House of Commons
Treasury Committee


First Special Report of Session 2014–15

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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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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, Thomas Francis (on secondment from the FCA), Gregory Stevens (on secondment from the Bank of England), and Callum Saunders (on secondment from the NAO) (Committee Specialists), Steven Price (Senior Committee Assistant), and Alitheia Williams and Paul Little (Committee Assistants).

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The Treasury Committee published its Ninth Report of Session 2013–14, Autumn Statement 2013 on 8 March 2014, as House of Commons Paper No. 826. The Government Response to this Report was received on 7 May 2014. It is published as an appendix.

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

Appendix: Government Response

The Macroeconomy

1. Recent data revisions suggest that GDP has been growing by more than previously thought, and business surveys also suggest that the recovery is taking root. That the recovery is, at the moment, consumer-led, is not surprising. As the Governor of the Bank of England has noted, "recoveries are very seldom, in this country or other countries, led by business investment". However, a broad based improvement in the long run performance of the economy will be required if the recovery is to lead to a long period of trend growth. As we have previously recommended, a greater focus on supply side reform will be required. (Paragraph 18)

The preliminary estimates of the GDP growth in the first quarter of 2014 show that the recovery is balanced across all the main sectors of the economy, with manufacturing, services and construction all growing by over 3% in the first quarter of 2014 compared to a year earlier. There is also evidence of a more balanced position on expenditure components of GDP, with business investment growing annually by 8.7 per cent in the fourth quarter of 2013. The consumption contribution to growth is similar in this recovery to the last two in the 1990s and 1980s and the contribution of consumption to growth has been smaller in recent quarters than the consumption share of GDP.

The government is determined to support this broad based recovery through its programme of supply-side reform. This includes significant support for businesses in key stages of their development – helping them to invest, export and grow, including reducing the costs of energy and cutting corporation tax to the lowest rate in the G20. The government is providing further help to young people to enable them to gain the skills and employment they need; investing in infrastructure with an infrastructure pipeline worth over £377 billion; and boosting the supply of new housing to support home ownership.
The public finances

2. The Committee has previously emphasised the considerable uncertainty in the measurement of the output gap and therefore the limit to its usefulness. The OBR's projection of the cyclically-adjusted current budget, which relies upon a forecast of the output gap, is therefore also highly uncertain. Despite these uncertainties, it nevertheless appears that a significant structural deficit has been the inheritance of the last decade, emphasising the need for further fiscal adjustment. Closing the structural deficit will require an improvement in economic performance. (Paragraph 25)

The government’s fiscal strategy is underpinned by a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. The OBR judged in December 2013 that the fiscal mandate will continue to be met a year early, in 2017-18.

However, the OBR judge that much of the recent improvement in the economy has been cyclical rather than structural. The persistence of the structural deficit supports the government’s argument that economic growth alone cannot be relied upon to fix the budget deficit, and the government’s consolidation plan remains appropriate. The latest data shows that the government has achieved 80 per cent of the spending consolidation set out in Spending Review 2010 and, in addition to meeting the fiscal mandate a year early, the OBR forecast in December 2013 that the structural deficit will fall below its pre-crisis level by the end of this parliament.

3. It is not yet clear what the outcome of the Government’s review of the Charter for Budget Responsibility will be. It is reasonable to suppose that it may contain amendments to the fiscal mandate. This Committee has previously recommended that any new fiscal framework should be subject to full public consultation. The requirement for the updated Charter for Budget Responsibility, including any amended fiscal framework, to be approved by the House of Commons, falls some way short of this proposal. The Government should consult on any proposed changes to the fiscal framework as part of its review of the Charter for Budget Responsibility. Effective public consultation will improve the prospects of creating a framework for fiscal policy that will be more stable and resilient than those used in the past. (Paragraph 33)

In 2010 the government was clear that its new fiscal framework reflected the exceptional fiscal environment in which the government was operating and that the future of the fiscal framework would be revisited once the public finances were closer to balance. As a result of the government’s strategy there has been significant progress in dealing with the deficit and fiscal credibility has been restored, allowing activist monetary policy and the automatic stabilisers to support the economy. Autumn Statement 2013 announced that over the course of 2014, the government would review the current fiscal framework and that outcome of the review will inform an updated Charter for Budget Responsibility. An updated Charter will be presented to Parliament alongside Autumn Statement 2014. The government notes the importance of ensuring a stable fiscal framework and that fiscal credibility is both hard earned and easily lost. In this context the government recognises the value of consulting stakeholders consistent with the need to ensure both market confidence and stability.
4. Ring-fencing, by definition, requires that the balance of public expenditure restraint and cuts be borne in the rest of public expenditure. Each successive year of public expenditure restraint results in an increase in ring-fenced spending as a proportion of the total. The smaller non-ring-fenced areas in turn have to bear a higher proportion of any savings in subsequent years. The IFS has shown that non-ring-fenced expenditure may fall from 61.6 per cent in 2010-11 to around 50 per cent in 2018-19 of total Departmental Expenditure Limits. Ring fencing also reduces the discipline on spending in these areas: the rigour of negotiations between the department and the Treasury on allocations will be weakened, since it is known in advance by both sides that this spending is protected. (Paragraph 45)

5. The Chancellor says that the ring-fencing of health, schools and overseas aid budgets reflects public preferences. Protection of health and education spending, but not overseas aid, appears to reflect public preferences. (Paragraph 46)

6. The Government should do what it can to ensure sufficiently informed public debate on the trade-offs inherent in ring-fencing and the allocation of spending cuts. Such a debate is especially important in a period of transformative spending reductions. (Paragraph 47)

The government recognises that protecting the health, schools and overseas aid budgets increases the savings required from other departments. However, the government is committed to protecting spending in these areas – maintaining the vital public services that everyone relies on at home, and supporting the poorest overseas. Like all other areas of departmental spending, spending in protected areas continues to be subject to detailed scrutiny to identify efficiency savings and deliver services cost-effectively.

The government has encouraged open debate when planning and allocating spending reductions. In the period before the 2010 Spending Review, the government consulted with experts and the public through roundtable discussions and regional events and the public were invited to submit money-saving ideas through the Spending Challenge website. To inform the 2013 Spending Round, the government undertook a series of seminars to discuss key public service reforms with external stakeholders.

Budget 2014 announced that the government is launching a seminar series led by HM Treasury which will engage with key stakeholders to consider opportunities for further reform, and to develop ideas to support further fiscal consolidation in the next Parliament.
Housing

7. Data from the end of 2013 indicate that national aggregate house prices have recently been growing at a rapid rate. Mortgage availability, and the demand for mortgages, have both increased. The growth in house prices has drawn considerable public attention, particularly regarding whether the activity yet represents a speculative housing bubble. Witnesses explained rising prices by drawing attention to pent-up demand and the limited supply of housing within the UK, and to the likelihood of a limited short-term supply response to rising house prices. (Paragraph 54)

8. The danger is that it will be difficult for the Financial Policy Committee to identify when a speculative housing bubble may have begun. Such a bubble, driven by increasing lending to households, would be a risk to the UK economy. As the Governor has told us, "experience has shown that imbalances fuelled by a credit boom, which may manifest themselves in asset-price movements, pose the greatest medium-term risk to the economy, because of the powerful deleveraging process they induce when they unwind." House prices are therefore a class of asset price which requires careful attention by policymakers, given their historic and continuing influence on the UK economy. (Paragraph 55)

It is important to realise that the housing market is recovering alongside the rest of the economy. Though prices have increased, they are well below their peak in real terms, and the OBR noted in March 2014 that they will still remain 0.5 per cent below this peak by the end of the forecast period in 2019. While the number of mortgage approvals has increased by a third in the past year, they still remain 17 per cent below their long run average. The government agrees that careful attention should continue to be paid to developments in the housing market as recovery progresses, and notes that a sustainable recovery in the housing market will only be secured if lenders continue to lend responsibly and borrowers do not take on unaffordable commitments.

The government is encouraging house building to ensure that increases in demand are matched by sufficient increases in the supply of housing. The government has already committed to invest over £11bn in housing during this spending review period. More recently, at Budget 2014, the government announced measures to support the building of over 200,000 new homes including plans to create a Garden City at Ebbsfleet, provide a £525m Builders’ Finance Fund to help small and medium-size developers access finance and extend the Help-to-Buy: equity loan scheme to March 2020.

One of the greatest failings of the Tripartite regulatory system designed by the previous government was the fact that no single institution was responsible for monitoring the financial system as a whole, identifying potentially destabilising trends and responding to them with concerted action. That is why the government created the Financial Policy Committee (FPC) within the Bank of England to ensure emerging risks and vulnerabilities across the financial system as a whole are identified, monitored and effectively addressed. This includes monitoring developments in the housing market.

In the 2014 remit and recommendations for the FPC and in his Budget speech, the Chancellor emphasised that, although housing activity remains below long-term trends, the Committee should remain vigilant against the emergence of potential risks in the
housing market. He also welcomed the clarity that the FPC has provided to markets and households on the tools that are available to it if risks were to crystallise in the future.

9. The Committee has previously concluded that the Help to Buy: Mortgage Guarantee scheme could produce negative distorting effects on the housing market. Our judgement has not changed. (Paragraph 60)

10. In addition to this, the Government's Help to Buy: Mortgage Guarantee scheme may have further distorting effects on the UK housing market when withdrawn. The Treasury should examine the impact of an abrupt end to this scheme, and act in advance to mitigate market distortions before they arise. The Government should explain now what the exit strategy from Help to Buy: Mortgage Guarantee will be in order better to influence expectations. The Bank of England may need to adjust the timing of its regular annual review of the Help to Buy: Mortgage Guarantee scheme accordingly. (Paragraph 61)

The government is committed to making the aspiration of home ownership a reality for as many households as possible. We want current and future generations to experience the benefits of owning their own home, in the same way as their parents and grandparents. The Help to Buy: mortgage guarantee scheme was introduced to support households who cannot get a mortgage because of the very large deposits required by lenders following the financial crisis, but who can afford the mortgage repayments.

It is already clear that the Help to Buy: mortgage guarantee scheme is having the desired effect. By the end of January, more than 2,500 households completed mortgages supported by the scheme. Over 80 per cent of these completions supported people taking their first steps onto the housing ladder. The majority of these sales have taken place outside London and the South East, with uptake the highest in Scotland and the North-West. The Help to Buy: mortgage guarantee scheme is supporting responsible lending, with households, on average, purchasing houses worth around £148,000, which is considerably below the UK average house price of £250,000.

The three-year scheme is designed to address the lack of availability of high loan-to-value (LTV) mortgages in the wake of the financial crisis. Given the time-limited nature of the scheme the government will monitor the impact of the scheme on the market to assess how a “cliff edge” effect when the scheme is withdrawn can be avoided. Now the scheme is open the government is collecting, and will be publishing in due course, data about the scheme’s performance which will aid this assessment. The government has a number of mechanisms available to adjust the scheme parameters, which could help smooth the transition. The government will make a judgement about how best to use those flexibilities according to the market conditions at the time.

Individual measures

11. The Treasury's analysis of the dynamic effects of the Government's corporation tax cut is subject to great uncertainty. Nonetheless, there is some merit in continuing to study the dynamic effects of policy decisions. It is important to emphasise, however, that the OBR took account of some of the effects of the Government's corporation tax cut discussed in the Treasury's paper in its own forecasts, including the effects on
business investment and profit shifting. The OBR has stated that the Treasury's analysis has not affected its official economic forecasts. We will expect the OBR to continue to reach its own independent judgement on the effects of tax changes on the yield. (Paragraph 66)

Since 2010 the government has committed to increase the transparency and sophistication of its modelling of the effects of policies. To support these objectives, HMRC have developed a Computable General Equilibrium (CGE) model to help gain a better understanding of the future impacts of corporation tax reform.

The model has been peer-reviewed by leading academics in the relevant field, who found that: ‘The basic design of the HMRC model for the UK economy meets at large the key requirements for state-of-the-art applied tax policy analysis’. However, the CGE model is not a short-term forecasting model. It is set up to model the transition of the economy to a new long run equilibrium following a policy change. It does not take account of exogenous short-term shocks and economic fluctuations.

The government agrees that the OBR should continue to reach its own independent judgement on the effects of tax changes on the yield. The OBR have provided further detail on how they incorporate the indirect effects of policy into their independent five year economic and fiscal forecast in their recent publication ‘Policy costings and our forecast’ (Briefing paper No. 6).

12. Every year estimates have to be made of the yield of anti-avoidance measures, in the face of great uncertainty about the outcomes. The OBR itself points out that there is a limit to what can be learned from previous policies in determining whether such costings are suitable. The Treasury Committee warned in 2012 that the proceeds of the UK-Swiss tax agreement might not meet expectations. The Government has reduced its estimate of the expected yield of the UK-Swiss tax agreement by almost two thirds over the course of a year. Given the great uncertainty that surrounds the fiscal effects of tax avoidance measures, the reduction in the estimated yield of the UK-Swiss tax agreement should not be a great surprise. (Paragraph 74)

13. The Government has now announced a series of further measures designed to close down avenues of avoidance, each vulnerable to similar uncertainties of their own. In the Government's own words, though, these further measures "will bring in more than £6.8 billion of new revenue over the forecast period—more than any other fiscal event this Parliament". Therefore this perennial problem has now assumed particular fiscal importance given the size of the revenue being forecast. The OBR should do all it can to report on whether yields were attained as originally costed. Where that is not possible, it should limit the extent to which the Government may account for such projected gains. (Paragraph 75)

At each Budget and Autumn Statement, the OBR consider each policy measure in order to determine whether estimates of yield should be certified as reasonable and central. HM Treasury and HM Revenue and Customs work closely with the OBR on the estimated Exchequer effects of all measures in the run up to Budgets and Autumn Statements. This includes providing the OBR with estimates of the yield from these measures and the
evidence to support those estimates. To date, the OBR has certified all the estimates of yield on anti-avoidance and other measures designed to tackle non-compliance measures.

There is always a degree of uncertainty in estimating the effects of anti-avoidance measures. In particular, there is the issue of attrition, which occurs when the yield from an anti-avoidance measure declines over time as taxpayers find new routes to reduce their tax liabilities. Specific allowance is made for attrition in policy costings as set down in the recent OBR publication ‘Policy costings and our forecast’ (Briefing paper No. 6). Some measures are forecast to deliver significantly more yield than originally estimated. For example, the Partnerships Review measure was originally forecast to raise around £1bn over the forecast period at Budget 2013. Following consultation the measure was extended at Autumn Statement 2013, raising around £2bn in additional yield, bringing the total revenue forecast to over £3bn. In addition the government’s annual tax on enveloped dwellings, targeted at those individuals who avoid paying a fair share of tax by “enveloping” high value residential properties (by owning them through corporate structures), has raised five times the original £20 million forecast for 2013-14.

The government considers carefully information on the effectiveness of measures designed to tackle non-compliance and will use this to inform the estimated yield from future measures where appropriate. However, the degree to which measures aimed at tackling non-compliance can be directly monitored or evaluated will differ. In some cases, the yield is more likely to be observable, for example, some of the additional revenues from the UK-Swiss tax agreement are collected and accounted for through a separate Swiss capital tax. For other measures, this task will be more difficult. This would be the case if, for example, the measure is designed primarily to deter particular behaviours, for example, the GAAR.

**Transport and energy infrastructure**

14. In the interests of transparency of decision-making, the Treasury should set out the absolute benefits and absolute costs, and the benefit-cost ratios, for each road and rail scheme considered by Government, whether approved or not. The calculations should be consistent with well established Department for Transport best practice. This practice is based on Treasury Green Book principles. (Paragraph 80)

15. The Treasury should ensure that contingency funds are used only for contingencies and do not become a safety margin to accommodate poor planning. (Paragraph 83)

The government agrees that contingency funds should be used to manage genuine risks and not as a safety margin to accommodate poor planning. Projects, like HS2, have effective control mechanisms in place to control costs and access to contingency. These control mechanisms have been designed in part on the basis of the lessons learnt from the funding and contingency arrangements which were used for the successful 2012 London Olympic Games.

The government published updated guidance on early cost estimates for infrastructure projects in November 2013. This underlines that contingency funds should not be used to compensate for poor management and that the cost estimate used to determine the value proposition in the economic case must not be automatically converted into the final cost estimate for the financial case and subsequent budget.