Budget, one of the elements of your speech was about what we can do to build on the proposals from James Dyson. Clearly as we think about the long-term strategic aims of our competitiveness we have got to get into the higher tech end of the spectrum and focus on the knowledge base. Again, can you give any further details about what is going to happen and what links are going to be going on with BIS to make this agenda really come alive?

Mr Osborne: James Dyson's specific proposals are now under examination within the Government and in particular his ideas around the research and development tax credit and how to make that more focused on smaller and medium-sized business and the higher end of the value chain. The Green Investment Bank and the broadband changes we are working on will help as well. I think we also have to go out and sell ourselves a bit more. The Prime Minister is leading a large delegation to India, an incredibly important export market for the future, in order to try and kick-start a better trade relationship with India. I think it is a striking fact about the British economy that we export more to Ireland than we do to Brazil, India, China and Russia put together. There is certainly scope as the world grows and these emerging economies become larger and become nations of consumers for British exports to those markets.

Q238 David Rutley: I think there is more to be done and one of the fundamental barriers to our success as a country is looking at what is going on with the labour market, particularly new entrants coming in from schools, from university. You are probably aware with AstraZeneca having major facilities in both of our constituencies that the biggest concern they have got is getting bright young talent that is interested in science and engineering and it is just not there. Too many of our children are focusing on wanting to be celebrities and footballers, but when you go to China they find that people want to do science and engineering, that is their love. Have we really got the policies in place under the coalition to make that happen?

Mr Osborne: Well, Mr Rutley, you are the Member of Parliament for Wayne Rooney so you need to be a little bit careful about slagging off footballers!

Q239 David Rutley: I was not slagging off footballers, I was talking about aspiration, Chancellor.

Mr Osborne: Lots of people aspire to be a successful England footballer, including potentially the England football team! You make a very good point about how we need to invest. I think it is accepted across all political parties that we need to be more aggressive about promoting certain parts of the economy and certain skills in the economy, and so on. If I could be allowed a one minute general observation. I think born out of the industrial failure of the 1970s came a view that we could be entirely neutral about the structure of the British economy and this was initially a Conservative Government view, it was embraced by the previous Labour Government wholeheartedly, and now there is a recognition that we cannot be entirely neutral, that we want an economy that is based on more investment and exports and where we move up the value chain. Particular industries like the pharmaceutical industry, which employs very large numbers of people in both our constituencies, is an important strategic industry for the UK, so we are not necessarily picking one company but we are understanding that sector is important and there is a whole set of things you can do around the tax treatment of intellectual property, the physical infrastructure of the country and access to markets, and so on, and export promotion that would help that industry. Let us be frank, when the chief exec of Goldman Sachs used to turn up in this country he would go and see the Chancellor of the Exchequer within 24 hours of arriving in the country, whoever was the Chancellor, but the head of a big pharmaceutical company would turn up and they would go and see the junior health minister who did not necessarily have the same economic clout in the government. I am trying to change that and understand that there are big sectors, like pharmaceuticals, aerospace, creative industries, which are really important for this country where we already have a comparative advantage, so we are not starting from scratch, which we should be seeking to promote without doling out large sums of money and getting back to some of those mistakes that were made in the past, but nevertheless taking the appropriate tax and regulatory changes that can help support those sectors.

Q240 John Mann: Chancellor, over this Parliament with your assumptions on the economy what is going to be the net increase in the numbers of people working in the private sector?

Mr Osborne: The Office for Budget Responsibility forecast, I think, a 1.6 million increase in private sector employment. Net of changes to the public sector that is a 1.1 million increase. That is their forecast.

Q241 John Mann: 1.6 million net increase in the private sector?

Mr Osborne: Yes.

Q242 John Mann: People working in the private sector.

Mr Osborne: Yes.

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Q243 John Mann: What is the net reduction in the numbers of people in this Parliament who will be working in the public sector on your assumptions?

Mr Osborne: The Office for Budget Responsibility forecast is half a million.

Q244 John Mann: You agreed with those in terms of the assumptions you have made within this Budget?

Mr Osborne: Those are macro assumptions and, of course, the Spending Review is still to happen. Tomorrow I am going to be receiving the first tranche of submissions from the government departments and it is clear there are measures we can take that can mitigate job losses. For example, the Office for Budget Responsibility have found that the two year pay freeze that I have proposed for the public sector for those earning more than £21,000 is the equivalent of 70,000 jobs. I think there is going to be a set of decisions for us as a country that will need to be taken this autumn.

Q245 John Mann: The Chartered Institute for Personnel and Development's economist, John Philpott, is estimating that the job losses annually from increased productivity in the private sector will be about half a million a year. What is your assumption in terms of job losses from productivity within this Parliament?

Mr Osborne: I rest on the overall forecast. I am not going to disaggregate.

Q246 John Mann: No, you do not because you have built in increases in productivity in terms of your income tax take, particularly in the latter end 2013–14.

Mr Osborne: And earnings growth across both. I think this was the subject of some questioning earlier on in the week.

Q247 John Mann: As your officials said two days ago, earnings growth is more than double projected inflation so productivity growth is significant. What is the assumption on the reduction in jobs that you have built into your estimate through productivity growth?

Mr Osborne: If that figure is available I am very happy to write to you.

Q248 John Mann: So you do not know?

Sir Nicholas Macpherson: Obviously it is the OBR who forecast these things, but in a dynamic labour market productivity increases generally are a resource of growth in employment over time.

Q249 John Mann: Let me ask the Chancellor something the OBR has not got a view on and that is the half a million job losses. The average earnings of those people you have an estimate on and the new 1.6 million jobs, they are new jobs in the private sector, are going to be relatively low paid jobs. What is the gap per person on the income tax take that you have assumed between the loss in the public sector job and the new private sector job?

Mr Osborne: I do not think we have made that assumption because I think you are misunderstanding the forecasts. The forecasts are macro forecasts and the income tax receipts were not disaggregated between the private sector and the public sector.

Q250 John Mann: So you have not built that into your income take forecast?

Mr Osborne: The income tax forecast, as has been the case in previous Budgets although, of course, they were done internally to the Treasury, are based on overall assumptions about earnings growth in the economy, not trying to disaggregate between the public and private sectors.

Q251 John Mann: So nowhere within the projections on income tax take and other tax take, but income tax take in particular, have you built in any assumption on the average earnings of the public sector job that goes and the average earnings of the new private sector job that is created?

Mr Osborne: Ultimately the forecast questions should be directed at the independent Office for Budget Responsibility, which is the whole point of creating one.

Q252 John Mann: You are the one who is forecasting income tax take. It is your job.

Mr Osborne: The point I would make is that the income tax forecast is based, as it has always been, on an assumption about earnings growth across the whole economy.

Q253 John Mann: You have not done that. That makes your figures on income tax take less credible then. I will not ask if you agree.

Mr Osborne: Less credible than whose—

Q254 John Mann: If they are not made—

Mr Osborne:—since they are done on the same basis that they have always been done?

Q255 John Mann: You are presuming in the past people have not reduced large numbers of higher paid public sector jobs. You are presuming that private sector jobs will be the same earnings as public sector jobs.

Mr Osborne: The March Budget, produced by my predecessor, had built into it an assumption of a very substantial reduction of public sector jobs. There is a big difference: he did not publish it and I have.

Q256 John Mann: I am asking you about your Budget.

Mr Osborne: Indeed. The only reason you are able to ask me these questions is because we made these statistics public.

Q257 John Mann: No, the reason I am able to ask you questions is because—

Mr Osborne: You are trying to say that somehow what I have done is not comparable with previous Chancellors. The previous Chancellor had an assumption for public sector job losses that was—

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Q258 John Mann: Let me ask you another question and see if you can answer this. What is going to be the net migration into this country in the five years in terms of new jobs?

Mr Osborne: The Office for Budget Responsibility is using the current ONS estimate, which I think is 140,000, for net migration into the country annually.

Q259 John Mann: So a 700,000 net increase?

Mr Osborne: Obviously government measures taken by this new Government to try and restrict the flow of economic migration will have an impact on that number.

Q260 John Mann: You have used demographics as a key base of your budget assumptions and on the ONS statistics, and I have studied them in some detail, if you take the base population net of any migration changes there is no increase in the working population over this Parliament. You are assuming 700,000 net new migrants working in the British economy, which is pretty much the same as under the 13 years of the last government, in your assumptions?

Mr Osborne: I think it is perfectly reasonable, unless one wants to turn the Office for Budget Responsibility into the entire Office for National Statistics, that instead of it going off and making its own immigration forecasts it relies on the immigration forecasts produced by the Office for National Statistics. Of course, this Government, unlike the previous government, has a plan to put a cap on economic migration.

Q261 John Mann: This is a critical point, Chancellor. Included in the tax take is it not the case that if you do not have a net increase in migration of 700,000 in this Parliament your figures in terms of reducing the budget deficit disappear into the ether because you are relying on the income tax take from these new migrants who are built into the new job statistics that you have because unemployment only comes down by half a million? Built into the statistics you are relying on your assumptions on budget deficit on a net increase as projected, as confirmed by the Chief Economist, of 700,000 net new migrants working in the British economy.

Mr Osborne: Maybe I am more optimistic than you are about the ability to get some of the five million Britons who are on out of work benefits into work rather than relying on immigration for all of our job creation. That was one of the imbalances of the economy that I inherited.

Q262 John Mann: But you have no control over European Union migration at all, no control whatsoever.

Mr Osborne: That is a matter for regret since my party proposed derogations, but we have to deal with the situation as we inherited it.

Q263 John Mann: We are dealing with your Budget. 700,000 is the projection of net migration, new people working in the British economy in this Parliament, which is comparable to the net

migration over the last 13 years. That is the stimulant for growth that you are basing your projections on and that is the basis on which you are making your projections on reducing the budget deficit. Is that not correct?

Mr Osborne: What I am working on the assumption of is that our Welfare to Work reforms will increase the incentives to work in this economy, will get people off out of work benefits, on which too many people sit permanently, and ensure there are British people of the skills and ability to take on some of the jobs that previously went to people who came as economic migrants to this country.

John Mann: That is your hope, but critically that is not your economic assumption within this Budget. Thank you, Chairman.

Q264 Mark Garnier: Chancellor, a bit earlier you answered Mr Thurso's question when he was talking about tax rates and the reduction of the corporation tax. You said that you hope that will encourage direct inward investment into the UK from overseas. I would like to ask you to expand a bit more on that in terms of how you anticipate, as a Government, going out and attracting direct investment? Secondly, also quite crucially, do you see this as being active investment in terms of bringing jobs or do you see this as being passive investment in terms of things like property and investment in equity markets?

Mr Osborne: I would hope it is both. The headline rate of corporation tax has become something of an advert for countries around the world, as Ireland demonstrated when it had its very low corporation tax rate of 12½%. It is not possible and was not possible in this Budget to get us to a 12½% corporation tax, but I think by setting out a path from 28% to 24% and doing it a penny a year we hope to crowd in some investment early on on the expectation of the lower rates. I think it is a good thing and a straightforward message to sell to the world that we are cutting our corporation tax rate rather than increasing our business taxes. There is also an effort required to roll up your sleeves, get out there, sell the country and attract investment. There is no doubt that certain countries, often quite small countries like Ireland and Singapore, have been very effective at targeted efforts to attract particular inward investment into their economy. Whether, as you put it, it is passive or active investment I think we want to attract both sorts and make this a place where people want to come and do business.

Q265 Mark Garnier: One of the problems with Ireland is that it has been attracting a lot of financial services and when the bubble blew up on the financial services sector that caused great problems for Ireland, so that is a short-term fix if you like. Singapore had a slightly different type of economy which started off in manufacturing and had a book, a paper written about how to create a city state and Lee Kuan Yew developed it from that and it has been a great success story, but Great Britain is a much bigger area. What do you think are the great selling points that this country has that will attract people to set up businesses that will employ people?

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Mr Osborne: I think there are some great selling points we have. We are an open trading economy. It is agreed across the political parties of this country that we are not protectionist and that is a massive advantage we have over many other European and Western economies. The rule of law here is strong and people feel confident that they are not going to be discriminated against simply because they are a foreign investor. We have a flexible labour market. We have universities which we want to make even stronger, but it is a good thing that 10 of the top 100 universities in the world are located in this country. There are lots of things we can sell about the UK. Obviously there are big challenges but we are addressing those. The quality of secondary education is something we are seeking to address with education reform. The endemic problems with low skills in our economy we are seeking to address as well. There are the questions over the public finances, which we have spent a lot of time talking about. There are obviously problems but we have got some big selling points and that is partly reflected in the way the markets are looking at the United Kingdom at the moment.

Q266 Mark Garnier: On top of the negatives we have got the burden of regulation which is quite heavy in this country.

Mr Osborne: Indeed, and it has risen very considerably. That is why my colleague, Vince Cable, is proposing this “one-in, one-out” regulatory rule. We are seeking to reduce the burdens of unnecessary regulation on small businesses, for example. I think there is a broader point here which may be a lesson we can all learn from the financial crisis, which is it is not the quantity of regulation that is the issue, it is the quality of regulation. Financial services were a very heavily regulated sector, probably more regulated than almost any other with the possible exception of pharmaceuticals. There was a lot of regulation, even if it was applied with a light touch, the problem was no one was exercising any judgment in the system. It is not something we are talking about today but my proposed changes to financial regulation to put the Bank of England in charge of prudential banking regulation is so there is more judgment and less box ticking.

Q267 Mark Garnier: Can I change the subject slightly to financing the budget deficit and the gilt market. I was asking questions of Mr Ramsden earlier this week about the rating agencies and how important they are. One thing he said which I found absolutely extraordinary was that the credit rating agencies tend to follow rather than lead the markets overall which has slightly changed things round from where they used to be originally. This seems to be the tail wagging the dog. Which side of this equation do you think is more important? With the messages that you are delivering are you trying to satisfy the credit rating agencies or are you trying to satisfy the credit market?

Mr Osborne: What I am trying to do is make sure that British businesses and families can borrow at reasonable market rates and competitive market

rates and obviously I want to finance the government debt. Those things are both made easier by keeping the country’s AAA credit rating which, as we know, has been put under question. The good news is that two of the three credit rating agencies responded very positively to the Budget and the third wanted to see whether this Parliament had the stomach to actually implement the measures. Things are looking quite favourable. From our point of view there was a very good announcement yesterday that the largest bond investor in the world, PIMCO, having previously put itself on instruction to sell gilts this year, has now changed that instruction and is going to be investing in gilts, and that is a good thing when you have got 149 billion of them to get away.

Q268 Mark Garnier: It is indeed. Professor Blanchflower said that the main danger to the UK’s credibility is when ministers spread fear in the markets and talk down the economy. Clearly the interest rates on gilt yields are now around the 330/340 basis point level which is lower than it was in January, but I would like you to comment on that.

Mr Osborne: It is worth looking at what has happened to the UK economy versus a whole host of other European economies, like Spain, Portugal and Italy, over the last few months when it was the case, for example, that with Italy we had identical market rates at the time of the March Budget and virtually the same was the case with Spain, but they moved in a different direction from us, so I think this new set of ministers has been instilling confidence in the UK and reassuring people that we have got a credible plan.

Q269 Mark Garnier: One final question. Have you ruled out a further round of quantitative easing?

Mr Osborne: That is a decision for the Monetary Policy Committee. The arrangements under which quantitative easing can take place were put in place by my predecessor, Alistair Darling, and I am not proposing to change that.

Q270 Stewart Hosie: In the evidence session earlier in the week the Chief Economic Adviser said: “A key lesson from the economic crisis is the need to find a way of curbing the potentially very strong pro-cyclicality of the financial sector”. He said that the kind of levy, the bank levy, and the way it has been designed does contribute to curbing that potentially strong pro-cyclicality. I can understand if the levy takes 2.5 billion that is 2.5 billion less the banks have to underpin lending and if we were going to go for a counter-cyclic approach that would work if it required credit to be tightened, but I am at a loss to see how the levy taking 2.5 billion would work in a counter-cyclic way if we required to loosen credit from the banks. Would the rules on the levy be changed? Would the amount it was due to take be changed? How would that work if it was to work in a counter-cyclic way?

Mr Osborne: The most effective counter-cyclical tool available is capital ratios. The bank levy is designed to do two things. The first is to ensure there is a price

paid for the implicit insurance that we all offer as taxpayers for the wholesale funding of banks, which became pretty explicit in the middle of the crisis. That is why, for example, insured deposits are not included in the tax base for the bank levy. It is, in effect, a tax on wholesale funding. One of the things we have learnt from the crisis is you do not want banks with very large exposures to wholesale markets, they need a more stable basis for funding long-term. We have stuck within exactly the parameters set out by the IMF. The IMF proposed two options for a bank tax if countries wanted to proceed with one. One was a financial activities tax, which we are looking at, and the other was this wholesale balance sheet tax. We have pursued the IMF model and, indeed, on the day of the Budget France and Germany, with us, made announcements that they were going to pursue something similar. The other reason, to be absolutely frank, was for reasons of equity. Asking the general population to accept a VAT rise, asking them to accept that there were going to be changes to welfare eligibility and the like, doing these things is a difficult thing for any government to do but I thought it would be totally inappropriate not to ask the banking sector to make a contribution as well. The position I inherited from my predecessor was that we would not introduce a bank tax unless all other countries had and I thought that was not appropriate, I thought it was perfectly reasonable to ask the UK banking sector to make a contribution for reasons of fairness and that was also why I did it.

Q271 Stewart Hosie: I understand the argument about equity and the technical issue about the levy being a tax to discourage activities in the wholesale market but, nonetheless, if a counter-cyclic approach requires the loosening of credit if the Government are not prepared to change the rules on the levy would they be prepared to look again at the funding model for the Asset Protection Scheme or the premia paid on the other paid for insurances on bank lending—intra-bank lending, commercial lending—which the banks pay at the moment?

Mr Osborne: Of course we can keep things under review, but I would make a broad observation that the most effective tool here is the capital liquidity requirements. They have a much greater effect on a bank's ability to lend than, say, the bank levy does. That is why it is so important that we try and get an international agreement here. What is happening at the moment is the banks are hoarding capital partly in anticipation of potential future regulatory changes and the sooner we can have some certainty on that the less they are going to have to hoard capital.

Q272 Stewart Hosie: Let me move on to the issue of capital ratios. The reason I asked the first two questions was to get to this point. Would it not seem slightly incongruous if the prudential regulator said to the banks individually and collectively, "The capital adequacy ratios are now to be a little lower in order to facilitate more credit", which may be seen

as counter-cyclic, but at the same time the amount of money paid towards the levy, the Asset Protection Scheme and the other insurances remain the same? Would there not be some contradiction between a counter-cyclic approach and a pro-cyclic tax base?

Mr Osborne: The argument that you advance is one that leads one to the conclusion that you should not have a tax on banks. For the reasons I have stated I think it is appropriate to have a tax on banks and I have tried to do it in a way that follows international best practice. When it is fully operational the bank levy is going to raise £2.5 billion and we made it clear that we are targeting a revenue sum rather than a particular rate because we think that is an appropriate contribution that balances fairness with the competitiveness of the UK banking sector. That sum of money, when it is put alongside some of the impacts of capital requirement changes, is relatively small. What is driving things at the moment is not so much the requirements of regulators but the requirements of the markets. The sooner we can reassure markets that the bank systems of Europe are stable, we get these stress tests which are coming on 23 July out of the way and people see them as credible and there is a plan to stand behind any banks that do not meet them, although I should say we are not expecting that to be the case at all in the UK, and the sooner we can get the G20 agreement the more the market's expectations will come into line with regulator expectations.

Q273 Stewart Hosie: Let us move that further forward. Agreeing that the capital ratios are probably the main driver for a counter-cyclic approach if we need to get more credit into the system, additionally we have the European Banking Stability Fund coming which will be financed through direct contributions from the institutions that choose to be part of it and those contributions will be proportionate to the level of risk and their contribution to systemic risk. Could we have a situation where the prudential regulator here suggests lower capital ratios to encourage more credit into the system but the European Banking Stability Fund is insisting on higher contributions to take cognisance of risk and have two systems effectively working against each other? How would that be managed?

Mr Osborne: First of all, that is a proposal on the table, it has not been agreed. I was at Ecofin at the beginning of this week and it was discussed there. The Council's proposed text on the financial supervision arrangements merely says we are going to review that option rather than implement it because, of course, there are the kinds of issues about it that you correctly raise. I should also note that the Ecofin meeting welcomed the UK Budget having previously been quite critical of the UK's position.

Q274 Stewart Hosie: So you are confident that if this proposal goes anywhere it will be managed in such a way that we will not get these explicit contradictions?

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Mr Osborne: The issues you raise are very legitimate ones and would have to be answered if we were ever to head down that path.

Q275 Stewart Hosie: When are we likely to get some clarity or certainty of decision on the European Banking Stability Fund and its shape?

Mr Osborne: The current text that the European Council of Finance Ministers—Ecofin—is proposing merely has that we review the option of a European resolution fund. This text is now the subject of discussion with the European Parliament and the European Commission. We hope in September to have an agreed text and it will pass through Parliament, but I am pretty clear that the appropriate thing to do at this stage is merely to review the option than to implement it.

Q276 Jesse Norman: Chancellor, I very much welcomed your remarks on the fuel duty review earlier on, coming from a very rural constituency. Can I ask that amongst the pilot schemes you consider one in Herefordshire to go alongside the ones that are being contemplated in Scotland. My question goes to some of the remarks you were making earlier about trend growth in the economy. One of the things that is so striking is how unaffected that was over the last decade or more by the enormous wave of investment that has been made in the economy. You have talked a lot about some of the micro things that the Budget does on that. Can I move up a stage and ask about the overall level of tax financed spending and public sector growth because both of those look like they are negative for trend growth and negative for productivity in the long run. Is it part of your economic philosophy to think in terms of trying to raise the long-term growth rate by moving towards a lower spending economy and one in which there is a higher productivity?

Mr Osborne: The Budget Red Book has an interesting mini essay on the trend growth rate on pages 20 and 21 which presents an alternative scenario to the one that was presented in the March Budget about whether there had really been an increase in the trend growth rate of the economy which then came down in the recession or, in fact, Britain had just stayed on its long-term trend growth rate. I am not assuming some spectacular improvement in the trend growth rate of the British economy. I would like to see that, of course, like everyone else on this Committee, and the ways one goes about doing that are trying to improve our education system, make our tax system competitive, make our regulatory system appropriate and so on. There are big structural reforms to the British economy which are required and which all parts of the Government are engaged in: educational reform, welfare reform and so on.

Q277 Jesse Norman: Thank you. This is a question really for Sir Nicholas. I think it is widely thought that the UK was inadequately prepared for the financial crash when it arrived, and that was one of the reasons why our economic recession was as prolonged as it was and as deep as it was. Do you feel

that the Treasury adequately exercised a degree of restraint over the previous Chancellor and the Prime Minister, or is it a cause of regret to you that you did not exercise more restraint?

Sir Nicholas Macpherson: I think as a matter of principle officials advise and ministers decide. It would be inappropriate to provide a running commentary on the private conversations between officials and ministers over the last few years. A more substantive point is I think there are huge lessons to be learnt from the economic and financial crisis and it is incumbent on all the major economic institutions in the UK to learn them.

Q278 Jesse Norman: Do you feel that the Treasury did what it could to prevent the, as it were, ramp up in public spending, consumer debt, housing bubble, those kinds of things? Do you feel you fought all the battles that were required to keep that situation under control?

Sir Nicholas Macpherson: If you are a Treasury official then fighting battles about public spending and fiscal policy is pretty ingrained. Sometimes you win and sometimes you lose. A really important point is the one which has just been made around trend growth. There is always a danger that you can delude yourself around trend growth and I saw that happening in the late 1980s and I have seen it happening again more recently. Caution and transparency should ideally inform economic policy formulation and I am very pleased to see plenty of that around at present.

Q279 Jesse Norman: In the specific Budget proposals on capital gains tax there is some concern that it has affected employee share ownership schemes of different kinds. Is that something that you might look to address in the longer term because—I suppose this is a question for the Chancellor—the new Government has put a tremendous emphasis on mutualism and exploring alternative economic models?

Mr Osborne: I think this is a point that Mr Fallon raised earlier in the week and we have sent a memo to the Select Committee. I did not think it was appropriate to expand the entrepreneurs' relief to include some of the tax advantage share ownership schemes. It would have detracted from the revenue raised by the measure and there are already quite generous income and National Insurance reliefs.

Q280 Jesse Norman: But it does not betoken, as it were, a resistance to employee ownership?

Mr Osborne: No.

Q281 Jesse Norman: It seems to me the doors are very much more open than they were previously.

Mr Osborne: Very much so. This comes back to the questions I was answering earlier. When I was thinking of the capital gains tax changes I was trying to keep the changes as simple as possible rather than introducing a whole new regime and a whole new definition of entrepreneurs' relief.

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Chair: I thought for a moment, Sir Nicholas, when you said that you were very glad to see plenty of caution around at present that you were actually going to transform yourself into Sir Humphrey, but you got yourself back into your own skin just in time.

Q282 Mr Umunna: Can I start by returning to some of the questions the Chairman was asking about fairness and also the issue of transparency, Chancellor? I know I am going to paraphrase slightly, but in your Budget statement you very much were putting forward the message that you would be the model of transparency when it came to disclosing figures and what have you, were you not, Chancellor?

Mr Osborne: Given that I did not want to give a speech of Gladstonian length, I thought I would touch upon and mention all the significant changes rather than leaving them out of the Budget speech as had become recent practice.

Q283 Mr Umunna: You have said that your Budget is progressive and you repeated that in answer to the question earlier. I must say this Budget is rather tabletastic. You have included quite a lot of tables in your Budget Red Book but you have not included one that shows a distributional analysis that shows the impact of your Budget measures alone detached from the Budget measures introduced in March. Why is that?

Mr Osborne: That was a point I made earlier. I take responsibility for the measures that I am going to ask the House of Commons to vote on. You are leading to a question, I suspect, or implied in your question, at least, is the issue of the National Insurance rise.

Q284 Mr Umunna: I was not actually going to pursue that.

Mr Osborne: The National Insurance rise is obviously a substantive measure that the previous government proposed and had plenty of opportunity to legislate for but never did. We have made a decision to go ahead with the employee National Insurance rise and that is a conscious decision. We have made changes, for example, to employers' National Insurance proposals from the last government and so will be legislating in a different way than the previous government would have done if they had got round to it. Therefore, that is a conscious, active decision, and I think it is appropriate to include that measure. After all, the person who is going to have to get up and make the argument is either myself or one of my colleagues in the Treasury.

Q285 Mr Umunna: Sure. Would it not be correct when you are saying that your Budget is progressive that actually what you are saying is that elements of the last Budget taken with your measures in your Budget are progressive? It is not an issue that your Budget alone has a progressive impact.

Mr Osborne: It is the case that my Budget does not have a recordable impact on child poverty numbers, so that is another example of its progressivity and that was using exactly the same child poverty model that the previous government created.

Q286 Mr Umunna: Why have you only chosen to show the impact of your Budget up until 2012–13? You said in answer to a question earlier that in terms of putting figures out there you have been adopting a similar approach to the IFS and the IFS are into all this table business as well. They, I am sure you have seen, have produced a table showing the impact going through to 2014–15. Why have you not done the same?

Mr Osborne: I thought 2012–13 was appropriate given that there are going to be subsequent Budgets which I hope to be presenting, although that is ultimately a decision for the Prime Minister. For example, the measures that I took on the child tax credit to increase that next year and the year after, there is always the scope to do further things in those directions in subsequent Budgets. It would be an inaccurate table going forward because it would not include potential subsequent announcements in subsequent Budgets.

Q287 Mr Umunna: Is it not the case, Chancellor, that you have actually put forward an inaccurate view of the impact of your Budget generally with the selected statistics that you have put in your Red Book? Robert Chote said, and I might as well quote: "The Budget looks less progressive, indeed somewhat regressive, when you take out the effect of the measures that were inherited from the previous government, when you look further into the future than 2012–13 and when you include some of the other measures that the Treasury has chosen not to model".

Mr Osborne: I have answered different components of that. The reason for not going beyond 2012–13 is that I have got a Budget in 2011 and 2012.

Q288 Mr Umunna: I understand the reasons.

Mr Osborne: I think people understand about this coalition government that we are very clear that fairness is a very important thing. We are committed to the child poverty—

Q289 Mr Umunna: I am slightly conscious of my time. Can I ask you, would you provide the Committee with your own version of the tables that the IFS have produced showing the distributional impact of your Budget taken with the one before going through to 2014–15 and also produce a table that disaggregates the effect of your Budget from the March 2010 one?

Mr Osborne: I will certainly see if that is possible.

Q290 Mr Umunna: Thank you. Can I go on to ask you just a bit about the deficit and the timeframe within which you are looking to eliminate the Budget, the structural deficit which is a four to five year timeframe. Many of your Ministers have presented this as an economic necessity, that we have

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to do this. To take what one of your backbenchers said, needs must. When I put this concept to Roger Bootle earlier this week, he said: "I think this is where the political process intervenes because what the Government wanted to do was to eliminate the structural deficit within a Parliament. In straightforward economic terms I am not sure it would make a great deal of difference if the adjustment were over a longer period". Now is it not right that actually this is not an issue of economic necessity but it is actually an issue of political judgment to do it over this four to five year term?

Mr Osborne: It is a political judgment about what is an economic necessity, I guess. The Governor of the Bank made it clear within days of my appointment that the most important thing now is for the new Government to deal with the challenge of the fiscal deficit. It was clear on arrival that no-one believed that Britain had a credible plan to deal with the Budget deficit. The G20 subsequently called for countries with serious fiscal challenges, and after all we have got the biggest budget deficit of the G20, to accelerate the pace of fiscal consolidation. The OECD in a report well worth reading yesterday said that the Budget was an essential starting point for future recovery. I think there is quite a lot of international support for the view that Britain did not have a credible plan and has introduced one.

Q291 Mr Umunna: It is a question of political judgment ultimately, is it not, Chancellor?

Mr Osborne: Of course it is a question of political judgment about what is the right economic policy to pursue. It is at least worth reflecting on that this week we have discovered that my predecessor wanted to increase VAT and cut corporation tax. There are political judgments, it is just a question of whether you could deliver those political judgments through your Prime Minister.

Q292 Mr Umunna: There is a choice, that is what I am cutting at.

Mr Osborne: Of course there is a choice.

Q293 Mr Umunna: Is not the real reason why you are not prepared to countenance, say, dealing with the structural deficit over a longer period because your political strategy is to set this up as a choice in order to cut the structural deficit of having public spending cuts in departments or having welfare cuts? Either way you achieve your political aim which is to reduce the level of state activity in the economy. Is that not the real political strategy here?

Mr Osborne: No, it is not the real political strategy as you put it. I think it is worth reflecting that the plans I inherited involved a 20% reduction in departmental spending.

Q294 Mr Umunna: I am not talking about what you inherited. I am talking about the choices that are available to a Chancellor.

Mr Osborne: You are suggesting that somehow there is a partisan political judgment involved and I am pointing out that I inherited plans for 20% reductions in government departments, that £44

billion of the consolidation in departments comes from the previous government plans, I have added £17 billion to that, but in other words the judgment that I made, and my predecessor made, was that there were going to have to be public expenditure cuts. We now know, thanks to Lord Mandelson, that actually his judgments were remarkably similar to the ones that I have come to when it came to some of the tools in order to fill in the blank spaces that I inherited, such as increasing VAT, but obviously that was not made public before the General Election.

Q295 Mr Umunna: I want to come to some of your benefit changes, and I suppose it is related because it is related to credit rating of the country. You said that we have got a new set of ministers a few moments ago instilling confidence in our economy. Your Economic Secretary in the House of Commons on 24 June described our economy as an absolute basket case of an economy. Could you tell me how that will help our credit rating?

Mr Osborne: What I would take comfort from are the—

Q296 Mr Umunna: Do you think it is good for the Economic Secretary to describe our economy in that way?

Mr Osborne: What I would take comfort from—I am not going to take your version of what he said—

Q297 Mr Umunna: She.

Mr Osborne: The point I would make here is that let us look at what the world markets are saying about the UK economy today. They are saying that we are a better place to invest than many of our European competitors, the market interest rates are lower and they were the same as Spain's and Italy's but whereas Spain's and Italy's have increased in the last couple of months ours has fallen. Our market interest rates are a full $\frac{1}{2}$ % lower than they were in the March Budget. This is not a matter of political judgment, this is the markets out there making a verdict on the credibility.

Q298 Mr Umunna: I was not talking about what the markets are saying, I was talking about what your minister has been saying. Chancellor, what is the current rate of JSA per week?

Mr Osborne: Just over £60.

Q299 Mr Umunna: Can I ask you to explain, and I asked your officials earlier this week, why you are applying a 10% reduction in housing benefit to JSA claimants who have been claiming for more than 12 months, notwithstanding the fact they may have been doing, as many people in my constituency have been doing, everything they possibly can to get a job. How can you justify that?

Mr Osborne: First of all, I have enormous sympathy for people who are looking for work, and I want to do everything I can to create an economy in which they can find work and I want to create a welfare

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system that helps them find work. The housing benefit budget has risen by 50% to £21 billion. This is the Treasury Select Committee and I think it should take an interest in the fact that one benefit costs more public money than the Police Service and the higher education system combined.

Q300 Mr Umunna: Have you ever been on JSA, Chancellor?

Mr Osborne: No, I have not been on JSA. The point I would make is this: we have to find savings across the Government. If you do not start looking at housing benefit then where else are you going to start looking.

Q301 Mr Umunna: You could increase taxes.

Mr Osborne: With the greatest respect, I have not checked the voting record, you voted I suspect against a £14 billion tax rise yesterday, or the day before yesterday, the VAT rise.

Q302 Mr Umunna: Which is a regressive measure.

Mr Osborne: If you would like to propose to me, because so far no-one from your party has, the kind of substantial tax rises you would rather see then I am very happy to look at them, of course. With respect, we have produced a very large tax increase—we regret having to do this—which members of your party and perhaps yourself voted against. I have also looked for expenditure savings which, again, the previous government always said it was going—

Q303 Mr Umunna: This is about reducing the benefit bill.

Mr Osborne: It is about two things. It is about reforming housing benefit so that it is fair and it encourages people into work. Second—

Q304 Mr Umunna: A 10% hit on your housing benefit when you are struggling to find work, that is going to incentivise you even further to go and find work, is it?

Mr Osborne: As we know, housing benefit has a particularly high taper and I think these measures will encourage people into work.

Q305 Mr Umunna: Have you done any analysis of that, Chancellor?

Mr Osborne: The answer to that is yes.

Q306 Mr Umunna: Will you publish it? Will you put it in the House of Commons Library?

Mr Osborne: I am very happy to write to you about the housing benefit proposals, but I would make this second observation which is it was not the only measure we took on housing benefit. We have capped housing benefit payments at £400 per week and, frankly, I think it is difficult to justify to the very hard working people of your constituency that there are some people currently receiving over £100,000 a year housing benefit.

Q307 Mr Umunna: How many, Chancellor?

Mr Osborne: The total number—

Q308 Mr Umunna: How many?

Mr Osborne: The total number of people over the £400 cap is around 5,000.

Q309 Mr Umunna: How many people claim housing benefit?

Mr Osborne: It is going to save this country close to £50 million. I completely understand if you do not feel this is the appropriate cut to make or that there is some other tax increase I should have introduced but, with the greatest respect, you have not proposed any to me. Unless you have got an alternative plan I will stick with the plan—

Q310 Mr Umunna: You are here to answer questions from us. We are not here to answer your questions. You have come here and said this is a progressive Budget, it is not going to affect the poorest. I have just demonstrated to you that it will. You have just acknowledged that it is going to be very painful for people to take this hit but they have to take it because you want to reduce the benefits bill.

Mr Osborne: No. What I am seeking to do is to help create a welfare system that encourages people into work, to help the five million people who sit on out of work benefits in this country, to help the record number of children who grew up in workless households in this country. I am trying to encourage them into work, to reform welfare. I am also trying to save money out of a welfare budget that has ballooned and in particular one benefit which has gone up by 50%, that now costs us £21 billion a year and involves some people receiving a £100,000 a year—

Q311 Mr Umunna: It is 5,000.

Mr Osborne:—which is equivalent to the tax paid by 16 working people in this country just to fund one person's housing benefit. You might believe that is acceptable, I do not and I have made these changes.

Q312 Michael Fallon: Chancellor, when you arrived in the Treasury on day one, what did you find? Did you find any detailed plans to deal with the deficit or reassure the markets?

Mr Osborne: There was no plan to identify the savings that had been pencilled into the March Budget. The 20% reductions in departments, there was not a penny, as far as I could tell, assigned to that.

Q313 Michael Fallon: No work had been done on the spending cuts at all?

Mr Osborne: There had been work done in anticipation of a Conservative government. Obviously I am not privy to the papers that are prepared in anticipation of the election of a Labour government.

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Q314 Michael Fallon: Were you not shocked?

Mr Osborne: I had come to suspect that there was not going to be a plan when I arrived, which is why we had done some preparation in advance. To be fair so had our coalition partners, not that we had expected to be in government together.

Q315 Michael Fallon: Could I ask you about the AME totals that you have helpfully forecast in table 2.3. You said this morning there is not going to be a theological division between AME and DEL in years ahead. Can you tell the Committee whether the AME totals you have put, the very large increase, over £100 billion between last year and 2015, what structural reforms they include or are those all awaiting the Spending Review?

Mr Osborne: Obviously subject to the last set of questions we have made some announcements on welfare savings and they are included in this. We have, as I have made it clear, held open the door to finding further welfare savings as part of the spending review, but we are not assuming that we can find those so we have scored those against DEL. Of course one of the biggest items, and indeed probably the fastest rising and largest item of AME expenditure here, is debt interest, which is a rapidly rising bill, and we were forecast to pay as a country in the figures I have inherited £67 billion a year in debt interest which is more than three times the housing benefit budget.

Q316 Michael Fallon: We should not assume in these figures any further welfare reform?

Mr Osborne: You should not assume them, Mr Fallon, but we are looking for them.

Q317 Michael Fallon: You are looking for them.

Mr Osborne: As part of the Spending Review.

Q318 Michael Fallon: The balance between AME and DEL, you said earlier this morning the division was not theological, that can still change then, can it?

Mr Osborne: I meant that in a different context. Certainly the answer to your question is it certainly can change if we can find further welfare savings. I should clarify when I said there was not theological about the division, what I was saying was that as Lord Freud proposed one could use anticipated AME savings to fund a DEL Welfare to Work programme which the Treasury had previously found very difficult to accept.

Q319 Michael Fallon: You would score it differently?

Mr Osborne: If you can pay your welfare provider by results and anticipate those results mean a lower AME expenditure, ie that you get someone off benefits, then you should be able to pay them upfront, which is a DEL payment.

Q320 Michael Fallon: Coming back to the question on capital gains tax, how else are you going to encourage employee share ownership given the increase that you have put on of capital gains tax? It is not much of an incentive for people to set up new schemes is it?

Mr Osborne: First of all, there are very generous tax advantages to employee share ownership schemes but I am very willing—I would do this anyway off my own bat—if the mood of some Members of this Committee is to go away and look at this and perhaps come back with further thoughts on how to encourage employee share ownership schemes.

Q321 Michael Fallon: The difficulty, it seems to me, is these are people who cannot decide or control when to realise their assets. Their company happens to be taken over, that is not a point of their choosing. They cannot adjust their liability.

Mr Osborne: That is true but of course there is an annual allowance which protects them for the first £10,100 of their gains. Many people in employee share ownership schemes are already exempt from capital gains tax.

Q322 Michael Fallon: You have not closed this off, you will look at this again?

Mr Osborne: I am very happy to look at it and get back to the Committee.

Q323 Chair: Chancellor, you very interestingly opened your remarks, or quite soon after coming, with the suggestion that we be given a power of approval over the chairmanship of the OBR. We will certainly consider that and I expect it will be favourably received by the Committee. It would be very helpful if you could also consider what arrangements can be put in place to enable that to be buttressed by a mechanism which would be triggered if this Committee had lost confidence in the Chairman of the OBR. I would not expect you to comment now unless you want to, but I think it would be helpful if some thought could be given to that question.

Mr Osborne: I am very happy to give consideration to that question. I would make an initial observation. The whole purpose of creating an Office for Budget Responsibility is to create an independent observer of the activities of Government and the activities of Parliament and its impact on the public finances. The risk of giving the Committee a power to sack someone or indeed the Chancellor the power to sack someone, a bit like the Governor of the Bank of England, you gave us the power to do that, it would be that it was potentially undermining the independence. My inclination, but I am very happy to consider it, is that we have a system whereby the appointment is made by the Chancellor but subject, for the first time, as I understand it, in the history of this Parliament, to a confirmation hearing and a veto by the Treasury Select committee, this person is then, having passed those hurdles, independent and able to get on with their job and say things which may be difficult for the serving Chancellor or indeed difficult for Parliament. Then when it comes to reappointing this person—and my current thinking is they would just be reappointed for one term, serve for one five year term but then be reappointed for one further five year term—that too would involve the Treasury Select Committee and the Treasury Select

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Committee and the Chancellor would both in effect have a double veto. The Chancellor would have to recommend the reappointment and the Treasury Select Committee would have the veto again.

Chair: Thank you for that. These are very interesting thoughts and we will be looking at them intensively next week.

Q324 John Mann: Just a short question, just to ask whether considering the new arrangements made with select committees, which obviously we all voted for and welcomed, would you envisage, if requested,

appearing before this Committee as often as the Governor of the Bank of England appears every year?

Mr Osborne: I am very happy to appear when the Chair of the Select Committee invites me. It was the only select committee vote that I absented myself from so therefore I am neutral in my view about the Chair of the Select Committee.

Chair: We asked you to come today and you came. Thank you very much indeed. It has been an excellent first evidence session from you. We look forward to seeing more of you in the future. Thank you.

Written evidence

Written evidence submitted by the National Institute of Economic and Social Research

THE BUDGET FORECAST AND FISCAL PROSPECTS

1. Tighter fiscal policy is needed to pay down the debt stock, and the government's general plan to do that is welcome. As the UK is the only large OECD country that has never defaulted on its debt, it is very unlikely that the UK will face a Greek style confidence crisis. It is therefore unlikely that we will see a noticeable premium on interest payments on UK debt. However, debt reduction is needed both to ensure we are fair to our children by not consuming their inheritance, and also to prepare our defences for the next financial crisis when debts will have to rise again. We can reduce the probability and the costs of crises, but we cannot easily banish them. Prospects and plans for the public finances currently depend upon the impact of the crisis on potential output, the size of the output gap that has resulted and the prospects for closing that gap. This in turn depends upon the growth of both potential output and demand, both of which may be influenced by government policy.

The impact of the crisis on potential output

2. Financial crises have been common in the OECD since the collapse of the fixed exchange rate Bretton Woods system in 1972. Although crises can be very damaging, the majority of crises in the last 40 years have had no significant impact on long run prospects. Indeed there is no strong evidence that any previous financial crisis the last 120 years in the UK has left a scar on output. However, systemic crises, as in the US in the 1980s, Japan, Finland, Norway and Sweden in the 1990s, and in a number of OECD countries in the last three years, do leave permanent scars to sustainable output. Risk gets re-evaluated, and less capital is held than otherwise would have been the case. As a result sustainable output is reduced, and this has probably happened in most OECD countries as a result of this crisis.

3. Estimates of the risk related scar for the UK vary from the OECD's 2% or so through the NIESR estimate of 3% to higher numbers. In addition the expansion of the banking system may not have been sustainable, reducing UK potential output by perhaps another 1% as compared to our perceptions in 2007. As result of these calculations NIESR has suggested that sustainable output per person will eventually be 4% lower than we had anticipated in 2007. Real wages in the public and private sector need to adjust to this shock, as must pensions and other incomes. The scar is good reason for reducing public spending, but through wage adjustment rather than employment cuts.

4. In addition NIESR estimates for the DCLG in 2009 suggest that the impact of the recession on the stock of migrants might reduce sustainable output by 1%. This is in part because longer term prospects in the major sources of migrants such as Poland, Australia and the Indian sub-continent have been less affected by the crisis than the UK. In addition once the recovery starts Polish migrants who have returned home will be free to go anywhere within the EU, and not just to the UK, Ireland and Sweden as we saw six years ago. They will not return here in such numbers.

The output gap and the forecast

5. It is very difficult to gauge the size of the output gap at present, but a reasonable estimate would be around 4% of GDP, much as in the last NIESR and OBR forecasts. This would suggest that output might have been up to 2% above long run sustainable capacity in late 2007. The scale of the output gap depends on the scar to output from increased perceptions of risk, on the speed at which migration has reversed and on the underlying trend rate of growth going forward from 2008. The prospects for the economy depend upon the speed at which the gap is closed. This in turn depends on underlying potential growth and on how quickly demand can pick up.

6. It cannot easily be denied that the budget will reduce demand growth over the next two years. Its impact is difficult to judge, in part because the split between cuts in departmental spending on heads and on wages are only just becoming clearer. Cuts in wages have much less short term impact on output than reductions in heads. Taxes also have less impact on demand than do cuts in real spending. Overall we would judge that the budget might slow growth by 0.1 to 0.2 percentage points this year and perhaps 0.4 percentage points next years. These impacts are not large enough to stop growth, and greater risks are faced from increased financial market turmoil.

7. Given the weakness of the world economy, the sustained scar to the capital stock and the continued need for longer term downward adjustment in the housing market the OBR budget forecast still looks to be rather optimistic in the short term, with output growing by a cumulated 1% more over the next five years than NIESR might consider a central forecast. Given trend growth, this would suggest that before 2015 we will need further small fiscal tightening to achieve the target the administration has set itself.

Trend growth in the economy

8. The underlying trend rate of growth is driven by the rate of growth of technical progress, increases in efficiency of factor use, and by increases in labour input. None of these are exogenous nor are they constant over time. Research at NIESR suggests that between 1997 and 2007 improvements in regulation and competition along with technical progress meant that labour productivity was rising more rapidly than in many other countries. In addition the working age population was rising, mainly because of increased inward migration. Trend growth was stronger than we project going forward. We project that the underlying rate of growth of technical progress will remain around 1.7% a year, but other factors raising trend growth, such as rising participation rates, may change.

9. Going forward we expect the working age population and the labour force to grow less rapidly, in part because of the planned reduction in migrant flows. This will slow growth. In addition, over the next decade women's retirement ages will rise in response to changes in their state pension age. However, the impact on the labour force will be limited as average retirement ages for women appear to be 62.4, and we would expect it to rise to around 65, much as for men now. Overall, on current policies we would be surprised to see underlying trend growth exceeding 2¼% over the next decade, whilst average growth will hopefully exceed this as the output gap closes.

10. Underlying trend growth could be raised in many ways, but probably the most effective would be to raise the age at which both men and women retire. For each year on working lives there would eventually be a rise in sustainable output of 1% or more. Hence raising the average age of retirement by one year, as is suggested in the budget, would raise trend growth over the next few years by up to 0.2% per annum. It would also have the triple benefit of inducing more consumption now as less saving would be needed for shorter retirements, investment might be stronger to match the increased labour force, and the public finances would improve noticeably, as NIESR has frequently argued. Of course the benefits would not be apparent immediately, but perhaps planning for the long term is wise at present, and transitional effects on the labour market would have to be managed. Given rising life expectancy, it would be wise to do much more than is currently suggested.

12 July 2010

Written evidence submitted by Professor David Blanchflower

I believe this ill-advised budget is a major gamble. I suspect it will turn out to be the biggest macro-economic mistake for a century.

All too soon the government, in my view, is going to have to reverse course as it becomes clear that the package of measures will push the UK back into recession. A particular concern is that no Plan B seems to be ready, if and when the austerity measures backfire, as they surely will.

I do welcome though reductions in corporation tax and taxes on SMEs, to get firms investing, and National Insurance cuts for firms outside the south-east, to aid new hiring. But these will be cancelled out by additional public spending cuts of £32 billion a year by 2014–15, plus £8 billion in tax increases over and above those to which Labour had already committed itself. It is time to provide the private sector with much bigger incentives, through tax cuts and subsidies, for additional hiring and investing, especially in the most disadvantaged regions.

It is the public sector that is doing the work, crowding in the private sector right now. There is zero evidence that the public sector is crowding out the private sector as the government appears to believe. The fragile recovery we are observing is being driven primarily by fiscal and monetary stimulus. There is no crowding out, period. The private sector is in no fit state to enter into the vacuum that would be left by public sector withdrawal.

Monetary policy of course is playing a large part, with interest rates at 0.5%. Over four million households on tracker mortgages have ridden out the storm pretty well as the payments on their mortgages have dropped substantially. Increases in interest rates would be extremely harmful to the economy in general and to home owners in particular. There is no room to cut rates further and it is unclear what impact additional amounts of quantitative easing would have.

But the MPC should be doing a lot more QE right now, perhaps by as much as £50 billion immediately. It may well have to do a lot more than that if this government proceeds with its cutting programme. The effects of such a large scale increase in QE remain uncertain though.

Previous examples where countries have made major cuts in public spending do not seem relevant especially when bank lending is impaired. Canada implemented smaller cuts than are being proposed for the UK. That occurred though at a time when the its neighbour to the south, the United States that was experiencing the Clinton boom. Plus there was room to cut interest rates. There is little room to cut rates in the UK as they are at the zero bound and our major trading partner, the Euro area, is in danger of slipping back into recession.

There are even signs that the US and China are also slowing. The Baltic Dry index, which reflects the cost of shipping dry bulk cargoes has fallen sharply since the end of May suggests that demand is falling for dry commodities such as iron ore and coal. Shipping prices continue to fall. The global recovery appears to have reached a turning point.

GDP GROWTH, EXPORTS AND IMPORTS

The latest GDP data suggest that the recession was much deeper than previously thought, with output declining by 6.4% from peak to trough. The latest data from 2010Q1 show that household consumption fell while the share of government spending rose sharply. These downward revisions to the past will inevitably result in lower output in the future and result in downgrades to forecasts.

The IMF downgraded its forecast of growth in the UK based on the budget cuts. The IMF said that Britain would grow by 1.2% this year, the second-slowest growth rate in the G7 group and 0.1 points lower than its previous estimate in April. Next year, it expects growth to pick up to 2.1%, 0.4 points down on its April forecast and below the 2.3% predicted by the Office for Budget Responsibility (OBR). Olivier Blanchard, the IMF's chief economist warned that, "downside risks have risen sharply".

Also last week the Institute of Directors (IOD) produced its own forecasts of GDP growth, which were even lower than those of the IMF. The IOD forecast GDP growth of only 0.9% in 2010 and 1.8% in 2011. Commenting on the economic outlook, Graeme Leach, their Chief Economist said: "after a very abnormal recession it would be foolish to rule out the possibility of a very abnormal recovery as well. A whole host of reasons support the idea of one L of a recovery."

Fathom Consulting in its most recent forecast predicts GDP growth of only 0.8% in 2010 and 1.6% in 2011 with unemployment rising to 8.4% in 2011. The risks to growth however in their forecast are heavily skewed to the downside, much more so than elsewhere. In their downside scenario, to which they attach a 40% probability, UK GDP growth next year is -1% (and a further -0.2% in 2012); and unemployment rises to 10% and stays there through 2012. This is the nightmare scenario that the government has brought into play. I fear this is where we are headed.

Adding to the worries that downside risks are starting to come to fruition the new data on exports and imports are worsening. The OBR in its forecast assumes that net trade—the balance between exports and imports—will make a big positive contribution to GDP growth in 2011 and onward. Data on exports and imports published last week by the ONS suggest this is probably not going to happen. The trade in goods and services gap widened unexpectedly to £3.8 billion in May, the worst since July 2008. Exports went up less than £100 million, or 0.2%, while imports climbed £700 million, or 2.4%.

This is consistent with the most recent Markit/CIPS manufacturing survey, which showed that export orders dropped sharply last month. The strengthening pound and weakening of growth in our major export market, the Euro area, reduce UK exports.

The OBR made it clear that there are considerable downside risks to its original forecast,

"A major uncertainty relates to developments in credit and financial markets, in particular whether the banks are able or willing to supply credit in the amount that is normally required in the recovery phase of the economic cycle; and, if not, whether that credit can be obtained elsewhere."

As if on cue, the Bank of England subsequently reported that the flow of net lending to UK businesses remained negative in April. The major UK lenders reported that demand for credit remained subdued. Total net consumer credit flows also turned slightly negative in April, with the stock of lending little changed from a year earlier. To put it simply, the banks are not lending, just as the OBR feared, which will inevitably constrain growth.

The OBR went on to warn that "another major area of uncertainty is whether, and to what extent, private-sector spending and employment are able to fill the gap that the cuts in public spending in our forecast leave. The prospects for external demand are also uncertain since the outlook for the euro area is particularly opaque at this time."

The euro area appears to be heading back into recession and the austerity measures being introduced in certain Eurozone countries, especially those in Germany, will inevitably lower UK growth, too. It is extremely unlikely, therefore, that net trade will leap to our rescue.

BUSINESS INVESTMENT AND CONSUMER CONFIDENCE

In the months leading up to the financial crisis in 2008, UK data on business and consumer confidence turned well before other more quantitative measures such as output or employment. These data were good predictors of the coming decline, especially in late 2007 and early 2008. This data has the great benefit that it is timely and not subject to revision.

Monthly reports from the Bank of England's regional agents show that, from mid-2007, investment intentions across the UK collapsed, hitting their lowest points in spring 2009. In their latest report, for June 2010, the agents said that investment intentions had picked up, "but remained consistent with a gradual recovery from a low level, rather than a robust pick-up in spending. Intentions continued to be depressed by uncertainty about future demand and by the existing margin of spare capacity."

Business investment in the first quarter of 2010 is estimated to be 6% higher than in the previous quarter. In spite of the quarterly rise, business investment was 11% lower than in the same period in 2009. Investment in private-sector manufacturing was down by 1% on the quarter and by 29% on the corresponding quarter of the previous year. The OBR is forecasting that business investment will grow by 1.3% in 2010, 8.1% in 2011 and nearly 10% a year on average from 2012–15. It is unclear whether firms will increase investment, but for the government's Budget to succeed, it is vital that they do.

As for *consumer confidence*, it is again on the wane. The chart plots data from the Nationwide Building Society's consumer confidence and expectations indices, which are available monthly. In a survey, respondents are quizzed on five areas: (1) appraisal of current economic conditions; (2) expectations regarding economic conditions six months hence; (3) appraisal of current employment conditions; (4) expectations regarding employment conditions six months hence; and (5) expectations regarding total family income six months hence.

The consumer confidence index takes the average of all five questions, while the expectations index averages questions 2, 4 and 5. Both indices began to fall from around September 2007 and recovered through early 2009, but have since fallen back.

The latest survey, conducted between 19 April and 23 May, covered the period after the general election and the announcement a £6 billion spending cut. The consumer confidence index fell sharply by 10 points to 65. The expectations index fell even more, by 12 points to 93. This index has now fallen by 26 points since February. Respondents expected the economic climate to worsen, which implies lower consumer spending, which is negative for growth. Other surveys are also downbeat.

WE ARE NOT GREECE

The government have argued that they need to implement these draconian spending cuts because (a) the markets are demanding it and (b) because the UK is Greece.

As Nobel Laureate Paul Krugman has argued, there is no evidence that the markets are demanding such action and called such arguments "utter folly dressed up as wisdom". Countries such as Ireland and Greece that have implemented such measures have actually seen the markets turn against them as the measures compromised growth.

The main danger to the UK's credibility is when ministers spread fear in the markets and talk down the economy. Harsh cuts in public spending have the potential to scythe growth and increase unemployment.

Over the last two years the governments have responded to the financial meltdown by loosening monetary policy, lowering interest rates, providing extra liquidity, introducing quantitative easing measures, alongside expansionary fiscal policies.

Yet a number of these countries, mostly in the euro area, are following Greece and announcing fiscal austerity measures to tackle rising public debts and lower fiscal deficits. The IMF has warned against such precipitate action.

Proposing the same medicine in the UK as in Greece, though at a lower dose, seems a priori absurd, as the problems are fundamentally different because the two countries suffer from different pathologies.

The Greek crisis is the result of a steady loss of competitiveness, reflected in a ballooning trade deficit and relatively high inflation, and a rapid expansion of public sector spending.

Greece is characterised by endemic tax evasion, a poor tax collection infrastructure, parochial patronage policies, corruption and huge delays in the administrative courts dealing with tax disputes. This clearly does not resemble developments in the UK.

The recent increase in the debt burden of the British economy is driven not by structural inefficiencies, as in Greece, but from the 2007 financial crisis, the immediate economic contraction, and the government's expansionary response.

Public debt in Greece is the highest in the euro area at about 120% of GDP. The country also has one of the highest fiscal deficits in the OECD, at 14% of GDP. The UK's is 11%.

In contrast, government debt to GDP in the UK in 2009 was 68%—much lower than the euro area average of 79%. While UK debt/GDP has increased over the past two years by about 20 percentage points, during the past decade it fluctuated around 40%–50%. The recent increase mainly reflects a rational Keynesian counter-cyclical policy in response to the global economic crisis.

These differences are reflected in government bond yields. Yields on long-term UK bonds are quite low, 3.32%, very similar to US Treasury bonds. German bund yields are lower, at 2.59%, reflecting the lower inflation expectations on the euro area.

In addition, only 20% of UK debt matures in the next three years compared with 34% for Greece. The ratio for the US is around 50% and 40% for Germany. So in contrast to Greece, the UK does not suffer at all from roll-over risk.

The forecasters' consensus suggests that Greece will suffer negative GDP growth of at least 4% in 2010 and -1% in 2011. So even if Greece succeeds in its fiscal consolidation plan the debt burden as a share of GDP will keep rising for the next couple of years, while the debt to GDP for the UK has already started falling.

While Greece would surely benefit from the recent slide of the euro, Greece does not have control of its monetary policy, which is decided in Frankfurt. In contrast the UK has exchange rate flexibility, which could prove quite useful in the adjustment.

Greece also has deep structural problems, mostly in product markets with oligopolies in almost every industry, closed professions, administrative and bureaucratic impediments to entrepreneurship alongside barriers to trade and exporting. In contrast, the UK economy is flexible, with fewer administrative burdens.

The diagnosis above suggests that the two countries are plagued with different diseases. There is zero chance that the UK will default on its debt. So each country needs a different treatment.

The UK is demonstrably not Greece.

THE IMPACT OF THE BUDGET ON EMPLOYMENT AND UNEMPLOYMENT

There has been a debate over the last few weeks over the potential impact of the Budget on employment and unemployment. The credibility of the OBR is in question given that its forecasts appear to have severely underestimated the likely impact on jobs. In my view their forecasts are overly optimistic. Unemployment will rise substantially as a result of this ill-considered budget.

Leaked Treasury analysis revealed that George Osborne's Budget will result in the loss of at least half a million jobs in the public sector and 600,000–700,000 in the private sector by the end of this parliament. This was closely followed by an indication, in a letter to ministers from the Lib Dem Chief Secretary to the Treasury, Danny Alexander, that the job losses could be even greater. Alexander ordered government departments (with the exception of Health and International Development) to identify possible spending cuts of up to 40%. He also asked departments to show how they would cut day-to-day administrative costs, excluding salaries, by 33% at the lower end and 50% at the upper end.

The loss of jobs in the private sector is partly the result of much private-sector employment being dependent on spending in the public sector. So cuts in public spending make people in the private sector redundant—or seriously reduce the incomes of, say, consultants, many of whom depend on the public sector for a significant proportion of their work. And yet, the OBR says, employment will grow from now on. Despite the Budget's expected destruction of 1.3 million jobs, the OBR projects that employment will rise by an astonishing 1.2 million between 2010 and 2014. Hence, according to the OBR, the private sector is going to create about 2.5 million jobs.

Subsequently the *Financial Times* reported that the OBR had also put a positive gloss on the employment numbers by trimming its forecasts for public-sector job losses by about 175,000. The OBR pre-empted the results of the Pensions Commission by assuming lower pension contributions and reduced promotions for public servants, even though the government hasn't announced such a plan. Both assumptions cut the job-loss figure. Meanwhile, policy initiatives that would lower long-term growth and increase unemployment were excluded.

Let's look at why the OBR's forecast is overly optimistic. First, job growth of this kind is unprecedented in the private sector. According to the Office for National Statistics, between the first quarter of 2000 and the first quarter of 2008, when the latest recession began, the private sector created 1.6 million jobs, at a time when the economy was booming.

Most of the job growth up to 2008 was in financial and business services and construction, along with the public sector. This seems highly unlikely to be repeated over the next five years. (Note that RBS and Lloyds are included in the public-sector estimates from December 2008 onwards.)

The coalition's austerity measures have already hit business confidence, according to the Chartered Institute of Purchasing & Supply's latest services survey. Business expectations dropped to a 15-month low in the single biggest month-on-month fall ever recorded. It is hard to see which industries all of these new private-sector jobs are supposed to come from.

Second, with all G20 members tightening fiscal policy at the same time, it will be "hard to deliver on improving growth for all, or possibly any", as the chief economist at Goldman Sachs, Jim O'Neill, has warned. Adding to that worry, O'Neill notes, is growing evidence that both the US and Chinese economies are slowing.

Third, it is unlikely that people fired from the public sector, such as care assistants, police officers and local authority workers, can simply jump to jobs in the private sector. Occupational differences between any new jobs and jobseekers will be a problem—a skills mismatch.

Fourth, the chances are that most people who lose their jobs in the public sector will live in regions that are heavily dependent on the public sector, such as the north, while any new private-sector jobs are likely to be in different regions—especially the south, where access to housing will be a problem—a regional mismatch.

Fifth, many companies have managed to retain staff during the downturn by reducing their hours of work. In any upswing, firms are likely to increase hours rather than create jobs. This will be especially bad for young jobseekers.

Sixth, any increase in jobs will lure back workers from eastern Europe, who left Britain when job opportunities began to disappear. In such circumstances, measured employment will not rise as the OBR expects.

Seventh, there is no intellectual basis for believing that the public sector is crowding out the private sector. In a letter to the *Times* on 1 January 1938, John Maynard Keynes argued: "Examples abound in all parts of the world where public loan expenditure has improved employment: and I know of no case to the contrary." That seems right. Public spending is keeping many private firms from bankruptcy.

Eighth, plans for building new schools and hospitals are to be scrapped under a review of capital spending, and private-sector construction jobs will fall as a result. Even the CBI thinks these cutbacks are a bad idea.

CONCLUSION

In my view the Budget that the Chancellor announced in June is misguided and wildly dangerous. No reputable economic theory justifies such precipitate action as cutting spending and increasing taxes by this amount at any time, but certainly not in the depths of the most serious financial crisis of our lifetimes. This is what happened in 1937 in the United States when Roosevelt tightened policy too quickly, which plunged the United States into, double-dip, recession. Re-armament expenditure—a classic Keynesian fiscal stimulus—prevented the UK doing the same.

I have every expectation that this austerity programme will generate widespread industrial and social unrest, worsen well-being and mental health, widen regional disparities and cause increases in crime and poverty. Social divisions, as a result, will widen. All for what?

Sadly, it appears that the poorest individuals in society are going to be hit hardest. VAT is a regressive tax. Inequality will inevitably rise. Cuts in free school meals, and in benefits will hit the weak and the vulnerable. Reducing the number of university places at a time when applications are up by over a hundred thousand appears to be a major mistake. Freezing public sector hiring hits the young hardest as they try to enter the labour market. Spells of unemployment while young leave permanent scars. Evidence from the Prince's Trust suggest that the young unemployed are unhappy and depressed. Cuts in programmes to help the young are also misguided and will result in rapid increases in the youth unemployment rate, which is already close to an alarming twenty percent. And long-term unemployment is rising fast for all age groups.

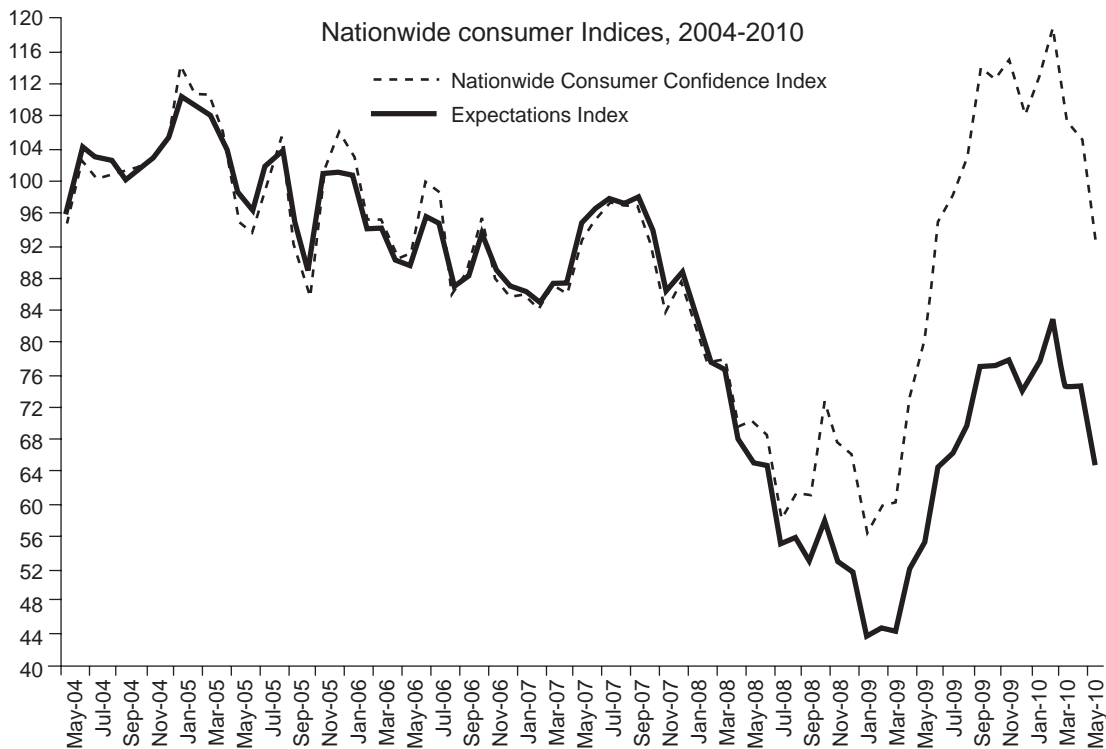
Far from boosting confidence this government has worsened it. The OBR's forecasts for the likely impact of these measures on output, employment and unemployment in particular are flawed. Unemployment is going to rise.

During the 1980s recession output also fell by around 6%. The unemployment rate increased from 5.4% in 1979 and peaked at 11.8% in 1984 but didn't return to 5.4% for over 20 years.

My concern is that this Budget, alongside the earlier efficiency savings of over £6 billion will push the UK back into a double-dip recession at best. Fed Governor Ben Bernanke, argued in testimony to the House Budget Committee "This very moment is not the time to radically reduce our spending or raise our taxes because the economy is still in a recovery mode and needs that support." This also applies to the UK.

This is not the time to pull my punches. It is time for this government to reverse course and stimulate growth and jobs before it is forced to do so by the very markets it so reveres. This rash and ill-judged Budget will lower growth and destroy jobs and will be a disaster for the British economy.

12 July 2010



Supplementary written evidence submitted by the Office for Budget Responsibility

We were very glad to have had the opportunity of appearing before your Committee yesterday. I greatly appreciated your forbearance in allowing me to make an opening statement, although I recognise this was certainly not a precedent. We were also grateful for the courteous approach of you and all the members.

In the course of questioning you asked me about the timing of the release of our whole economy employment forecasts on 30 June. I have consulted our records and can confirm that the information was released on our website at 11 am.

You also asked me when on 30 June the House of Commons was notified of the release of the employment forecasts. I can confirm that as you said in the Committee meeting the House was not notified until 1.50 pm. This was an oversight on our part and I apologise for this delay.

For the future, it will be a strict principle that any information that is released by the Office for Budget Responsibility (OBR) must be made available to Parliament either prior to or simultaneously with its publication on our website, with copies of published material placed in the Library of the House. I hope this reassures you that the regrettable delay in notifying Parliament in this instance will not occur in the future.

14 July 2010

Written evidence submitted by the Child Poverty Action Group

In previous years the Treasury Committee has retained a strong focus on the impact of budgets, spending reviews and pre-budget inquiries on child poverty and the likelihood of the Government's child poverty targets being met. At times, it has devoted full chapters of its reports to child poverty when conducting such inquiries. We very much hope that this focus continues during your stewardship of the Committee, especially now that there are statutory duties under the Child Poverty Act 2010. We are therefore sending this letter as evidence that we hope will support the Committee in its current inquiry into the Emergency Budget that was delivered on 22 June 2010.

CHILD POVERTY ACT TARGETS

The Child Poverty Act requires the Government to meet statutory targets on:

1. Relative low income.
2. Combined low income and material deprivation.
3. Absolute low income.
4. Persistent poverty.

This basket of complementary targets and methodologies for measuring child poverty captures the key dimensions of material deprivation associated with child poverty and an elevated risk of negative life outcomes.

The Chancellor's Budget statement claimed that the overall impact of the Budget would not increase "measured child poverty" (which we understand to be a reference to the relative low income measure). However, this assurance was limited to a two year timeframe; no such assurance was given for the other three targets in the Act; and external analysis since the Budget has cast doubt on the claim of neutrality in regard to "measured child poverty".

We are also particularly concerned about families already below the relative low income line who will be hit by some of the budget measures. The claim that "measured child poverty" will not rise may be met despite some of those already below the poverty line being plunged into deeper poverty by cuts to benefits. This would be counter to the overall aims of the Child Poverty Act and would have appalling consequences for those families affected.

Child Poverty Action Group believes that the Government should, in each Budget, seek not just to have a neutral impact on child poverty, but to make positive progress on all four statutory targets. Documentation should be provided with each budget, or as soon as possible following the Budget, to analyse the measures taken and determine the impact they will have on progress towards the Child Poverty Act targets.

SPECIFIC CONCERNS FROM THE EMERGENCY BUDGET

Child Poverty Action Group believes that some of the measures announced in the Budget will have a particularly strong impact on low income families over time. Given that the Budget included so many changes to taxation and welfare, it is not possible to focus on every measure that will have a negative impact; however we are highlighting here those of greatest concern.

We would like to draw the Committee's attention in particular to the cumulative impact of these measures on some families. A family that is expecting a new child, is receiving out of work benefits, DLA for a disabled family member and is renting in the private sector—especially where the cost of living and housing is high—will be particularly hard hit by the Budget and could see a dramatic fall in income (especially income after housing costs).

Losses to families with babies and infants

There is a cluster of measures that will hit families expecting a new child or with infants. This includes the scaling back of maternity grants, the removal of the baby element of tax credits and the cancelling of the tax credit rise linked to infants that was announced by the previous government.

There are particular costs associated with pregnancy, birth and the first months and years of life that these streams of financial support are intended to assist. There is also a growing body of scientific evidence about the importance to healthy physical and mental development of the first months and years of life. Financial assistance is also particularly important during this period because the level of parental care required for healthy development can preclude working opportunities available to parents of older children. The impact of cuts on families with babies and infants may be dramatically worsened if services like Sure Start are targeted in the forthcoming spending review. This cluster of cuts runs against the political consensus that had developed around the evidence base for the importance of early years care and environment.

Benefit uprating change from RPI to CPI

Uprating under RPI was already providing a steady motor to drive inequality, pushing the gap wider and wider, year on year, as earnings continued to rise above RPI. The downward escalator benefit claimants have been on for decades will now move even faster. One of the benefits subject to this change in uprating, Child Benefit, is also to be frozen for three years; and in the case of this benefit the impact hits working families too (more than half of families below the poverty line have work).

Child Poverty Action Group's founder, Peter Townsend, described poverty as follows:

"Individuals, families and groups in the population can be said to be in poverty when they lack the resources to obtain the type of diet, participate in the activities and have the living conditions and the amenities which are customary, or at least widely encouraged or approved in the societies to which they belong. Their resources are so seriously below those commanded by the average family that they are in effect excluded from the ordinary living patterns, customs, and activities."

Some may say that it is acceptable for benefit rates to rise much slower than earnings because it does not lead to an increase in "absolute" poverty. But this cannot be guaranteed. RPI was already leaving some households worse off in absolute terms in some years. This is because the effective inflation rate for the poorest households was higher than RPI in recent years when the cost of basic essentials like food and domestic fuel rose much faster than other prices. At the same time there has been downward pressure on RPI in areas such as imported electronic goods that the poorest households spend much less on than the mainstream. This danger will probably worsen with CPI uprating. Child Poverty Action Group is in any case much less interested in what could be seen as pedantic disputes about "real" or "absolute" poverty than

we are in the importance of the good society: one in which the poorest are not excluded from the mainstream, as captured in the Townsend definition. We have economic segregation in this country; it is bad for us all and CPI uprating will worsen it.

Housing Benefit cuts

Some of the changes to Housing Benefit are both alarming and puzzling. An immediate negative impact will come from the cap limiting the LHA to 4 bed properties for HB and the move from the mid point to the 30th percentile of rents. There is no obvious explanation for why HB should be cut by 10% for those who have been on Jobseekers Allowance for 12 months. It could be considered a stealth cut to JSA of more than 10%; and it is politicians, not claimants, who should be blamed for the lack of affordable housing that has pushed up the cost of HB to government. Easier to understand is the outcomes it will produce: debt, homelessness and the forcing of families away from a home within contact of social and family networks, which will undermine wellbeing as well as employment and childcare opportunities. As the Institute for Fiscal Studies has highlighted, new restrictions and caps on LHA will force some families to move. There may be, in effect, an expulsion of low income families from some communities and a tendency for greater ghettoisation of poverty where there are concentrations of substandard housing stock.

VAT rise

Analysis by the Institute for Fiscal Studies suggests a loss of net income to the poorest income decile of over 2% compared to less than 1% for the wealthiest decile. It notes that this analysis picks up some households in the lowest income decile that are pensioners living on savings, households temporarily not working, or with fluctuating incomes. A second IFS analysis, by expenditure decile, shows a much flatter distribution of impact for proportion of expenditure, with a small gradient towards greater impact on those spending most. But it must be recognised that within the lower expenditure half of the spectrum, low income families will tend to have higher spending needs than single or couple pensioner households, so may no longer be so prevalent in the lowest expenditure decile and may be distributed closer to the middle. This suggests the VAT rise will have a significant impact on low income families and a possible regressive impact overall for low income families compared to wealthier households. It also suggests a more progressive approach could have been taken using tax options targeted to the assets and incomes of the wealthiest households.

PROCESS FOR FAIR DECISIONS

The Coalition Government has repeatedly committed to fairness and included “fairness” as one of the three defining principles of the Government in the coalition agreement document. Both the Prime Minister and the Deputy Prime Minister also made commitments to fairness during the general election campaign.

Child Poverty Action Group was one of several organisations concerned to ensure that there was a process of delivering on commitments to fairness, to ensure it was not just a veneer of rhetoric.¹ We therefore jointly wrote to the leaders of each party during the election campaign calling for them to commit to a “Fairness Test”, which we described as:

“An inequality impact assessment to ensure that tax rises and spending cuts necessary to cut the deficit do not lead to an increase in inequality of incomes, assets or access to services.”

In the days prior to polling day we received replies from both Nick Clegg and David Cameron. Nick Clegg stated that:

“The Liberal Democrats want to make sure that the burden of controlling spending falls on those who can afford it . . . This is exactly why we are committed to a fair and transparent approach to deficit reduction—and I am more than happy to sign up to a Fairness Test, so that closing the gap doesn’t bear down on those who already have too little.”

David Cameron did not say he would sign up to the test, but stated:

“We will ensure that fairness is at the heart of our approach to tackling the deficit.”

We wrote to both the Prime Minister and Deputy Prime Minister on 20 May 2010 reminding them of the replies they gave prior to the election and asking them to make a joint statement in regard to the position of the Coalition Government on the proposed Fairness Test process. To date we have received no response.

Without a transparent and verifiable process within government, making use of (i) capacity for modelling impacts of tax and benefit changes across the income deciles; and (ii) access to relevant data on service use and impact assessments of cuts across income deciles, we do not see how it is possible for the Government to meet its commitments on fairness and to be held publicly accountable.

We also believe that the Fairness Test is important to the Government meeting its responsibilities under the socioeconomic equality duty of the Equality Act. Ministers are subject to the duty contained in Section 1 to have due regard to the desirability of making strategic decisions in a way designed to reduce inequalities

¹ Others in the “Fairness Test” group included Barnardo’s, Save the Children, Community Links, One Society, Gingerbread, Church Action on Poverty, TUC, London Play and Women’s Budget Group. Since the election further organisations have backed the call for the Fairness Test, including Oxfam and the coalition campaigns Get Fair and End Child Poverty.

of outcome which result from socio-economic disadvantage. To meet this duty, they need the information and analysis that allows them to exercise the due regard required of them. The Fairness Test would provide such information.

ALTERNATIVE OPTIONS FOR CUTTING THE DEFICIT

While there is strong economic consensus for a clear timetable for deficit reduction, there is not a strong consensus for the dramatic pace that the Government is pursuing. The unbalanced reliance on spending cuts over tax rises has a greater impact on low income families because of their greater dependence on services and lower contribution in absolute terms to taxes. We believe this has had the consequence of precluding proper investigation of progressive taxation options to make a greater contribution to deficit reduction. We are also concerned that the Government has not pursued the development of a comprehensive strategy to close the tax gap. The National Audit Office estimates the gap represents a loss of revenue of at least £40 billion and acknowledges that this is likely to be a very conservative estimate. Other estimates place the gap at potentially more than £100 billion. Even if the gap was as low as £40 billion and other estimates are overstated, there remains the possibility that a tax gap closure strategy could make a significant contribution to deficit reduction, which would help insulate the poorest families from service cuts. However, HMRC are currently set to proceed with plans to reduce to the numbers of revenue collection staff and tax offices.

ECONOMIC CONSEQUENCES

We are concerned that the government is pursuing deep cuts at a swift rate despite the lack of a broader economic consensus on the safety of doing so at the current stage of economic recovery. We are also concerned that decisions are being taken with short-term time frames for analysis of economic benefit. This means that the long-term economic benefits of child poverty reduction and prevention through the protection of jobs, wages and minimum income standards for welfare recipients are being overlooked. Research commissioned by the Joseph Rowntree Foundation suggests that there is an annual cost to the UK economy of £25 billion per annum as a consequence of the current levels of child poverty. We believe that a long-term economic strategy for sustained recovery must actively seek the economic dividend of reduced child poverty. There are health cost concerns too. A study published in the *British Medical Journal* (BMJ 2010;340:c3311) indicates that radical cuts in social welfare spending by governments intent on reducing budget deficits can damage health and cost lives as well as cause financial hardship. The report suggests that while governments think that ring-fencing healthcare budgets is sufficient to safeguard the population's health, they may be ignoring the health dangers implicit in welfare cuts.

CONCLUSION

In summary, Child Poverty Action Group believes that the Emergency Budget was not, despite the Government's claims, a progressive budget. This view is supported by the Institute for Fiscal Studies, which has disaggregated the measures taken by the previous government from those taken in the Budget and concluded on the day following the Budget that the "overall impact of yesterday's measures was regressive". We believe the impact on the poorest households will be greatest and that duties under the Child Poverty Act and Equality Act have not been given sufficient regard.

We believe that the Government must urgently redress these failings through the decisions it will make in the spending review due on 20 October 2010; and that it should have in place, in time to assist the final decisions on the spending review, a framework for a "Fairness Test" as called for by ourselves and others.

It is also of concern to us that the Government chose to headline the Budget as "progressive" by combining new announcements with the pre-announced measures of the previous government, rather than giving a clear presentation of the overall impact of new measures. This seriously impeded the immediate reaction of organisations such as CPAG and the reporting of the impact of the Budget in the media. The 24 hour rolling news culture and competitive pressures for media outlets to be first to break news means that misleading presentation can dominate the story before journalists and independent analysts have time to uncover the true picture. We hope therefore that the Committee will not only consider the content of the Budget, but will also address concerns about presentation.

14 July 2010

Written evidence submitted by HM Treasury

1. The Treasury Select Committee has asked for a note on the cost of allowing shares acquired via approved employee share schemes to qualify for Entrepreneurs' Relief for capital gains tax (CGT).
2. The estimated Exchequer cost of including approved employee share schemes in the definition of Entrepreneurs Relief rises to upwards of £175 million by 2014–15. This estimate is subject to a high degree of uncertainty due to its dependence on the forecast uptake of these schemes, limited availability of data on gains realised by employees benefiting from tax-advantaged shares schemes and potential behavioural effects.

3. A minority of individuals participating in approved employee share schemes have capital gains in excess of the Annual Exempt Amount (AEA) and are therefore liable to pay CGT. The June Budget announced that the AEA for 2010–11 would be maintained at £10,100 and would continue to rise in line with inflation.

4. For individuals with share scheme capital gains above the AEA, there is not a clear rationale for including these gains in the definition of Entrepreneurs' Relief:

- approved share schemes already provide generous income tax and National Insurance Contributions relief;
- Entrepreneurs' Relief is targeted at entrepreneurial activity, ie it is intended to benefit individuals who are active in the business and have a significant stake in it; and
- this proposal would open up new opportunities for aggressive tax planning and avoidance. It would also present additional difficulties for HMRC's ability to tackle tax evasion.

5. This proposal would make the CGT rules for shares significantly more complex:

- employees would have to keep separate records of shares eligible for Entrepreneurs' Relief by virtue of having come through an approved share scheme and other shares of the same class in the same company that didn't qualify. They would have to know and apply extra identification rules to determine whether they had disposed of qualifying or non-qualifying shares. The rules needed to trace their original shares into other shares or securities they received in a company reorganisation or takeover, etc. would be particularly complex to follow; and
- operators of approved share schemes would have additional burdens in explaining the rules to qualifying employees.

14 July 2010

Supplementary written evidence submitted by the Office for Budget Responsibility

THE INTER-RELATIONSHIP BETWEEN PRODUCTIVITY, INCOME TAX RECEIPTS AND EMPLOYMENT AND DIFFERENT WAGE RATES BETWEEN GOVERNMENT AND MARKET SECTOR

1. Wages and salaries are the key economic determinant of the forecast for Pay-as-you-earn (PAYE) and national insurance contributions (NICs). This determinant consists of two main components:

$$\text{Wages and salaries growth} = \text{employment growth} + \text{average earnings growth}$$

2. The path for whole economy wages and salaries is determined at the macroeconomic level. It is not constructed "bottom-up" via a simple aggregation of its components, but "top-down" ie with reference to other whole economy indicators such as inflation and the output gap.

3. This is because (in the medium term) the Bank of England is assumed to be able to control the aggregate (and only the aggregate) level of nominal demand in the economy. The Bank will therefore target the level of nominal demand judged to be consistent with meeting the inflation target. The forecast for wages and salaries growth will be the path consistent with this level of demand in the economy.

4. In the medium term, when the economy is at its potential level of output and inflation is at target, whole economy average earnings can be expected to grow at around 4½%, (representing growth of 1.7% pa in productivity per worker and 2.8% growth in RPIX inflation).

5. Although the overall forecast is determined at the whole economy level, forecasts are also produced and published for its individual components. There are separate forecasts for the government and market sector.²

6. The government sector forecasts for employment and earnings are determined exogenously. They are projected as set out in the OBR document *General Government Employment Growth Forecasts* released on the OBR website on 13 July.

7. The market sector forecasts are then determined by whole economy factors such as the output gap and inflation, given the path of the government sector forecasts.

8. There is no explicit modelling of the characteristics of those workers flowing between the government and market sector. Workers leaving government sector employment are implicitly assumed to have the same average earnings as those remaining.

9. The level of employment also depends upon population. The forecast for population is a combination of the contribution of natural demographic change and an assumption that net migration to the UK is 140,000 per year. No attempt is made to model, at the microeconomic level, which sectors of the economy migrant workers flow into, if they become employed.

² Private sector plus public corporations.

10. The whole economy forecast for wages and salaries growth is then used to construct the PAYE and NICs forecasts, although the split between growth due employment and to earnings is important. The PAYE and NIC forecasts apply an average marginal tax rate to changes stemming from higher earnings, while the average tax rate is applied to changes resulting from higher employment.

19 July 2010

Supplementary written evidence submitted by HM Treasury

During my appearance before the Treasury Select Committee on Thursday 15 July, I agreed to provide you with a further clarification on a number of points raised by members of the Committee. I attach a note summarising the requests from the Committee and, where possible, providing further detail. This has been agreed with the Treasury Select Committee secretariat.

This note includes:

- further information on Housing Benefit reforms announced at Budget (Annex A);
- further detail on the modelling of the distributional analysis published for the first time at Budget (Annex B); and
- an explanation of the analysis supporting my decision to set the top rate of Capital Gains Tax at 28% (Annex C).

You also asked about the Office for Budget Responsibility's (OBR) employment forecasts. This is a question for the independent OBR and has been passed to the OBR to answer. They will provide the Committee with a note shortly.

I have already written to you separately setting out some more of my thinking on arrangements for the permanent OBR.

George Osborne

Annex A

JUNE 2010 BUDGET: HOUSING BENEFIT REFORMS

Background

Housing Benefit (HB) expenditure is forecast to increase to £21 billion in 2010–11, an increase of nearly 50% in real terms in the last 10 years. HB provides an important safety net for around 4.7 million people. However, the current system creates significant disincentives for claimants to move into work and to manage their housing costs.

In particular, the Local Housing Allowance (LHA) scheme, which was introduced in the private rented sector in 2008, subsidises some private rented sector tenants to live in expensive properties that could not be considered by other low-income households. High rates of benefit increase dependency by making it difficult for these families to find work that would take them off benefit.

Budget measures

The June 2010 Budget sets out a suite of measures designed to make the system fairer and strengthen work incentives, as well as controlling costs. From April 2011, LHA rates will be subject to caps of £250 per week for a one-bedroom property, £290 p/w for a two-bedroom property, £340 p/w for a three-bedroom property, and £400 p/w for a property with four bedrooms. The LHA size criteria will be amended to remove the five-bedroom rate and to fund an extra bedroom for claimants with a disability who have a non-resident carer. From October 2011, LHA rates will be set at the 30th percentile of local rents for each property size, rather than the median. From 2013–14, LHA rates will be uprated in line with CPI inflation.

The Budget also announced that from April 2013, working age social tenants who occupy a larger property than their family size warrants will be restricted to a standard regional rate for a property of the appropriate size. The value of contributions that adult non-dependant earners in HB households are expected to make towards the rent will be updated to ensure that the benefit system does not subsidise the housing costs of non-claimants. For JSA claimants, receipt of the full HB award will be time-limited to 12 months. After this point these claimants will be restricted to 90% of the full HB rate while they remain in receipt of JSA.

To support the implementation of these measures, the Budget announced that the Government would increase its annual contribution to the Discretionary Housing Payments budget from £20 million to £60 million. This will enable local authorities to provide help to those who, in their opinion, require further financial assistance with housing costs.

Together, the Budget measures will save £1.8 billion per annum by 2014–15. This means that by the end of the forecast period, HB expenditure will be brought back to 2008–09 levels.

Time-limiting support for JSA claimants

You also asked for some background information on the Government's plans for reducing Housing Benefit entitlement by 10% for customers who are claiming Jobseeker's Allowance (JSA) after one year.

The measure sends a clear message that people who are expected to work cannot continue to receive maximum help from the benefit system to pay their housing costs indefinitely. It builds on a principle introduced into the welfare system for JSA claimants by the previous administration, which set a two-year time limit on Support for Mortgage Interest for JSA claimants.

Around 600,000 working age HB recipients receive JSA—18% of the total working age caseload. Just under 50% of this group have been claiming JSA and HB for 12 months or more. The average reduction in HB for these claimants when the measure comes in will be £9 per week.

The measure will increase the financial incentive for these claimants to work, and encourage them to take up jobs that they would not otherwise consider. There are nearly half a million vacancies in the UK, over 10,000 new vacancies are posted through Jobcentre Plus every working day, and there are a number of vacancies for low-skilled work that employers find very difficult to fill, with more than 7,000 vacancies in jobcentres advertised for at least six months, suggesting that some claimants may not be fully considering these vacancies when looking for work.

There is a significant body of research pointing to the impact of changes in benefit levels, such as this measure, on incentives to take up work. While results between studies vary, there is a general consensus that high levels of out-of-work benefits can be detrimental to employment. Recent research backs up these conclusions.

For instance in commenting on the French system, Bargain and Dooley (2009)³ find that on becoming eligible for more generous out of work benefits at age 25, a significant proportion of those affected withdraw themselves from the labour market. And in the UK context, the IFS (Meghir and Phillips, 2008)⁴ have recently shown that the probability of people choosing to work responds to the level of out of work income, and that this is particularly true for those with lower levels of education. They state that "welfare benefits can have substantial effects on the work behaviour of unskilled and even for men with high school education".

The increase in Discretionary Housing Payment funds announced in the Budget will enable local authorities to provide additional support on a discretionary basis to deal with any particularly difficult cases.

Annex B**DISTRIBUTIONAL ANALYSIS OF BUDGET MEASURES IMPACTS**

As noted by The Committee not all measures announced in the June 2010 Budget are included in the charts published in Annex A of the Red Book. This was explicit in paragraph A10 of the Red Book which said "The policies that can be modelled account for two-thirds of benefits and tax credits changes and the majority of direct and indirect tax announcements. A full list of measures that can be modelled together with a methodological explanation is set out in the data sources document". This note explains why it was not possible to include certain measures in the analysis.

Background to the analysis

The charts were produced using HM Treasury's tax and benefit micro-simulation model ("the model") and include all measures that it was possible to model. To be able to obtain consistent results across Budget measures on household incomes and expenditure a single source of data is required. For this analysis we have used the Expenditure and Food Survey (EFS) produced by the Office of National Statistics. The EFS is a cross-sectional survey taking a snapshot of around 5,000 household incomes and expenditure at a moment in time.

HM Treasury has included in the analysis published in Annex A all measures where there is robust data available. Where there is insufficient data available to be able to reliably model measures these are not included in the Government's published analyses.

Explanation of measures that cannot be modelled

The analysis published in the Red Book includes the switch to CPI uprating for all benefits and tax credits, including Disability Living Allowance. It does not include the switch to CPI uprating for public service pensions due to data constraints.

The reforms to Disability Living Allowance have not been included in the analysis, as they do not come into effect until after the period the charts cover. Even if they came into effect earlier they could not be included in the analysis as the reforms to Disability Living Allowance is a change to the medical assessment, so medical condition will determine the number of losers, rather than income level.

³ Bargain, O, Doorley, K, (2009) *Caught in the Trap? The Disincentive Effect of Social Assistance*. IZA Discussion Paper Series, No 4291.

⁴ Meghir, C, and Phillips, D, (2008). *Labour Supply and Taxes*. Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.

For Housing Benefit many of the changes are to Local Housing Allowance. LHA is based on rents at a very local level. Data is not available to determine which Broad Rental Market Area a household is located to be able to allocate their LHA. Even if the data was available Household surveys like the EFS are not designed to be representative below a Government Office Region level so it is unlikely that analysis of changes to LHA would be robust.

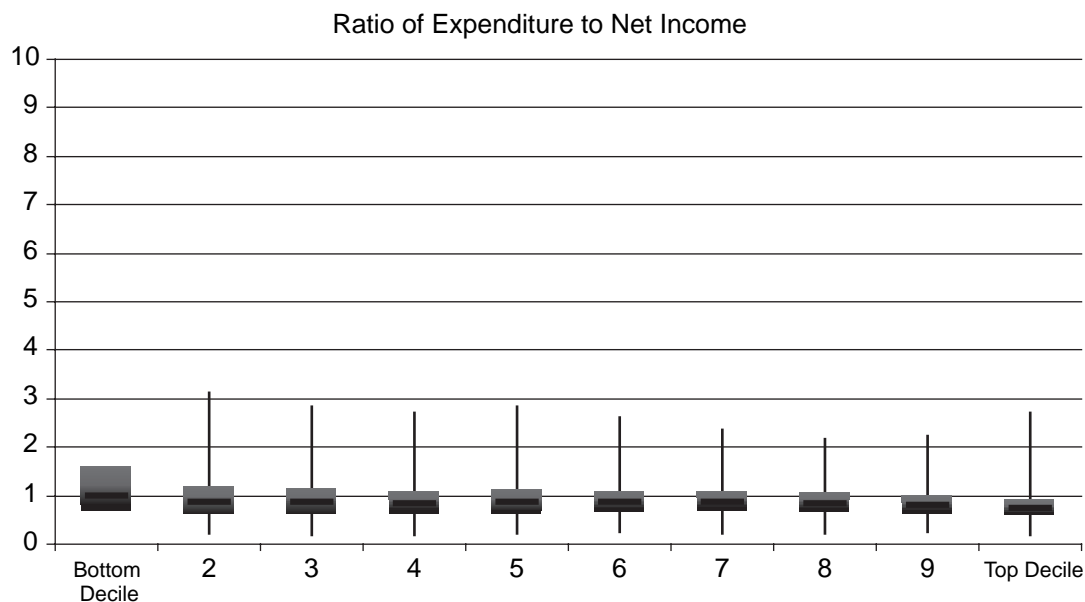
As the EFS is a snapshot survey, it is only possible to know about the current household income. To be able to model tax credit income disregards, for example, we would need to know how incomes have changed over a longer period. As this data is unavailable these changes to tax credits cannot be modelled.

Pension tax relief has not been included because of a lack of data. The IFS have chosen to assume that it is all borne by the top decile to include in their modelling. The Government does not make assumptions where the impact of a policy would fall in the income distribution, although it accepts that the IFS assumption is a reasonable one to make.

Students in the bottom decile

Households in the bottom decile contain many households with temporarily low incomes. Although you asked for the number of students there are other groups in the bottom decile such as temporarily unemployed or self-employed with low incomes because they are starting-up or for other reasons. It is important to consider all these groups rather than one in isolation. In the bottom decile 43% of households contain an adult that is self-employed, unemployed or a student. While some of these households will have permanent low incomes, many will not. In contrast, in the second decile only 22% of households contain an adult in one of these groups.

The following chart shows the variation in the relationship between expenditure and net income in each decile. It shows that in the bottom decile one half of households have expenditure exceeding income; 25% of households have expenditure 1.6 times their net income and 1% of households have expenditure exceeding nearly 17 times their net income. This contrasts with other deciles where the variation in household expenditure is much smaller and more consistent. The very large expenditures in relation to income in the bottom decile will bias the overall average of the impact of an indirect tax change towards the large amounts in this decile.



Disaggregating Budget and inherited measures

The previous Government made a number of announcements about the policies it would pursue in this Parliament if re-elected, but for which it chose not to legislate for. In light of the fiscal position I have reviewed all the announcements and decided not to go ahead with some of them (eg the toddler addition in Child Tax Credits) while confirming that we will legislate for others (eg increase to National Insurance rates). Because of this I believe that all the measures I have decided to legislate for, both those previously announced by the last Government and those announced by this Government, is the best representation of my decisions in the June 2010 Budget.

In the interests of transparency, and as set out in the Data Sources document, measures announced by the previous Government that were included in this analysis were:

- increase all National Insurance rates by 1 percentage point;
- increase Primary Threshold in 2011–12 by £570 above alignment with where the personal allowance would have been under plans inherited by this Government;

- freeze higher rate threshold in 2012–13, keeping upper earnings limit and upper profits limit aligned with higher rate threshold (I took the decision to freeze the Basic Rate Limit until 2013–14); and
- above indexation increases to tobacco, alcohol and fuel duty rates.

The increases to excise duties are relatively minor and do not substantially change the distribution of the impact of indirect taxes published in charts A1 and A2. The direct tax changes announced, but not implemented by the previous Government do not substantially change the shape of the distribution for households in the lower half of the income distribution; but they have negative impacts on the top two deciles.

Publishing years beyond 2012–13

The Government chose to present the distributional impacts for 2012–13 because of the staged implementation of some measures, eg tax credits. We chose not to model analysis for years beyond 2012–13 as analysis becomes less robust the further from the present day you go. In particular:

- The assumptions on which the modelling is based become more uncertain the further out you go.
- Publishing analyses of years far into the future may not be representative of the impact of Government policy as the Government will take a view on tax and welfare policy based on the emerging fiscal position in future fiscal events. For example, the Coalition Government has expressed its aim to increase the personal allowance to £10,000 which will benefit some households towards the bottom of the income distribution.
- Furthermore the model is a static model which means that it does not take into account behavioural and macro economic effects. These could be significant over time.

Presenting Distributional Analysis in the future

Annex A is the first time that the Government has produced distributional analysis of the Budget. The analysis published includes all measures that the Government considers can be reliably modelled. As was explained in the introductory paragraph of the Annex “For future fiscal events the Government will consider how best to present the impact of changes on households consistent with these aims of transparency”.

Annex C

CAPITAL GAINS TAX

Whilst there is a degree of uncertainty to all costings, HMRC’s central assessment is that the revenue maximising rate of CGT is not much further beyond 28%.

Furthermore, a rate of 28% keeps the UK in line with other industrialised nations and continues to be below the top rates charged in France, Italy and Germany.

Further information about the costing is publicly available in the *Budget 2010 Policy Costings* document, which was published alongside the budget and for the first time sets out the assumptions and methodologies underlying policy costings. To summarise, there are two behavioural effects that underpin HMRC’s central assessment:

- Bringing CGT more into line with income tax rates is likely to reduce the incentive to substitute income for a capital gain and therefore increase income tax receipts. The costing assumes that for every 1-percentage point reduction in the gap between the CGT rate and the income tax rate, there is an increase in income tax yield in 2011–12 of about £60 million. Thereafter, this rises in line with the forecast for income tax receipts.
- Increasing the rate of capital gains tax also has a so-called “lock-in effect”, which means that individuals are more likely to retain assets than sell them, thus locking in some unrealised gains. The costing assumes that a 1-percentage point increase in the CGT rate would reduce gains realised by 2.75%.

Taper relief and indexation

The introduction of an indexation allowance was considered but the complexity and administration involved would have been self-defeating:

- Introducing an indexation allowance would have made the tax system significantly more complex, imposing large administration burdens on both taxpayers and HMRC. This goes against the Government’s aim of simplifying the tax system.
- Indexation could not have been implemented before April 2011 and there was a need to act now to ensure that there was minimal forestalling and disruption to the economy.

The introduction of a tapering relief was also considered. However, this approach would not have met the policy aims:

- A tapering relief does not address the incentives to substitute income for a capital gain. The latest available survey data (2006–07) suggests that around 75% of gains are made on assets held for five years or longer.
- Taper relief can exacerbate the lock-in effect, which reduces yield. Tapering options offering a lowest CGT rate of less than 18% also have a substantial exchequer cost.

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