House of Commons
Treasury Committee


Sixth Special Report of Session 2014–15

Ordered by the House of Commons
to be printed 23 March 2015
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.

All publications of the Committee (including press notices) and further details can be found on the Committee's web pages at www.parliament.uk/treascom.

Current membership

Mr Andrew Tyrie MP (Conservative, Chichester) (Chairman)
Rushanara Ali MP (Labour, Bethnal Green and Bow)
Steve Baker MP (Conservative, Wycombe)
Mark Garnier MP (Conservative, Wyre Forest)
Stewart Hosie MP (Scottish National Party, Dundee East)
Mike Kane MP (Labour, Wythenshawe and Sale East)
Mr Andy Love MP (Labour, Edmonton)
John Mann MP (Labour, Bassetlaw)
Jesse Norman MP (Conservative, Hereford and South Herefordshire)
Teresa Pearce MP (Labour, Erith and Thamesmead)
David Ruffley MP (Conservative, Bury St Edmunds)
Alok Sharma MP (Conservative, Reading West)
Rt Hon John Thurso MP (Liberal Democrat, Caithness, Sutherland, and Easter Ross)

Powers

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

Publication

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

Committee staff

The current staff of the Committee are Chris Stanton (Clerk), Anne-Marie Griffiths (Second Clerk), Adam Wales and Gavin Thompson (Senior Economists), Hansen Lu, Gregory Stevens (on secondment from the Bank of England), Callum Saunders (on secondment from the NAO), and Laura Saks (on secondment from the FCA) (Committee Specialists), Steven Price (Senior Committee Assistant), Alithea Williams (Committee Assistant), and Sanjay Odedra (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, 14 Tothill Street, London, SW1H 9NB. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk.
Sixth Special Report


The Government Response is in plain text and the Committee’s conclusions and recommendations are in bold text. It is attached as an appendix.

Appendix: Government Response

Introduction

1. The Treasury has again been unable to provide all the information needed by deadlines agreed with the OBR. The Government may, as the Chairman of the Office for Budget Responsibility suggested, have decided that for political reasons this was a "price worth paying." This would set an undesirable precedent. The work of the Office for Budget Responsibility depends on the Treasury meeting the agreed deadlines. (Paragraph 7)

The Government recognises the importance of providing the OBR with timely information. Unfortunately, as the Chancellor made clear, the details of the announcements on health were not finalised until after the OBR’s initial deadlines for the economic forecast.

2. We welcome the OBR’s innovation of providing uncertainty ratings for policy costings. (Paragraph 8)

3. We recommend in future that the OBR publish a breakdown of the uncertainty rating assessment against the three criteria for all announced measures at Autumn Statements and Budgets. (Paragraph 8)

4. The Committee welcomes the Government's continued publication of the distributional analysis of the Government's policy changes. The Committee recommends that the next Government continue with this important aid to transparency. (Paragraph 9)

The government agrees with the committee that the publication of distributional analysis at fiscal events is an important contribution to transparency about tax and spending decisions.

5. The current inflation target set by the Government is symmetrical, and is 2 per cent at all times. Several witnesses alluded to the risks of very low inflation and subsequent deflation, including the Chancellor. The Chancellor has publicly welcomed the current level of inflation. This is not likely to help anchor inflationary expectations. The Governor of the Bank of England is required to write to explain to the Chancellor why
inflation has fallen below 1 per cent. It is important to avoid mixed messages on inflation targeting. (Paragraph 27)

Annual CPI inflation declined to 0.3 per cent in January—its lowest rate since modern recording began—down from 0.5 per cent in December 2014. Inflation has been below target over the past 13 months which is largely due to declining prices in food and energy goods—of the -1.7 percentage point decline in headline inflation between December 2013 and January 2014, -1.4 percentage point is explained by lower food and energy prices, as global commodity prices decline and UK retailers face intensified competition. Annual inflation in Food prices was -2.5 per cent in January—the fastest decline since modern recording began. Core inflation (which excluded the more volatile food and energy components) has increased over the last two months, to 1.4 per cent in January suggesting that underlying inflationary pressure is more stable than headline.

The Government’s commitment to medium term price stability remains absolute. The 2 per cent inflation target applies at all times and remains the primary objective of monetary policy. As highlighted out in the update of the MPC remit in January 2015, this target is symmetric: deviations below the target are treated the same way as deviations above the target. This ensures that the framework does not have a deflationary bias.

Low inflation recently experienced in the UK has mostly been driven by global factors, notably the sharp fall in oil prices and the decline in food prices. Earnings growth has recently been showing signs of strengthening, with total pay up 2.1% on the year according to the latest data, and now rising significantly faster than inflation. This is good news for hard-working families.

On 12 February, the Governor of the Bank of England wrote an open letter to the Chancellor explaining why inflation had deviated from target and what the MPC was going to do about it. This was the first open letter for inflation falling more than 1 percentage point below target.

In his open letter, the Governor of the Bank of England highlighted that a few months of very low or even negative inflation, driven mainly by external factors, does not in and of itself mean that we run the risk of generalised deflation. Indeed lower energy and food prices are welcome news for Britain’s households, which is why we are robust in insisting they are passed on in lower pump prices and utility bills, and we should not confuse this with the threat of persistent low inflation.

As set out in the inflation open letter, the MPC’s latest forecast shows that while inflation is likely to remain low for the next year or so, this mostly reflects the recent falls in commodity and food prices, so that inflation then returns to target in two years’ time. The MPC judges that it is appropriate to return inflation to target within the next two years.

In his response to the Governor’s open letter, the Chancellor welcomed that the MPC remains vigilant to both upside and downside risks to its forecast and stands ready to act if these risks materialise, to ensure inflation remains likely to return to target within two years.

6. The Bank of England should undertake research on the effect of net migration, and the potential for future net migration, on the supply of labour and wage growth as part
of the work on meeting the MPC’s remit. The Treasury should ensure that discussions within Government on immigration policy fully consider the requirements of the economy. (Paragraph 36)

The UK’s monetary policy framework, set out in the Bank of England Act 1998, gives operational responsibility for monetary policy to the independent Monetary Policy Committee (MPC). Determining what research is needed to inform its discussions and judgements is a matter for the MPC.

The Government believes we should continue to be an open and diverse society, attracting and welcoming those who help promote economic growth and competitiveness by working, studying and investing in the UK. The Government is addressing the factors which draw people to Britain for the wrong reasons whilst continuing to attract the most highly skilled workers and students. The Government is continuing to simplify and improve immigration policy and law to make sure the UK has an internationally competitive visa system alongside an efficient and effective enforcement operation.

7. Witnesses have emphasised to the Committee that productivity growth will be the key to sustainable improvements in wages, economic growth and the public finances. Yet productivity growth has once again fallen short when compared against the OBR’s forecast in March 2014. Should this pattern continue, the OBR may have to consider whether its forecast of productivity growth returning to its long-term trend rate remains an appropriate one. (Paragraph 44)

Public Finances

8. For the fifth Economic and Fiscal Outlook in a row, the OBR forecasts that the Government will meet the rolling fiscal mandate, but not the supplementary target. The Government has, as in previous Budgets and Autumn Statements since December 2012, not proposed any action in order to meet the supplementary target. (Paragraph 49)

In its latest forecast at Autumn Statement 2014, the independent OBR forecast that the government was on track to meet its fiscal mandate in 2017–18—2 years early relative to the target year under the Charter for Budget Responsibility in force at the time. Going forward, on the basis of the latest OBR forecast from the December Economic and fiscal outlook, the deficit will continue to fall year-on-year throughout the forecast period and the UK will run a small surplus in 2018–19—the first surplus in 18 years.

Prior to the Autumn Statement 2014 update to the Charter for Budget Responsibility, the fiscal mandate was complemented by an aim for public sector net debt to be falling by 2015–16, as a percentage of GDP. The OBR forecast public sector net debt as a percentage of GDP to be falling in 2016–17, a year later than set out in the supplementary debt target. However public sector net debt peaks at a level of 81.1% of GDP, 0.5 ppts lower than Budget on an ESA10 basis. While debt is peaking later than originally planned, this is due to the lasting impact of the euro area crisis and higher commodity prices in 2011 and 2012. As a result, economic growth in 2011 and 2012 was not as high as originally forecast. Due to the credibility earned through its long-term economic plan and by utilising the flexibility offered by its fiscal mandate, the Government was able to allow the automatic stabilisers to
complement active monetary policy, supporting the economy through the headwinds faced in 2011 and 2012. Meanwhile, the Government has stuck to its long-term economic plan and, as a result, debt is forecast to be falling from 2016-17 and thereafter over the forecast period.

In 2010 the Government said that it would revisit the fiscal rules once the public finances were closer to balance and a revised Charter for Budget Responsibility was approved by Parliament on 13 January 2015. This sets out:

- A revised fiscal mandate, with an aim to achieve cyclically-adjusted current balance by the end of the third year of the rolling five-year forecast horizon
- A supplementary aim for public sector net debt as a percentage of GDP to be falling in 2016–17.

As a result of the progress the Government has made to date on reducing the deficit, the revised fiscal mandate shortens the horizon for the Government to achieve a cyclically adjusted current balance, creating a tighter fiscal constraint. The record deficit inherited by this Government means that, on the basis of the latest OBR forecast, public sector net debt is still forecast to peak in 2015–16 at its highest level since the late 1960s. Both parties in the coalition recognise that the UK faces a long-term debt challenge and, are committed to bringing down debt as a percentage of GDP once this supplementary target for debt has been met. The revised Charter focuses on getting debt on a declining path and reinforces the Government’s commitment to addressing the long-term challenge. The Government will be assessed against the updated Charter for Budget Responsibility for the first time at Budget 2015.

9. The OBR is required to provide a forecast of public spending over the next five years. From 2016–17 onwards it has used the Government’s policy assumptions to achieve this. The implied path of public spending set out by the OBR from 2016–17 indicates that further fiscal consolidation will be achieved primarily through reductions in departmental spending. It is, though, important to recognise that these policy assumptions do not reflect the view of either of the coalition parties on how fiscal consolidation should be achieved. (Paragraph 70)

10. Institute for Fiscal Studies calculations show that following the Government's outlined path will lead to a total cut to DEL in real terms of 22.2 per cent between 2010–11 and 2019–20. However, within DEL, the government has so far chosen to protect certain departmental budgets from budget cuts. If these protections are maintained, IFS calculations show that non-ring-fenced departments will have experienced real-terms budget cuts of 41 per cent between 2010-11 and 2019-20. As we have previously reported, ring-fencing will require spending reductions to be targeted on the diminishing budgets of the non-ring-fenced departments; and we have previously reported on the possible consequences. (Paragraph 71)

The Government has taken tough decisions in order to bring down the deficit while maintaining the vital public services that everyone relies on at home, and supporting the poorest overseas—over this parliament, the Government has successfully delivered spending reductions while maintaining real terms growth in health spending. Key to the fairness of the Government’s deficit reductions has been the focus on efficiency and cost-
effectiveness across all areas of public spending, including those that have been protected from headline reductions.

11. The Government's new Charter for Budget Responsibility shortens the target date of both the fiscal mandate and the supplementary target. It also now describes the former 'targets' as 'aims'. Aims are generally considered to be less binding than targets. The Chancellor's assertion that they amount to the same thing was surprising. (Paragraph 77)

This change does not make a substantive difference to the fiscal framework. The Budget Responsibility and National Audit Act 2011 requires the OBR, on at least two occasions for each financial year, to prepare an assessment of the extent to which the fiscal mandate has been, or is likely to be, achieved. The OBR will continue to make their assessment of the government's progress against the fiscal mandate, supplementary aim for debt and welfare cap in the same way as they have made their assessments to date.

The OBR was established in 2010 in a major reform to the fiscal framework, introducing independence, greater transparency and credibility to the economic and fiscal forecasts on which fiscal policy is based. As one of a growing number of independent fiscal authorities around the world, the creation of the OBR places the UK at the forefront of institutional reform internationally.

The Government has addressed key weaknesses of the past by providing the independent OBR with executive responsibility for producing the official forecasts and assessing progress against the fiscal mandate. All OBR forecasts are produced independently of Ministers, supporting the credibility of official economic and fiscal forecasts.

12. The new Charter still relies on the OBR coming to a nominally authoritative view about the unmeasurable and unobservable output gap, something of which this Committee has been sceptical in the past. (Paragraph 78)

13. Furthermore, the current Charter for Budget Responsibility will become obsolete by 2016–17—the target date for the supplementary aim. The Charter may therefore be better regarded as a statement of policy intention until then, rather than a long term fiscal rule. (Paragraph 79)

The previous fiscal mandate, set in 2010, reflected the exceptional fiscal challenge the Government faced. In 2010 the Government said that they would revisit the fiscal rules once the public finances were closer to balance. Since then, the Government have made significant progress on their fiscal consolidation, reducing the cyclically adjusted current Budget deficit from its peak of 4.7% of GDP in 2009–10 to 2.6% of GDP in 2013–14. On the OBR's central forecast in their December 2014 Economic and Fiscal Outlook, the cyclically adjusted current Budget will be in surplus by 0.7% of GDP in 2017-18.

In this context the horizon on the fiscal mandate can safely be shortened to create a tighter constraint on future fiscal policy choices. The new Charter sets a three-year rolling horizon—so at Budget 2015 the target year will be 2017–18—while retaining flexibility for the automatic stabilisers to operate. The revised Charter for Budget Responsibility also sets a new supplementary aim for debt to be falling as a percentage of GDP in 2016-17. Both parties in the coalition recognise that the UK faces a long-term debt challenge and, are
committed to bringing down debt as a percentage of GDP once this supplementary target for debt has been met.

14. The Chancellor has said that the sharp cuts to departmental spending assumed by the OBR from 2015–16 can be mitigated by savings to the welfare bill. The experience of the past five years shows that the achievement of planned welfare savings depends partly on economic developments, particularly in the labour and housing markets, that are not within government control. It also depends on the timely implementation and operational success of any major reforms to the welfare system. Any decision to reduce welfare expenditure while protecting other specified areas will increase the proportion of savings to be found from other parts of the welfare bill. (Paragraph 97)

15. In its first assessment, the OBR has found that the Government is on track to meet the welfare cap commitment. Although there was no disagreement between the Treasury and OBR on this occasion, the potential for disagreement over whether a measure is a "discretionary policy change" risks causing dispute between them in the future. In the event that the Treasury's own view differs from the OBR's, it should explain the reasons for this in the Budget or Autumn Statement Command Papers. (Paragraph 103)

The welfare cap is a new mechanism that improves control and scrutiny of welfare spending. It ensures that unplanned increases in spending do not go uncorrected. At Autumn Statement 2014, the OBR’s assessment was that the Government was meeting the cap in every year.

The Government agrees that there should be transparency over definitions of policy measures. The OBR makes the decision in any given case as to what constitutes a policy measure, in accordance with the request made to OBR by the Chancellor in his letter of 3 Dec 2013. In the event of any disagreement, an explanation would be provided. The precise format of this explanation will depend on the circumstances.

**Taxation**

16. Estimating the yield from anti-avoidance measures is inherently difficult. In response to this Committee's recommendation from 2013, the OBR in the December 2014 Economic and Fiscal Outlook published its evaluation of all past avoidance measures since 2010. It found that there was no systematic bias across the costings—some produced higher returns, some lower. However, in cash terms, owing to the shortfall in the UK-Swiss tax agreement, significantly less revenue was raised in total than originally expected. The underperformance of a single measure with a large expected yield can more than offset better performance of a number of smaller measures. (Paragraph 108)

As the committee notes, in their evaluation into anti-avoidance costings the OBR found that there has not been systematic bias across the costings; some measures have resulted in greater yield than expected, while others have lower. Of the 23 measures the OBR evaluated, 15 are expected to generate yield within 10 per cent of the original costing.

The original forecast for the Swiss deal was based upon the best available information at the time and was certified by the independent OBR. Estimating the prospective yield from
such agreements is difficult due to the lack of information on the assets held in offshore centres and the extent of any behavioural response to these agreements. HMRC continue to work closely with the Swiss authorities to find out why what we have received is less than had been expected. While the UK-Switzerland agreement has under-performed, two measures taken together - Disguised Remuneration and Annual Tax on Enveloped Property have overperformed by around £1 billion.

HMRC is continually improving estimation methods to take account of the lessons learnt from evaluations such as the one done by the OBR.

17. The restriction on loss relief for banks is the largest revenue generating measure in the Autumn Statement, with an expected yield of £4 billion over the next Parliament. It has been assigned an uncertainty rating of 'very high'. The OBR should continue to monitor the performance of all avoidance measures against their original costings. (Paragraph 109)

18. The assignment by the OBR of uncertainty ratings to each individual policy provides useful information to outside observers. The OBR's creation of uncertainty ratings could also encourage the Treasury to provide more information on their own judgement of the uncertainty of new policy measures. The OBR should compare its uncertainty ratings on policy costings of individual measures against the outturns, and report its findings in its Forecast Evaluation Report. (Paragraph 110)

The Government welcomes the OBR's greater focus on the uncertainty associated with costings. Further detail of the costing methodology is published by the Treasury in the policy costings document, which also highlights key uncertainties with the costing, supplementing the information provided by the OBR.

Where the OBR is content with the costing, it will certify the costing as a central estimate of the impact of the measure on the public finances. As a result, any uncertainty lies on both sides: the measure could raise or cost more or less than expected. The Treasury will continue to work with HMRC and the OBR to evaluate anti-avoidance measures as they become active.

19. Loss relief is an important element of tax planning for all firms across all parts of the economy. The Committee has previously highlighted the importance of certainty in the tax system in its 2011 Report, Principles of Tax Policy. Apparently lucrative tax raising measures against unpopular sectors of the economy, while attractive to governments, carry the risk of undermining the principle of certainty in the tax system. Uncertainty may well reduce the yield. (Paragraph 117)

The government set out its approach to tax policy making in December 2010 and promotes certainty and stability throughout this process where possible. Loss relief restriction was a specific response to a particular combination of circumstances: losses accrued as the result of the financial crisis, misconduct and mis-selling scandals being used to reduce future corporation tax payments. To maximise the potential yield from the measure it was not possible to consult with the sector prior to making the announcement and an anti-forestalling provision was required to reduce the scope for banks to circumnavigate the restriction. Draft legislation was published on the day of the announcement; we have subsequently consulted on this and incorporated certain recommendations.
20. Tackling tax avoidance, specifically the problems associated with base erosion and profit shifting, is an internationally recognised problem which requires an international response. This is currently taking place in the form of the OECD’s base erosion and profit shifting project. The Committee notes the Government’s decision to announce a unilateral Diverted Profits Tax ahead of the conclusion of the OECD’s work. This should not be permitted to destabilise the international effort. (Paragraph 128)

The G20-OECD BEPS project presents the opportunity for comprehensive reform of the international tax rules and the UK is fully supportive of this work. However, this does not preclude action at the national level where we are able to strengthen our domestic defences to counter aggressive tax planning. The Government is acting now so that multinationals can no longer avoid UK tax through contrived arrangements.

The Diverted Profits Tax is consistent with international tax rules and complements the work going forward in the BEPS project. The Diverted Profits Tax supports the overall aim of the BEPS project to better align taxing rights with economic activity.

21. The draft legislation is long and highly complex. This is undesirable in itself, and is likely to be a source of uncertainty. (Paragraph 129)

The tax avoidance techniques targeted by the Diverted Profits Tax involve a wide range of complex arrangements designed to avoid paying tax in the UK. Tackling this requires comprehensive legislation.

Draft legislation was published on 10 December 2014 for consultation and the Government is considering where changes to the final legislation for Finance Bill 2015 are appropriate to ensure that it is clear and properly targeted. In addition to this, HMRC will also be issuing further guidance before 1 April 2015 to provide more detail on the operation of the rules.

22. In its Report, Principles of tax policy, the Treasury Committee recommended as its first principle that tax policy should be fair. By imposing thousands of pounds of additional tax liability owing to a penny’s difference in a property’s price, the old ‘slab’ structure of residential stamp duty clearly breached this principle. The Committee therefore agrees with the Chancellor and the Institute for Fiscal Studies that the design of residential stamp duty was significantly flawed, and welcomes its reform in the Autumn Statement. However, the unfair and distortionary slab structure continues to apply to stamp duty for non-residential property transactions. The Government should explain the reasons for reforming residential stamp duty in this way but not making a similar reform of non-residential stamp duty. (Paragraph 134)

The Government welcomes the Committee’s support for the Government’s reform to Stamp Duty Land Tax (SDLT) on residential properties, which makes SDLT fairer and more efficient. The reformed system will provide help to first time buyers and aspirational homeowners wishing to move up the housing ladder. The Government believes that the market for non-residential property is very different from the market for residential property. For example, non-residential properties have a higher value on average. Furthermore, non-residential property has been treated differently to residential property
for SDLT purposes since 2003. For these reasons the Government does not feel it appropriate to make changes to SDLT on non-residential properties at this time.

23. The Committee notes this example of how fiscal devolution can lead one government to alter tax policy in response to the decisions of the other. With further fiscal devolution to Scotland, this is likely to be more common. (Paragraph 135)

Devolution puts power closer to the citizen so that local factors can be better recognised in decision-making, whilst ensuring that the benefits of the union—currency, pensions, single market, economic stability and security—are retained.

The Committee is right that devolution can lead to a different policies on devolved areas between Devolved Administrations and the rest of the United Kingdom. Some of these differences may arise in response to policy changes by another Government. This is already a feature of the current devolution settlements and the Smith Commission will have noted it when determining which taxes should be devolved to the Scottish Parliament.