



House of Commons
Treasury Committee

June 2010 Budget: Government Response to the First Report from the Committee

First Special Report of Session 2010–11

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The Treasury Committee

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

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

Committee staff

The current staff of the Committee are Eve Samson (Clerk), David Slater (Second Clerk), Adam Wales, Jay Sheth, Jonathan Tang, Daniel Fairhead (Committee Specialists), Phil Jones (Senior Committee Assistant), Caroline McElwee (Committee Assistant), Gabrielle Henderson (Committee Support Assistant) and Laura Humble (Media Officer).

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First Special Report

The Treasury Committee published its First Report of Session 2010–11, *June 2010 Budget*, on 20 July 2010, as House of Commons Paper No. 350. The response to this Report from the Government was received on 3 November 2010 and is published as an appendix to this Special Report.

The response from the Government is in plain text and the Committee's conclusions and recommendations are in bold text.

Appendix: Government response

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)**

The Government notes this recommendation and its response to the Committee's detailed report on the OBR explains in full the steps being taken to entrench the independence of the office.

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)**

The OBR published an assessment of trend growth at the June Budget.

The Spending Review prioritised spending that promotes long term economic growth, introducing structural reforms to enable a private sector led recovery and building a low carbon economy. As part of the Spending Review process, the Government looked at a range of capital projects to identify those with the highest economic value, and assessed spending pressures from the previous government's contractual commitments. In light of this, the Spending Review increased the capital envelope by £2.3 billion a year by 2014-15 relative to the Budget plan in order to ensure that capital projects of high long term economic value are funded. This change has no direct impact on the fiscal mandate, which targets the cyclically adjusted current balance, and will also not alter the year in which public sector net debt as a percentage of GDP begins to fall.

The Spending Review:

- protects high value transport maintenance and investment, including over £10 billion over the Spending Review period on road, regional and local transport schemes, including
- construction of the Mersey Gateway bridge; £14 billion for Network Rail, including major improvements to the East and West Coast Main Lines; £6 billion for upgrades and capital maintenance on the London Underground network; and funding to enable Crossrail to go ahead;
- ensures the UK remains a world leader in science and research by continuing support for the highest value scientific research, maintaining the science budget in cash terms over the Spending Review period with resource spending of £4.6 billion;
- increases adult apprenticeship funding by £250 million a year by 2014-15 relative to the level inherited from the previous government;
- invests in the low carbon economy, including through £1 billion of DEL funding and additional significant proceeds from asset sales for a UK-wide Green

Investment Bank, and up to £1 billion for one of the world's first commercial scale carbon capture and storage demonstrations on an electricity generation plant; and

- puts higher education on a sustainable financial footing, while providing support to individuals from low income backgrounds. Building on Lord Browne's Review of higher education funding and student finance, universities will be able to increase graduate contributions from the 2012-13 academic year.

The Government cannot create private sector growth, but it can create the conditions that enable UK businesses to be successful. That is why the Spending Review will put public spending on a sustainable footing by taking decisive action to reduce the deficit, to help keep long-term interest rates low and encourage businesses to invest. The key elements of the Government's approach to creating the conditions for private sector growth are:

- creating macroeconomic stability, so that interest rates stay low and businesses have the certainty they need to plan ahead;
- helping markets work more effectively, to encourage innovation and the efficient allocation of resources;
- ensuring that it is efficient and focused in its own activities, prioritising high-value spending and reducing tax and regulatory burdens; and
- ensuring that everyone in the UK has access to opportunities they need to fulfil their potential.

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)

The Government's fiscal consolidation plans have been designed to support continued economic growth and deliver fairness, including, as much as is possible, by avoiding punitive increases in tax rates on capital and labour, and reforming the welfare system to reward work.

The June Budget set out additional consolidation on top of the plans announced in the March Budget. Plans in the March Budget were for 71 per cent of the consolidation by 2014-15 to be delivered through lower spending. By 2014-15, 80 per cent of the additional consolidation measures set out in the June Budget will be delivered through spending restraint. This means that in 2014-15, 73 per cent of the total consolidation will now be delivered through lower spending. By 2015-16, the final year of the forecast period at the June Budget, 77 per cent of the overall consolidation will be as a result of lower spending.

Public spending has grown to unsustainable levels, so a reduction in public spending should make the greatest contribution to deficit reduction. Total Government spending increased from 41% of GDP in 2006-07 to 48% of GDP in 2009-10, while tax receipts fell by 2% of GDP over the same period. The consolidation will bring spending back to the same level as 2007-08 by the end of the Spending Review period in 2014-15, while keeping the tax-to-GDP ratio close to its historical average.

The OBR pre-Budget forecast highlighted the UK's ageing population and the upward pressure this will place on health care and pension spending in the future. Reducing government expenditure now will help to accommodate these future spending pressures.

Reflecting this, the greatest contribution to the Government's fiscal consolidation will come from public spending reductions, rather than tax increases. This approach is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that largely rely on spending restraint promote growth.

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)

The Department for Work and Pensions will publish an impact assessment for Housing Benefit reforms that require primary legislation when the relevant legislation is brought forward.

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)

The impact of the June Budget is progressive with every part of society contributing to deal with the deficit, but with the rich paying more than the poorest. The poorest households benefit less on average from the changes to direct tax because the bottom decile includes fewer households containing taxpayers. The average impact of the VAT increase when shown as a percentage of income affects the bottom decile more strongly because the bottom income decile includes a number of households that are experiencing temporarily low incomes while continuing previous spending patterns. As explained in the Red Book, looking at the impact of the VAT increase for these households by expenditure decile may represent a more accurate representation.

For the Spending Review, the Government has developed a new methodology to help show the distributional impacts of the fiscal consolidation as a whole. Chart B6 shows that the top 20% contribute most to the fiscal consolidation as a percentage of net income and benefits-in-kind, and that the overall impact is progressive.

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)

The Government recognises the need for greater transparency for effective scrutiny of tax policy making. The distributional analysis presented in Annex A of the Red Book, and that shown for Spending Review, goes further than any Government has gone before in presenting the impact of its decisions.

The analysis provided in Annex A of the Budget is produced using HM Treasury's tax and benefit micro-simulation model and is underpinned by surveys managed by the Office for National Statistics and the Department for Work and Pensions. These surveys are collected under National Statistics protocols. In collecting data public bodies have to balance the burden on respondents with the need for the data collected. Additional burdens on respondents also risks reducing the level of co-operation with the survey.

Owing to the time lag between changes to data collection and the data being made available, decisions on what to collect data on need to be identified somehow in advance.

Publishing detailed analysis of survey data at regional level requires a large enough sample to provide sufficiently robust data for such breakdowns. Social surveys can be expensive to conduct, and the cost is a function of sample size. It is therefore necessary

to balance the benefits of obtaining high-quality data with the requirement to provide value for money.

For Spending Review this Government has taken an innovative approach to try to capture some of the impacts of the fiscal consolidation which are not typically included in distributional analysis. For future fiscal events the Government will consider how best to present the impact of tax and welfare changes on households consistent with the aims of improving transparency.

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)

It is essential that Government policy is informed by analysis that is known to be robust, and the Treasury has followed a well-established methodology, similar to that used by external commentators for tax, tax credit and benefit analysis.

For Spending Review, given the importance in understanding the possible impacts of changes to public services and in response to the comments of the Treasury Select Committee, a new methodology has been developed to understand the impact of spending decisions on households. Given the significance of changes to DLA, ESA and Pensions Tax, it was considered important that the impact of these measures was captured in analysis of the overall impact of fiscal consolidation. Whilst this has provided a way to show a picture of the overall impacts of fiscal consolidation, it remains important that our distributional analysis of tax, tax credit and benefit measures is robust, for example taking into account interaction between aspects of the system where they are significant at an individual level. We welcome efforts to extend the scope of tax-benefit modelling, and where this is shown to be robust remain open to exploring ways of including this in our analysis.

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)

The Government recognises that access to finance is critical for businesses to survive and grow, and that small and medium-sized enterprises (SMEs) face particular challenges. Evidence suggests that financing conditions have improved since the economic crisis, but this does not mean that potential risks surrounding the future price or availability of finance can be ignored. There are already a range of measures in place to help SMEs to access the finance they need, including the Enterprise Finance Guarantee, which was increased in the June Budget by £200 million to support additional lending of up to £700 million for small businesses until 31 March 2011. The recently published Green Paper, Financing a private sector recovery, highlights further potential support options – including many that are industry-led. To support the Green Paper process, the major UK banks and the British Bankers' Association have also

established a taskforce that will explore options to create a stronger and more sustainable business banking market in the UK. The Government's response to the Green Paper will be published in the Autumn, while the actions agreed by the taskforce have already been published and will include a range of measures to improve customer relations with small businesses and to increase finance options. Foremost among these proposals is the creation of a new £1.5 billion Business Growth Fund, which will provide equity finance for small businesses with strong growth potential throughout the country.

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)

The Government welcomes the continued interest of the Committee on the Bank Levy, which will come into effect on 1 January next year. As part of the current consultation exercise, the Government is discussing the detailed application of the Levy to help ensure it achieves its desired objectives while minimising compliance and operational burdens. The Government will review the design of the Levy in 2013 to ensure it is operating efficiently.

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)

The Government operates four approved share schemes, which already provide full relief from income tax and National Insurance contributions. The majority of individuals participating in approved employee share schemes pay no Capital Gains Tax (CGT) on their employee held shares, as they realise capital gains below the Annual Exempt Amount. As announced at Budget, the Annual Exempt Amount for 2010/11 will be maintained at £10,100 and will continue to rise in line with inflation.

We have considered a number of options for providing CGT relief to gains made on shares held within approved share schemes. However, we have found that these proposals open up new opportunities to engage in tax avoidance, make it harder for HMRC to tackle tax evasion and make the CGT rules for shares significantly more complex. However, we will continue to keep the issue of encouraging share ownership schemes under review.

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)

The OBR, having independently considered the Coalition Government's consolidation measures, does not forecast that the economy will fall back into recession but that GDP growth will strengthen, rising to above trend levels from 2012 with the economy adjusting back towards potential output. Furthermore, external forecasters and

commentators have, since the Budget, endorsed the OBR's judgement, with the OECD forecasting the UK will be the G7's second fastest growing economy in the second half of 2010. The IMF central scenario for the UK economy forecasts GDP growth of 2 per cent in 2011, strengthening to 2½ per cent in the medium term.

The Government's mandate for fiscal policy is based on a cyclically-adjusted aggregate, to allow some flexibility for the position of the economy at a time of uncertainty. The mandate is therefore flexible as it will allow the automatic stabilisers to operate to support the economy.

As highlighted in the June Budget, the reaction of the bond market to an accelerated and more credible fiscal consolidation plan could leave long-term interest rates lower for longer.

In addition, during the period of fiscal consolidation, the independent MPC could provide additional stimulus, including by maintaining historically low interest rates for longer or undertaking further quantitative easing, should it judge that conditions warrant such a response.