House of Commons
Treasury Committee

Autumn Statement
2014

Ninth Report of Session 2014–15

Report, together with formal minutes relating to the report

Ordered by the House of Commons to be printed 11 February 2015
Treasury Committee

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1 Introduction

Our inquiry

1. The Committee took evidence from four panels of witnesses during the three meetings we held, as follows:

9 December 2014: City economists and the Institute for Fiscal Studies

First panel: Alan Clarke, Head of UK and Eurozone Economics, Scotiabank; Kevin Daly, Senior Economist, Goldman Sachs; and Jamie Murray, Senior UK Economist, Bloomberg Economics

Second panel: Paul Johnson, Director, and Carl Emmerson, Deputy Director, Institute for Fiscal Studies.

10 December 2014: Office for Budget Responsibility

Robert Chote, Chairman, Graham Parker CBE, Member, and Professor Stephen Nickell CBE, Member, Budget Responsibility Committee.

17 December 2014: HM Treasury

Rt Hon George Osborne MP, Chancellor of the Exchequer, and James Bowler, Director, Strategy, Planning and Budget, HM Treasury.

2. We are very grateful to all our witnesses and to those who submitted written evidence. Their willingness to provide evidence within the short timescale available for this inquiry is particularly appreciated.

The Principles of Tax Policy

3. We normally ask the three main professional accounting and tax bodies—the Association of Certified Chartered Accountants, the Institute of Chartered Accountants of England and Wales, and the Chartered Institute of Taxation—to provide the Committee with written evidence on the extent to which the provisions of the Budget, and the Finance Bill which will implement them, meet the criteria set out in our Report of 2011, Principles of Tax Policy. The principles are: fairness; supporting growth and encouraging competition; certainty, including simplicity; stability; practicality; and coherence. On this occasion, we asked them to undertake similar work on tax measures in the Autumn Statement, as well as providing further written evidence subsequent to publication of the draft Finance Bill 2015. We are very grateful to these bodies for their assistance.

1 Eighth Report of Session 2010–11, Principles of Tax Policy, HC 753
The Office for Budget Responsibility

4. The Chairman of the Office for Budget Responsibility once again confirmed to this Committee that the OBR had been able to undertake its work “wholly independently”, with, when required, the immediate assistance from the Treasury. He also confirmed that if problems were to be encountered by the OBR, he would tell this Committee, if necessary privately, but also publicly if that was appropriate.

5. However, the OBR did not receive all the spending plans it required from the Treasury in time for them to be incorporated into its macroeconomic forecast. Its December Economic and Fiscal outlook (EFO) noted that:

   On 28 November, we were provided with details of changes to spending plans in 2015–16—and the Treasury’s assumption for total spending growth from 2016–17 onwards—that would have had an effect on our economy forecast had they been provided in time. This has meant that in this EFO unfortunately our economy and fiscal forecasts are not fully consistent.

Mr Chote explained the effect of the Treasury’s failure to provide the relevant information on time on the work of the OBR as follows:

   Basically, we were notified of the additional money that was being allocated to the NHS from the reserve and the consequences for the Government’s medium-term spending assumption over the subsequent years, from 2015–2016, after the date at which we had agreed with the Treasury to close down the economic forecast in order to provide a stable basis for the Chancellor to take decisions on. That is never ideal when it happens, and I always want to make sure that we are transparent about those things when that sort of thing happens. It would not, I think, quantitatively have made an enormous amount of difference.

Mr Chote concluded that:

   In an ideal world, we would receive the information in time to produce a consistent set of forecasts. On the other hand, if there are political reasons to take late decisions, then it is for the Government to decide whether that is a price worth paying.

6. This is not the first time the Government has provided information late to the OBR. In our Report on the 2014 Budget, the Committee concluded that:

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2 Qq118-119
3 Q120
4 Office for Budget Responsibility, Economic and Fiscal Outlook, Cm 8966, December 2014, pp. 2-3
5 Q121
6 Q123
It is regrettable that the Government did not supply details of its additional support for childcare to the OBR in time for it to verify the Government’s claims about the costs of this policy. The OBR has said that it will look at this measure closely in the run up to the Autumn Statement. It is not acceptable, however, that the Government’s figures should be left unverified for what may be more than eight months. We recommend that, when Budget announcements are not submitted before the OBR’s deadline, the OBR should scrutinise major uncosted policies as soon as reasonably possible thereafter and publish its findings.7

7. 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.

The OBR’s uncertainty ratings

8. The OBR has, for the first time, assigned policy costings in the Autumn Statement with an uncertainty rating—ranging from ‘low’ to ‘very high’. This is in addition to the OBR’s annex in the HM Treasury’s policy costings document to highlight costings that were particularly uncertain. The ratings are determined by assessing the uncertainty arising from three data sources: “the data underpinning the costing; the complexity of the modelling required; and the possible behavioural response to the measure”.8 The OBR then “take into account the relative importance of each source of uncertainty for each costing”.9

We welcome the OBR’s innovation of providing uncertainty ratings for policy costings. In the December 2014 Economic and Fiscal Outlook, the OBR illustrated how an uncertainty rating was assigned to a policy by including a worked example of a sample policy measure—the Government’s exemption of air passenger duty for children under 12.10 This shows that the overall rating is based on the extent of uncertainty across three criteria: data, modelling and behaviour. Upon request, the OBR provided this Committee with the same analysis for each of the measures in the Autumn Statement. 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.

Distributional analysis

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.
2 The macroeconomy

Prospects for growth

10. As Table 1 below shows, the OBR’s forecast for real GDP growth in 2014 and 2015 has improved from its March 2014 forecast. Set against this are reductions in forecast GDP growth in 2016–2018. The average of GDP growth forecasts of independent forecasters in HM Treasury’s November 2014 Forecasts for the UK economy were 2.6% in 2015, 2.4% in 2016, and then 2.3% in 2017 and 2018.\(^\text{11}\)

<table>
<thead>
<tr>
<th>Year</th>
<th>March 2014 Economic and Fiscal Outlook</th>
<th>December 2014 Economic and Fiscal Outlook</th>
<th>Change (percentage points)*</th>
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<tbody>
<tr>
<td>2013 (Outturn)</td>
<td>1.8</td>
<td>1.7</td>
<td>0.0</td>
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<tr>
<td>2014</td>
<td>2.7</td>
<td>3.0</td>
<td>0.3</td>
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<tr>
<td>2015</td>
<td>2.3</td>
<td>2.4</td>
<td>0.1</td>
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<tr>
<td>2016</td>
<td>2.6</td>
<td>2.2</td>
<td>-0.4</td>
</tr>
<tr>
<td>2017</td>
<td>2.6</td>
<td>2.4</td>
<td>-0.2</td>
</tr>
<tr>
<td>2018</td>
<td>2.5</td>
<td>2.3</td>
<td>-0.1</td>
</tr>
<tr>
<td>2019</td>
<td>-</td>
<td>2.3</td>
<td>-</td>
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* change may not equal difference between December 2013 and March 2014 columns due to rounding

Source: Office for Budget Responsibility, Economic and Fiscal Outlook (March 2014 and December 2014 editions), Table 1.1

11. Mr Daly, Senior Economist, Goldman Sachs, argued that the OBR had been too pessimistic in its forecasts for GDP growth. He told us that:

their forecasts are significantly more pessimistic than ours but even more so pessimistic than the Bank of England’s. In the near term they expect growth already in Q4 to have slowed to a pace of around 2% to 2.5%. There is no evidence of that having taken place in the data.[…]

In the near term [the OBR] are relatively pessimistic beyond any evidence that you can find of such a slowdown in the data, but also in the medium to long term, by the end of 2017, they expect the level of GDP to be a full 2% lower than the Bank of England expects. If you factored the Bank of England’s forecasts into the OBR’s fiscal projections, the deficit would be eliminated a full year earlier than the OBR expects. My personal view is that the Bank of England’s forecasts are more likely to be correct than the OBR’s forecasts.\(^\text{12}\)

In evidence to the Committee on the Bank of England’s November 2014 Inflation Report, the Governor of the Bank of England noted that the Bank’s forecast had been “consistently

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11 HM Treasury, Forecasts for the UK economy, November 2014, p18
12 Q25
at the high end of expectations of external observers for growth in the UK,” but that it had been “directionally correct”. He explained the reasons for the Bank’s view as follows:

We have balance in terms of the recovery between business investment and household spending. All those factors are continuing to contribute. In addition, while wages are only just starting to turn—and there are tentative signs there of the turn in wages, so we would not overplay it—households will be receiving an income boost from lower commodity prices, lower food prices, lower petrol prices and diesel prices are sharply lower as well. So real incomes start to be boosted, at least in the near term. For all those reasons, we see that momentum continuing, but this is still an economy that requires monetary stimulus both to grow above trend and to bring inflation back to target, which is why we have the stance we do.14

12. Mr Chote gave two reasons for the differences between the OBR and the Bank of England’s forecasts. First, the Bank’s forecast reflects its view of revisions to past data, which the OBR’s does not.15 Secondly, he explained that:

As I recall, one of the other differences from the Bank’s latest forecast is they have a stronger pace of growth for business investment. As we have discussed, this is trying to pin the tail on a very rapidly moving donkey given the way in which the data are revised here. We have a path for business investment that looks to us broadly in line with the recoveries of the 1980s and the 1990s, but I would lay even more warnings about the uncertainty of: do we actually know where we are today? The discussion with Mr Hosie on many iterations here where we were both trying to explain why investment had not picked up over the last two years and now the ONS tell us it was cantering away very happily as we were having the discussion. So I would lay that caveat there.16

Risks to the GDP growth forecast

13. Mr Chote provided the following outline of the main risks to the OBR’s GDP growth forecasts:

It is a simple forecast so there is a roughly 50% chance in our view that it outperforms or underperforms. In terms of the most consequential risk, then this issue about when you are going to see the long-awaited pickup in productivity growth and the pickup in real earnings that will come with that is probably the major uncertainty. Of course, it then links back into this issue

13 Oral evidence taken on 25 November 2014, HC 829, Q34
14 Oral evidence taken on 25 November 2014, HC 829, Q34
15 Q176
16 Q176
of how healthy the underlying potential output of the economy is and, therefore, to where we can rebound as the economy gets back to normal.

We have highlighted a number of other risks in the report in terms of the economy, renewed instability in the euro area, for example, geopolitical issues, weakness of demand more generally, a return to the sorts of volatility that resulted when people were anticipating the unloosening of global monetary policy. There is a long list of things there, but if you wanted to highlight the one that we—and I think most forecasters have wrestled with—have got wrong in recent forecasts, and what will be most consequential for the public finances, it is how the productivity puzzle is going to resolve itself and where that leads you with earnings. I think it is important to distinguish that we are assuming and the benign outcome is that you see productivity growth and earnings growth picking up pretty much in tandem. If you get wage growth picking up without productivity growth picking up, that is not a good outcome because it will confront the Bank of England with choices on inflation.17

14. Other recent witnesses also cited external risks as a major source of concern. Professor Forbes, an external member of the Monetary Policy Committee, said in November 2014 that “The biggest risks I worry about today are external. I worry about continued stagnation or a sharp downturn in the eurozone. The eurozone is such an important trading partner: 40% of our exports. That will have significant effects on the UK.”18 Prof Forbes did tell us though that she “put slightly more probability on the risk that the global economy could be somewhat stronger than in [the MPC’s] baseline forecasts, especially the US economy”.19 The concern about the Eurozone, and the external risks to the UK economy, was also emphasised by the Governor of the Bank of England:

Certainly in recent months global economic conditions have deteriorated in two of the major economies, Europe and Japan. I agree with Professor Forbes that the situation in the United States is somewhat different. I would layer on top of that the geopolitical situation remains difficult and the combination of that suggests a heightened degree of external risk to the United Kingdom.20

15. On the outlook for the eurozone’s economy, Mr Daly, of Goldman Sachs, did not think that “the eurozone in aggregate will go into recession”, but that in the medium term he was “most concerned about Italy and the political developments there”.21 On the effect of any weakness in the Eurozone on the UK economy, Mr Daly explained that:

17 Q151
18 Oral evidence taken on 25 November 2014, HC 829, Q29
19 Oral evidence taken on 25 November 2014, HC 829, Q4
20 Oral evidence taken on 25 November 2014, HC 829, Q28
21 Q10
As it relates to the implications for the UK, I think there is a distinction to be drawn between the negative impact that will come from sluggish growth, which we clearly have in the eurozone, and the negative impact that comes from a full blown sovereign/banking crisis, as we had in 2010, 2011 and 2012. The sovereign crisis had the effect of significantly raising the funding costs of the UK banks and I think that was very significantly negative for the UK, but my view would be that the UK could continue to deal with a period of sluggish growth. There is a distinction to be drawn between those two scenarios.22

16. Other domestic risks were also identified to the GDP growth forecasts. Ian McCafferty, external member of the MPC, told us that:

We have had to downgrade our forecasts of productivity growth in the Inflation Report over the course of the last couple of years on the basis of the continued disappointments that have been contained in the data as they have been released. If we do not see a pick-up in productivity in this economy over the course of the expansion as it continues, then that expansion cannot be fully sustainable and the rate of growth will be lower as a result. I think it is a big risk. I think there are other equally big risks. We have discussed a whole series of risks, but it is something that we certainly need to pay a good deal of attention to.23

The importance of productivity growth for the UK economy was a common theme in the evidence we have taken during our inquiry, and we discuss it further below (see paragraphs 37–44).

**Household debt and savings**

17. The current GDP growth forecast is based on the reduction of saving by households to fund consumption. As Prof Forbes, external member of the Monetary Policy Committee of the Bank of England, explained: "Recently the recovery has been balanced in the sense it has been driven largely by consumption and investment and it has been fairly balanced between consumption and investment driving the recovery, but that consumption has recently been driven more and more by consumers drawing down their savings and that is not sustainable".24 When asked how long households could continue to reduce their saving, she pointed out that at the moment this could be seen as "a sign of confidence in the recovery."25 But she added that "they cannot keep drawing down savings at this rate or savings will fall too low. We do not know exactly where that level is, though".26 Mr Murray,
of Bloomberg Economics, agreed with Ms Forbes’ view that consumers’ willingness to draw down their savings was a sign of confidence, telling us that:

To some extent the reason that people feel confident enough to reduce their savings is because they think their job prospects are better than they were previously. There is certainly something to be said along those lines and reduced uncertainty does boost consumption.  

18. Although Mr Murray acknowledged that a sudden fall in consumption would not be a “good scenario”, he argued that:

the policy settings are such that the most likely outcome is that households will have to keep spending and the saving ratio probably will slide a bit further. That is because monetary policy is loose and there is a very large adjustment happening in the economy and there is going to be some displacement of Government spending to other consumers. So really it is the policy stance that is driving that behaviour.  

Mr Daly, of Goldman Sachs, provided the following view about the sustainability of current levels of consumption:

The growth in the last couple of years has been driven to a large extent by people reducing savings ratios. I think in part that was driven by improved prospects for employment, so they were saving a very high amount a couple of years ago because of the fears over unemployment. Those fears have fallen; that is a good thing. I think you are absolutely right that going forward the degree to which consumption can continue to be driven by people reducing their savings is limited. I think the good news, however, is that this year more growth is likely to be driven by an acceleration in household incomes, in part because of the decline in the oil price and so forth that we have discussed but also because wage growth will gradually begin to accelerate.  

In written analysis on the Autumn Statement 2014, Mr Clarke, of Scotiabank, argued that some of the measures in it, most notably stamp duty reforms, could provide further support to continued household consumption. But he told the Committee that he thought that this further stimulus was “a temporary quick fix, temporary as in a couple of years, but what we really need is wage inflation to pick up”.  

19. Mr Chote, Chairman of the OBR, also argued that households could not run down their savings forever. He said:

27 Q14
28 Q8
29 Q17
30 Scotiabank, UK Autumn Statement, December, 2014
31 Q18
Certainly if you look at the relatively robust pace of growth over recent quarters, that has been reflected particularly in terms of the contribution from the consumer of people running down savings rather than having stronger income growth. We have assumed that it is not plausible, and I think if you look at the last year the real consumption growth has been running further ahead of real wage growth than in almost any other year over the last 15 or 20 or so. Therefore, in our forecast, the main reason we expect the quarterly pace of growth to slow into next year is that you see consumer spending moving more into line with income growth and being less driven by the sort of decline in saving you are talking about.32

But the Chancellor of the Exchequer argued that the Government had taken policy measures to ensure the savings rate would rise in the future:

It is a feature I think of all recoveries that savings ratios fall, as economic security returns. What I have sought to do is to address, therefore, a longer term issue rather than this year’s saving ratio, and that is to try to get the support in place for people who want to save. In the Budget I set out measures to increase ISAs, abolish the 10 pence saving rate, undertake the major reform of pensions, and of course in this Autumn Statement we took the additional measure on supporting the spouses of people with ISAs who die. So I would say we are seeking long-term policy solutions to the broader challenge of the UK, which is we do not save enough.33

When asked about the concern of consumption falling off should households decide to save more, before wage growth picks up, the Chancellor pointed out that there were other drivers of growth:

I would say we are seeing very encouraging signs on business investment, up 27% over the last four years. On exports the performance remains disappointing, although if you look into those numbers you will see our exports to the continent of Europe have declined but our exports to the rest of the world have gone up by almost 20%.34

When questioned on whether he was prepared to see Government consumption fill the gap if private consumption dipped, he replied:

We have set out our spending proposals for the coming years. I think they are the right proposals. They continue the pace pursued in this Parliament. I

32 Q153
33 Q280
34 Q281
think that consistency and certainty is a contributory factor to economic security in our country.\textsuperscript{35}

**Inflation and monetary policy**

20. Inflation, as measured by the consumer prices index (CPI), was lower in Q3 2014 than the OBR forecast at the time its March 2014 Economic and Fiscal Outlook.\textsuperscript{36} The OBR also reduced its forecast for inflation when compared with its March 2014 forecast.\textsuperscript{37} It said that “We expect CPI inflation to reach a low of 0.9 per cent in the first quarter of 2015, well below our March forecast of 1.9 per cent”.\textsuperscript{38} The OBR argued that inflation would be muted in the near-term owing to low food and fuel price inflation, the appreciation of sterling and lower than expected unit labour costs.\textsuperscript{39} Mark Carney, Governor of the Bank of England, gave his views on the outlook for inflation:

I think it is more likely than not that inflation is going to go below 1%. It is more likely than not that I will write a letter to the Chancellor in the near term. […] external factors are an important element of that, but domestically generated inflation is not particularly pronounced. We expect to see a pick-up over the forecast horizon but, as Sir Jon [Cunliffe] said, it will take some time and, in fact, embedded in our forecast those external factors—falling oil prices, sterling pass-through and so on—are basically dissipated by about 18 to 24 months out and we still do not get back to target on our forecast until the end of the forecast horizon, which gives you a sense of it.\textsuperscript{40}

21. Early indications suggest that these forecasts for subdued inflation were appropriate, as inflation fell to 0.5% in December 2014.\textsuperscript{41} This was the joint lowest 12-month rate on record. The CPI 12-month rate was previously 0.5% in May 2000.\textsuperscript{42} One of the main drivers of this fall in inflation has been a substantial decline in the price of oil. This decline can be seen in the minutes of the Monetary Policy Committee. In December 2014, they state that “The price of Brent crude oil had fallen by 15% in sterling terms since the previous MPC meeting and by 35% since mid-June.”\textsuperscript{43} In January 2015, the MPC notes that “Oil prices had fallen further during the month. The spot price of Brent crude oil had

\textsuperscript{35} Q282
\textsuperscript{36} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, para 3.59, p63
\textsuperscript{37} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, para 3.59, p63
\textsuperscript{38} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, para 3.59, p63
\textsuperscript{39} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, para 3.59, p63
\textsuperscript{40} Oral evidence taken on 25 November 2014, HC 829, Q17
\textsuperscript{41} Office for National Statistics, Consumer Price Inflation, December 2014, 13 January 2015, p1
\textsuperscript{42} Office for National Statistics, Consumer Price Inflation, December 2014, 13 January 2015, p2
\textsuperscript{43} Bank of England, Minutes of the Monetary Policy Committee meeting held on 3 and 4 December 2014, published: 17 December 2014, para 7
fallen to $50 per barrel, down $20 on the month and $32 lower than at the time of the November Inflation Report.”  

**Meeting the inflation target**

22. Under the Bank of England Act 1998, as amended, monetary policy is the responsibility of the Bank of England, which is set the following objectives:

   In relation to monetary policy, the objectives of the Bank of England shall be

   (a) to maintain price stability, and

   (b) subject to that, to support the economic policy of Her Majesty’s Government, including its objectives for growth and employment.  

23. The Government sets the definition of price stability in a remit letter from the Chancellor of the Exchequer to the Governor of the Bank of England. The March 2014 remit letter, which applied at the time of the Chancellor’s statement in the House on the Autumn Statement, said that “I hereby re-confirm the inflation target as 2 per cent as measured by the 12-month increase in the Consumer Prices Index (CPI). The inflation target of 2 per cent applies at all times. This reflects the primacy of price stability and the inflation target in the UK monetary policy framework.” The March 2014 remit also provided further detail on what would happen if the target was not met:

   If inflation moves away from the target by more than 1 percentage point in either direction, I shall expect you to send an open letter to me, alongside the minutes of the Monetary Policy Committee meeting that followed the publication of the CPI data and referring as necessary to the Bank’s latest Inflation Report and forecasts, covering the same considerations set out above. The reason for publishing this letter alongside the minutes is to allow the Committee time to form and communicate its strategy towards returning inflation to the target after consideration of the trade-offs.  

The Bank of England explains that the overall design of the monetary policy target means that:

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44 Bank of England, Minutes of the Monetary Policy Committee meeting held on 7 and 8 January 2015, published: 21 January 2015, para 11
46 Letter from the Chancellor of the Exchequer to the Governor of the Bank of England, REMIT FOR THE MONETARY POLICY COMMITTEE, 19 March 2014
47 Letter from the Chancellor of the Exchequer to the Governor of the Bank of England, REMIT FOR THE MONETARY POLICY COMMITTEE, 19 March 2014
The remit is not to achieve the lowest possible inflation rate. Inflation below the target of 2% is judged to be just as bad as inflation above the target. The inflation target is therefore symmetrical.48

24. While the target may be symmetrical, witnesses warned that the risks presented by very high inflation and very low inflation may be different. Mr Daly, Goldman Sachs, said:

the dangers presented by inflation falling below target, certainly significantly below target, are more substantial than those presented by too high inflation. Simply put, central bankers, monetary policymakers know how to deal with relatively high inflation. That is not to say it is not painful but there is a well-worn path of how to bring it back under control.49

Sir Jon Cunliffe, Deputy Governor of the Bank of England, held similar concerns about the difficulties in dealing with below target inflation:

As I made clear in my report, with policy at the zero lower bound, in order to take an even view of overshooting and undershooting the target, I am more concerned about the risks to inflation on the downside surprise at the moment. At the zero lower bound you have fewer ways of managing a downside surprise than an upside surprise.50

25. However introducing his Autumn Statement in the House, the Chancellor welcomed the OBR's forecast of lower inflation, arguing that:

Living standards are also supported by our robust monetary policy arrangements with the Bank of England. Today, there is welcome news that the OBR has significantly revised down its forecast for inflation: it is expected to be down to 1.5% this year, 1.2% next year and 1.7% the year after, before it returns to target. So we have lower inflation, lower unemployment and higher growth.51

Following the publication of the December 2014 CPI figure of 0.5 per cent, the Chancellor argued in a speech to the Royal Economics Society 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 deflation.

Core inflation, which strips out those factors, remains relatively stable and indeed rose slightly in yesterday’s data.

48 Bank of England website, www.bankofengland.co.uk
49 Q1
50 Oral evidence taken on 25 November 2014, HC 829, Q8
51 HC Deb, 3 Dec 2014, Col 307
Even more importantly, expectations about future inflation remain well anchored and the latest data show that earnings growth is accelerating not slowing down.

Of course we will always remain vigilant to ensure that inflation is low for the right reasons.

But we should not confuse this welcome news for Britain’s households as a result of falling oil prices with the threat of damaging deflation that we see in the Eurozone.\(^52\)

26. When the Committee questioned the Chancellor on why he had welcomed a forecast by the OBR that inflation would be below the Government’s own target of 2 per cent inflation, he argued that:

**Mr Osborne**: Of course, we set a symmetrical target of 2% and the Governor is required to write a letter when we are outside the 1% margin on either side. I would say that Britain’s low inflation, unlike some other economies at the moment in the world, is good for our economy because it is driven by things like falling energy costs, and I believe the credibility of the Government’s economic policy. Inflation expectations are anchored. This is absolutely crucial. Core inflation remains stable. So I do not think you are seeing some of the signs of the deflationary problems you have obviously over a number of years in Japan and more recently signs that those problems are emerging in the Eurozone.

**Chair**: So there is such a thing as a good overshoot to the inflation target?

**Mr Osborne**: The target has a band on either side, so there were many months when inflation was just over the target, certainly the precise target, and now it is under the target.\(^53\)

27. 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.

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\(^52\) HM Treasury, Extracts from the Chancellor’s lecture on economic policy at the Royal Economic Society, 14 January 2015

\(^53\) Qq251-252
The labour market

28. Employment growth has been higher than the OBR forecast in March 2014:

In March, we expected employment to rise by 265,000 (0.9 per cent) between the fourth quarter of 2013 and the third quarter of 2014, but in fact it has increased by 505,000 (1.7 per cent). This was bigger than the positive surprise in real GDP relative to our forecast, which means that productivity growth has continued to be weaker than we expected. 54

Alongside the better than forecast employment figures, unemployment also fell by more than the OBR forecast:

The LFS unemployment rate has also fallen more rapidly than we expected, reaching 6.0 per cent in the third quarter of 2014 compared to our March forecast of 6.8 per cent. The error on claimant count unemployment was even larger. We expected the claimant count to fall by 7 per cent between the fourth quarter of 2013 and the third quarter of 2014, in line with the expected 6 per cent fall in the number of LFS unemployed. In the event, the claimant count fell by 23 per cent, compared to a 17 per cent fall in the LFS unemployed. 55

The ONS’s Labour Market Statistics released in January 2015 reported that for September to November 2014, 73.0 per cent of people aged from 16 to 64 were in work, unchanged from June to August 2014, but up from 72.0 per cent for a year earlier. The unemployment rate for September to November 2014 was 5.8 per cent, down from 6.0 per cent in June to August 2014 and down from 7.1 percent for a year earlier. 56

29. The OBR forecast for employment is now more favourable than it was in March 2014:

We have revised our employment forecast higher due to stronger-than-expected growth so far in 2014. We project employment to rise by 1.0 million between now and the start of 2020, having risen by 1.7 million since the recovery began in 2009. Over the course of the next Parliament, we project that government employment will fall by 1.0 million, compared to the 0.4 million decline that we are likely to have seen over this Parliament. (This reflects a combination of sharper implied cuts in cash spending, plus some pick-up in pay growth.) But over the same period private sector employment is expected to rise by 1.8 million. 57

Unemployment is forecast by the OBR to continue falling:

54 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p30, paras 2.17-2.18
55 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p30, para 2.19
56 Office for National Statistics, UK Labour Market, January 2015, released 21 January 2015
57 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p10, para 1.22
We expect the unemployment rate to continue falling over the coming year and a half—though at a slower pace than we have seen so far this year—and to reach a trough of 5.2 per cent in mid-2016. That would be slightly below our estimate of its long-term sustainable rate, so we then expect it to rise a little thereafter.  

30. However, while employment may be higher than expected, and unemployment lower, this has not been reflected in earnings. The OBR noted that:

  While employment has surprised on the upside, private sector earnings growth has once again surprised on the downside. Average weekly earnings in the private sector in the year to the third quarter grew by just 1.1 per cent, compared with our forecast of 2.4 per cent. This negative surprise is more than would be implied by our productivity forecast error.  

The OBR forecasts a gradual return to more normal rates of productivity and wage growth, implying that “the real consumption wage will be just below its pre-crisis peak in the third quarter of 2007 by the end of the forecast period.” The latest ONS release showed that when comparing September to November 2014 with a year earlier, pay for employees in Great Britain increased by 1.7% including bonuses and by 1.8% excluding bonuses.  

31. Mr Clarke, of Scotiabank, agreed with the OBR’s forecasts, but warned that there were:

  significant risks in both directions. In the latest single month the wage data was 2%. We have seen this spurt in the last three or four months. It would not take an awful lot to be on the headline measure in the low 2% by early next year. However, reports from the wider labour market are quite downbeat. For example, on the settlements data from Incomes Data Services, because of the national minimum wage hike in October, settlements had been 2.5% for well over a year. The 3% minimum wage hike comes in and settlements dive to 2%. That sounds illogical but the reason that has happened is that firms, particularly in the retail sector, have honoured the national minimum wage increase for their lower paid workers but they have compensated for that by paying higher income workers much smaller wage rises. For me, that is a sign that there is not a lot of pricing pressure in the labour market. There is a lot of supply of workers.
Mr Clarke emphasised the importance of productivity growth for the outlook for wages, saying that "On the productivity side, typically fast productivity does tend to be the thing that sees wages pick up, so that is true."63

32. Underlying the aggregate figures on employment and unemployment, the Committee heard of some important changes to the structure and composition of the labour market. The Governor of the Bank of England explained that:

My personal view is that there will be an increase in self-employment and part-time work relative to history, in part—I will not necessarily make comments on changes to benefits or other factors, but just the reality of technology—driven by an ability to disaggregate, if you will, the production of a good or a service, which creates a greater ability to have contractors for firms, which effectively are meaner, have fewer direct full-time employees and have other relationships with designers, accountants, engineers, salespeople and so on, and that ecosystem has developed. In the end, I think we will not go back to historic levels, but that is my personal assessment—there are some structural changes that are driven as much by technology as they are by any particular policy.64

Mr Chote explained that changes in the composition of the labour force were having an effect on household income:

the increase in labour income has come more from a rise in employment than it has come from a rise in earnings and the composition of employment has been less revenue rich. More of the employment growth has been in relatively low-paid work at the bottom of the income distribution. In the assumptions we are making, that surprise on the distribution of income and the implications that has had in knocking down the average rate of income tax is something that we are assuming persists through the forecast. So, in a sense, that is a structural deterioration.65

The Governor of the Bank of England also explained that low income workers had not been the beneficiaries of higher wages:

The short answer is that lower skilled workers are not seeing wage growth. The composition of job growth in recent quarters has been more heavily weighted towards lower skilled jobs. That is one of the things that has weighed on the average increase in earnings, just statistically, and we have not seen a pick-up in those wages. We have seen a pick-up in wages—it has

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63 Q21
64 Oral evidence taken on 25 November 2014, HC 829, Q73
65 Q126
been somewhat volatile—in construction, for example. We have seen a pick-up in fixed pay in financial services.66

Impact of immigration

33. The Committee also heard evidence on the effect of immigration on the labour market, including on wages. The Governor of the Bank of England explained that:

> We have seen an increase in net migration to the UK since the recovery has begun. Those workers are finding jobs at the same pace as people here and they are doing a couple of things. One is yes, it is additional labour so it comes into the supply-demand equation in the labour market. They are also—and we hear this constantly around the country—filling important skills gaps, skills bottlenecks, particularly in the manufacturing sector but more broadly than that, in IT and other areas.67

34. On the impact on immigration on wages, Mr Clarke, of Scotiabank, said that the additional supply of labour provided by immigration could be having an effect on wages:

> There are more migrant workers coming in—200,000 in the last year—and more older workers staying in the labour market. That is a bigger reason for wages to have been low rather than the housing market attracting capital away from productive assets. So it is more than just the housing market in that regard.68

He also argued that it was low and middle skilled jobs where the wage effect of immigration are most pronounced:

> The CIPD, the Chartered Institute of Personnel and Development, did a study on this in their autumn labour market outlook. A quarter of firms have said that EU applicants have gone up in the last year and of those I think it is two-thirds of EU migrants have gone into low to middle-skilled jobs. In the Bank of England’s latest inflation report and the one before that they showed a cumulative increase in employment and the bulk of the increase has been in low to middle-skilled jobs. The headline wage numbers that you see from the ONS is not the average wage increase. It is the average company wage bill. If we move from one year to the next and you have more people working but they are more in low to middle-income jobs, that will depress the wage inflation number, and that seems to be what is going on. I think, based on

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66 Oral evidence taken on 25 November 2014, HC 829, Q65
67 Oral evidence taken on 25 November 2014, HC 829, Q68
68 Q22
what the CIPD found that two-thirds of these jobs are in low to middle skills, migrant workers are depressing wages.69

However, Mr Daly argued that participation by older workers was also a factor behind weak wage growth in recent years:

While I think immigration has had an impact, there has been immigration through the 1990s and the early 2000s, in fact in bigger flows as a share of population through that period. The change that has taken place in the labour market in the last two to three years has come more from the increase in older age labour force participation, which occurred as a result, in my view, of the changes to retirement legislation and pension availability that were implemented in 2010 and 2011. It is my view that this increase in labour supply from immigration is having a dampening effect but it has been a relatively steady dampening effect. The change and the different dynamic you have seen in the last two years has been due to older workers, in my view.70

Mr Daly did acknowledge, though, that:

there are stresses that are presented by immigration. Although economists in general are favourable towards immigration, they need to recognise the social strains it presents. I think it is a measure of the UK’s relative success, absolute success, that it remains an attractive destination for workers across the world.71

Mr Nickell, of the OBR, provided us with the following evidence on immigration and its impact on the labour force:

It is perfectly true and I think you will find it in the evidence that the pay of unskilled workers, particularly in the service sector, has been held back to some extent—not to a massive extent, but to some extent—by unskilled immigration. But I think that there is a huge literature and lots of investigations on the economic pluses and minuses of immigration, and at the end of the day, at least over the next 10 years or so, the general consensus is that for the native population, the existing population, immigration may be a little bit good, it may be a little bit bad economically, but there is not overall that much in it. Obviously there are special situations like in the health service. For example, some 35 per cent of health professionals are migrants and so it is quite plain that if they were not there, the health service would be
in absolutely dire straits, so that is a special point. But overall, economically I think the arguments are not fantastically strong in either direction.\textsuperscript{72}

Although Mr Chote echoed Mr Daly’s evidence by noting that “It might be worth making the other point that this is not the only source of increased labour supply, the fact that you have older people staying on in the labour market for longer”\textsuperscript{73} He told us that he “would just highlight it as another area where you would see that there has been more people working, and I suspect some of those, as with immigrants, more of a skew towards relatively low-paid, relatively low-productivity work.”\textsuperscript{74}

35. Given the effect on the labour market of immigration, the Committee questioned the Chancellor on the work undertaken by the Treasury on the effects of immigration. He replied that:

\textbf{Mr Osborne}: I think immigration benefits Britain but it needs to be controlled. I think that is—

\textbf{Chair}: Have you done the analysis?

\textbf{Mr Osborne}: The analysis was done by the Government, not exclusively by the Treasury. So there was a BIS/Home Office study published earlier this year, which of course we were aware of and had sight of. That did find that low skilled workers are more likely to be displaced than higher skilled workers by people coming into the country. It did identify that challenge. As I say, there are economic benefits and economic challenges with immigration. I think that the policy that is best pursued is, as I say, immigration, the benefits to the country and is controlled.\textsuperscript{75}

36. 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.

\textbf{Productivity}

37. As the discussion of wages and economic growth above has shown, the outlook for productivity is one of the key determinants of how the economy will perform in the future. The OBR said that:

\textsuperscript{72} Q177  
\textsuperscript{73} Q178  
\textsuperscript{74} Q179  
\textsuperscript{75} Q278
domestically, productivity and real wages remain weak and the pick-up we forecast from 2015 is a key judgement. If productivity fails to pick up as predicted, the consumer spending and housing investment that has driven the recovery could falter as the resources to sustain them would be lacking.\footnotemark[76]

Mr Nickell, a member of the BRC, also emphasised how important their judgement on productivity was to the OBR’s forecasts:

As you will notice in the scenarios, we do have a scenario where, over the forecast period, we do not have a recovery in productivity growth and the outcome is pretty dire. So this is a very important call we are making and it is the best judgment in our opinion.\footnotemark[77]

Productivity growth has however continued to underperform against the OBR’s forecasts.\footnotemark[78] The Governor of the Bank of England provided the following explanation of why productivity growth had been so weak:

If you look at productivity, the latest vintage of data suggests a shortfall of about 13 percentage points of productivity. We can explain a portion of that, let us call it 2 percentage points, on measurement error. There is a balance that reflects in part the realities of weak demand. Companies having to work harder for sales is just one example of the implication of weak demand. There is an important component, we think, that comes from the financial sector not having functioned as well as it could for a period of time. Capital was not being recycled and, as well, we have not seen births and deaths of companies move as rapidly.

There is also an important sectoral explanation for the productivity shortfall and Mr McCafferty has done some very good work and speeches on this as well. The most obvious example of this is North Sea oil, as you are well familiar. The decline rates there have had an impact on measured productivity as well as in financial services.\footnotemark[79]

Mr Nickell also provided the following explanation of why productivity had been weaker than expected:

There are a few bits and pieces like the increase in part-time working and self-employment and so on, but we see those as relatively minor. If push came to shove, I think we would argue that it is the consequences of the credit crunch that have led to this productivity puzzle. That is to say quite a high proportion of productivity growth is generated because high...
productivity firms start up and expand and low productivity firms contract and go out of business. There is some evidence to suggest that, because of the credit crunch, there has been a barrier to the expansion of high productivity firms and the starting up of high productivity firms. I am not too convinced about this, but some people argue that the credit crunch as part of the whole business has also led to low productivity activities surviving, so-called zombie firms and so on and so forth.80

39. The Chancellor also gave his views on weak productivity growth:

My personal hunch is that the impairment of the financial system was deeper, had more damage on our economy than people perhaps realised at the time. I think it is interesting, if we look at the Eurozone at the moment, clearly the effects of the banking crisis there in 2012 has had a long tail effect and indeed continues to starve Spanish and Italian small businesses of credit, for example. We can see they have gone through a shock. We went through a different but a similar in scale kind of shock in 2008–09 and it is still being felt.81

40. Mr Chote provided the following explanation of the OBR’s productivity growth forecast, and described their implications:

We are still assuming [productivity growth] does turn round and there is some tentative evidence of an improvement there, but the profile has been pushed back. The fact that you have a more pessimistic view of productivity growth feeds through to a more pessimistic view of real earnings growth and that then feeds back on to the income tax forecast.82

Mr Chote did acknowledge that the lowering of the OBR’s forecast for productivity growth was “repeating a pattern that we have seen in recent forecasts of hoping that that was going to turn round and it has not yet”.83 Mr Chote also explained that much of the loss of productivity was permanent. He explained that:

We would expect some cyclical rebound in productivity growth. However, compare this to the precrisis position and we are assuming that there is a considerable permanent loss. The path to which productivity growth and, indeed, the potential growth of the economy returns is significantly lower than the path you would have anticipated precrisis.84
The permanency of this loss of productivity growth was also a feature of the Bank of England’s forecast. Sir Jon Cunliffe, Deputy Governor of the Bank of England said:

It is quite important to the second part of the forecast that productivity starts to get back to its pre-crisis trend productivity growth of about 2 per cent and it only just does it by the end of the forecast. I should say, nowhere in the forecast do we assume that any of the productivity growth relative to pre-crisis trend, the 13 per cent that the Governor mentioned, is recovered. This is just getting back to trend. Clearly if that does not happen then it is more difficult for household consumption to support the economy because it is dependent on savings with an external sector that is a drag on the economy right throughout the forecast period. This return of productivity growth to relatively modest levels compared to precrisis trend is key, and that is what I meant.85

Although the OBR had pushed back the profile of productivity growth, Mr Nickell explained that its view on the trend growth rate for productivity had not changed:

The feeling is we believe that you are not going to get the productivity back but gradually the path of productivity will come back to its historic normal level. In some sense, we feel that we are not in a position to argue that the normal level of productivity growth has fallen. That is we have not had enough evidence. We have had six years of weakness, but it would be such a big call to make to argue that the long-run trend level of productivity from now on is going to be different from what it has been outside wartime in the last 100 years.86

41. Mr Nickell did emphasise to us that the OBR expected “wage growth to rise”, but that “it is coming back to this productivity issue, this productivity growth. The cost of living crisis is a crisis of no productivity growth […] you cannot have real wage growth without productivity growth in the long run”.87 The Chancellor of the Exchequer also acknowledged that productivity was key to sustainable earnings growth and a return of the public finances to health.88

42. Ian McCafferty, an external MPC member, when asked whether the Government had in place the right supply side measures to increase the productivity rate, replied:

I think the medium-term growth rate is going to depend heavily on investment, and investment not only in the sense of fixed capital but also in terms of improving knowledge, and I think the supply side that I see on the part of this Government, which has been to talk about the importance of

85 Oral evidence taken on 25 November 2014, HC 829, Q51
86 Q138
87 Qq181-182
88 Q263
infrastructure investment in the economy as well as helping innovation through investment in sciences, is helpful to that.[…]

Chair: Was the answer yes?

Ian McCafferty: The answer to that extent is yes. One can always do more but clearly we live in a fiscally constrained economy. One can always spend more on infrastructure and investment in sciences, but so far I would say that that and the flexibility in the labour market that is currently in place are all conducive to a recovery in productivity growth over the medium term.89

43. When asked what policies the Chancellor had undertaken to ensure productivity growth, the Chancellor replied:

Ultimately, productivity growth I think is best addressed by some of the things we have just been talking about: improvement in skills; the infrastructure package for our transport system that we announced a couple of weeks ago, on roads and railways and the like; investment in science. I think one of the potential causes to Britain’s disappointing productivity performance has been the impairment of [the] financial system. I think that was identified—reading up in advance on this—by Steve Nickell when he appeared before this Committee, and continuing to repair the financial system, including returning banks to private ownership and the like, all I think will contribute to improvement in our productivity performance.90

44. 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.

89 Oral evidence taken on 25 November 2014, HC 829, Q60
90 Q264
3 Public finances

Performance against the fiscal targets

45. The Government’s fiscal targets are set out in the Charter for Budget Responsibility. The Charter sets two medium-term fiscal targets—the fiscal mandate and the supplementary target. The fiscal mandate is to target a “cyclically adjusted current balance by the end of the rolling, five year fiscal period”, whilst the supplementary target is for “public sector net debt as a percentage of GDP to be falling at a fixed date of 2015–16.”

46. A new Charter for Budget Responsibility was published by the Government on 15 December 2014, shortly after the publication of the Autumn Statement. The Government’s performance was therefore judged by the OBR against the Charter for Budget Responsibility published in March 2014.

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<th>Table 2: Changes to the cyclically-adjusted current budget since March 2014</th>
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<td>Per cent of GDP</td>
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<td>March forecast</td>
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<td>December forecast</td>
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<td>Change</td>
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Source: Office for Budget Responsibility, Economic and fiscal outlook, December 2014

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<th>Table 3: Changes to public sector net debt projections since March 2014</th>
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<tr>
<td>Per cent of GDP</td>
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<td>March forecast</td>
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<td>December forecast</td>
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Source: Office for Budget Responsibility, Economic and fiscal outlook, December 2014

47. According to the OBR’s December 2014 Economic and Fiscal Outlook (EFO), the Government is on course to meet its fiscal mandate, but is projected to miss its supplementary target. The cyclically adjusted current budget is projected to be in surplus by 2.3 per cent of GDP in 2019–20, with a surplus of 0.7 per cent in 2017–18. This is the fifth consecutive occasion that the OBR has forecast that the Government will not achieve its supplementary target.

48. The OBR said that National Accounting Standards changes had affected the presentation of the Government’s fiscal position. As a result of these changes, the basis...
upon which the March 2014 EFO was calculated is no longer consistent with that used in the December 2014 EFO. The OBR has addressed this problem in its latest EFO by restating its March 2014 forecasts “on an ESA10 basis […] to facilitate like-for-like comparisons”.96

49. 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.

Discretionary changes announced in the Autumn Statement

50. Taken together, the policy changes in the Autumn Statement will result in net spending increases of £1,195 million over the six year forecast period. Across the forecast horizon, the announced spending changes amounted to net spending increases in all years, except for 2015–16.97

Table 4: Changes to the cyclically-adjusted current budget since March 2014

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<td>Total spending policy decisions</td>
<td>+130</td>
<td>-470</td>
<td>+240</td>
<td>+250</td>
<td>+260</td>
<td>+565</td>
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<td>Total tax policy decisions</td>
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<td>+410</td>
<td>+450</td>
<td>+425</td>
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Source: Autumn Statement 2014, HM Treasury, 3 December 2014, p9

51. Of the 59 policy changes announced at the Autumn Statement, six are projected to cost or raise more than £1 billion in total over the forecast period. These policies are:

- An increase in the personal allowance to £10,600 in 2015–16, with full gains to higher rate taxpayers (cost to exchequer);
- A new marginal rate system for stamp duty (cost to exchequer);
- A fund to pay for advanced care in GP practices in England (cost to exchequer);
- The diverted profit tax (raises money for the exchequer);
- A restriction in the ability of banks to use carried-forward losses to offset profits, for tax purposes (raises money for the exchequer); and
- Public service pensions: Next steps in revaluation (raises money for the exchequer).

In addition to these discretionary measures, the Government received additional revenues from fines levied by the Financial Conduct Authority on banks for failing to control

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96 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p14, para 1.31
97 HM Treasury, Autumn Statement 2014, 3 December 2014, p9, table 1
business practices in their foreign exchange trading operations. These fines totalled £1,115m.98

**Forecasting changes since March 2014**

52. The OBR also made a number of changes to its forecast of government spending and receipts for the period to 2018–19 that were not the result of discretionary changes announced by the Government. Compared to its March 2014 forecast, the OBR has revised down its forecast of government receipts and spending for each year of the forecast period as Table 5 shows.

| Table 5: Forecast changes since March 2014, excluding Autumn Statement policy measures |
|-------------------------------------|--------|--------|--------|--------|--------|--------|
| Forecast changes since March 2014  | 1.7     | -5.8    | -6.6    | 0.1     | -0.8    | -1.8    |
| Of which:                          |         |         |         |         |         |         |
| Receipts forecast                  | 1.6     | -7.8    | -14.3   | -18.9   | -22.7   | -25.3   |
| Spending forecast                  | 0.1     | 2.0     | 7.7     | 19.0    | 21.9    | 23.5    |

Source: Economic and Fiscal Outlook, Office for Budget Responsibility, December 2014, p15, table 1.2

53. In particular, changes to the inflation forecast, GDP deflator forecast, and to market assumptions on gilt and short rates had the most significant effect on the forecast for government spending.99 These changes in turn had a particular effect on the forecast for central government gross debt interest. The size of the downward revision increases from £5.2 billion in 2014–15, to £14 billion by 2018–19.100

**Tax-to-GDP and government receipts**

54. As a result of the downward revisions to government receipts made by the OBR, the tax-to-GDP ratio is now expected to fall 0.5 percentage points between 2013–14 and 2014–15. This is, as the OBR notes, “despite real and nominal GDP growth picking up strongly, with employment rising sharply and the output gap narrowing—both factors that would normally contribute to a rising tax-to-GDP ratio.”101

55. Mr Chote gave the Committee two reasons for the reduction in the tax-to-GDP ratio. He said that while “nominal GDP growth has been more rapid during the first three quarters of this year than we anticipated back in the Budget”, the “bits that have outperformed have not been the bits that generate you a lot of tax revenue”. In particular, he noted that areas of unexpectedly high growth had not been in the tax revenue rich areas of consumer spending or labour income.102 He also said:

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98 HM Treasury, Autumn Statement 2014, 3 December 2014, p64-65, table 2.1
99 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p137-138, para 4.101 and table 4.21
100 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p141, table 4.24
101 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p108, para 4.33
102 Q126
[...] the pool of money you are getting income tax receipts from, has been rising less quickly than GDP, [and] we are also getting less revenue per pound of that than we would have anticipated. That partly reflects the fact that the increase in labour income has come more from a rise in employment than it has come from a rise in earnings and the composition of employment has been less revenue rich. More of the employment growth has been in relatively low-paid work at the bottom of the income distribution.103

Mr Chote described the growth in low paid employment as a “structural deterioration”.104 He added that this reduction in the average tax rate had been unexpected.105

56. Beyond 2014-15, the OBR expects the tax-to-GDP ratio to recover in 2015-16 to 2016–17, and then to remain the same to the end of the forecast period.106 Mr Chote explained to the Committee that higher projected productivity growth was the source of this recovery:

Looking forward, an important source of increase in the tax-to-GDP ratio is that we assume that productivity growth, real earnings growth, resumes and that means that we start to get fiscal drag again, pulling people up into higher tax brackets.107

Mr Chote explained why the initial reduction in the forecast for the tax-to GDP ratio was then reversed in later years:

The big picture is that you have seen a drop in the tax-to-GDP ratio for this year, partly for reasons that we do not assume reverse themselves, but the overall decline is reversed over the next three years for reasons such as fiscal drag and other effects.108

57. Income tax and national insurance contributions have been the largest single contributors to the decrease in forecast revenue. Including the effect of Autumn Statement measures, the OBR reduced its income tax and NIC forecasts by a total of £4.6 billion for 2014–15. The size of this reduction increases over the forecast period, to a total of £15.2 billion by 2018–19.109

58. Mr Chote told the Committee that, in calculating future revenues, the OBR did “not do a projection of the distribution of income” and so made some “relatively rough and ready judgments” on the matter.110 Paul Johnson, Director of the Institute for Fiscal Studies, told
the Committee that one determinant of future tax income would be whether the economic changes driving the OBR’s forecast changes were structural or cyclical:

If it remains the case that a larger proportion of the working population is self-employed, that will result in less tax revenue than the similar world in which those people were in employment […] If that economic change is structural then the tax change will be structural. […] If we are in a structural world of very low earnings growth, then we are in a structural world of very low tax revenue, but if we are not then the tax revenues ought to take off again.\textsuperscript{111}

Carl Emmerson, Deputy Director of the Institute for Fiscal Studies, also said that there was uncertainty on both the upside and downside of the revised forecasts:

Clearly there is a risk on one side that recent trends could continue and the OBR may be proved to be too optimistic again, but these things could unwind and one lesson learned is that it is very difficult to do these forecasts.\textsuperscript{112}

Public finances: 2015–16 onwards

59. While the OBR produces its own forecasts of Annually Managed Expenditure (AME), it uses the Government’s published plans for Departmental Expenditure Limit (DEL) spending.\textsuperscript{113} The latter are only available up to 2015–16.\textsuperscript{114} Beyond the point where DEL spending plans exist, the OBR makes projections of spending based upon assumptions given to them by the Government.\textsuperscript{115} The December EFO provides more detail about this process:

Beyond 2015-16, the Government has not set out detailed spending plans. Instead, our projections for total spending from 2016-17 to 2019-20 are based on the Government’s stated [Total Managed Expenditure] policy assumptions [...]. We produce a bottom-up forecast of [Annually Managed Expenditure (AME)] for these years, which is subtracted from the level of TME that results from the Government’s policy assumptions to derive implied resource and capital DELs. This approach means that changes in

\textsuperscript{111} Q71

\textsuperscript{112} Q69

\textsuperscript{113} Annually managed expenditure, or AME, is more difficult to explain or control as it is spent on programmes which are demand-led – such as welfare, tax credits or public sector pensions. It is spent on items that may be unpredictable or not easily controlled by departments, and are relatively large in comparison to other government departments. (Source: gov.uk)

\textsuperscript{114} The government budget that is allocated to and spent by government departments is known as the Departmental Expenditure Limit, or DEL. This amount, and how it is split between government departments, is set at Spending Reviews. (Source: gov.uk)

\textsuperscript{115} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p132, para 4.89
AME spending beyond 2015–16—e.g. debt interest or benefits—are offset by changes in implied DELs.\textsuperscript{116}

Mr Chote told the Committee:

[...] Parliament have told us to do our forecasts on the basis of current Government policy so we have to ask the Government for a policy as regards public expenditure beyond 2015–2016 [...]. The way they have chosen to do that is to give us an assumption, a very complicated assumption, for the change in total public expenditure from which we can then back out some public services numbers. [...] It is not our assumption.\textsuperscript{117}

**Sources of fiscal consolidation**

60. The Government has previously stated that it intended to follow a deficit reduction “rule of thumb” that would see 80 per cent of reductions arising from spending cuts and 20 per cent from revenue increases.\textsuperscript{118} The Institute for Fiscal Studies calculated however, that taking into account the OBR’s projections to 2019–20, more of the consolidation would come from spending cuts than an 80:20 rule would imply. In particular, the IFS found that from 2010–11 to 2019–20, 88 per cent of fiscal consolidation would be delivered through spending cuts and 12 per cent through revenue increases.\textsuperscript{119} Mr Chote agreed, saying that 88:12 was “roughly the breakdown”, although he warned that it depended on when the comparison started.\textsuperscript{120}

61. Mr Emmerson, of the IFS, said:

The reason the ratio is changing is because originally the plan was for 80:20 but since then the deficit has proved more stubborn. More action is needed to get it down and what the Chancellor has done is, instead of responding by saying, “Hey, I am going to do some more tax rises”, he has said, “Hey, what I am going to do is do some more squeeze on spending in the next Parliament”. At the margin, all of the additional action he is doing to get the deficit down is coming on the spending side. That brings that ratio up from what was 80:20 to something like 88:12.\textsuperscript{121}

62. According to the OBR’s spending projections, the Government’s current plans reduce total annual government spending to 35.2 per cent of GDP by the end of the forecast period in 2019–20, from 2009–10 peak of 45.3 per cent.\textsuperscript{122} Mr Chote said that the

\textsuperscript{116} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p132, para 4.91
\textsuperscript{117} Q227
\textsuperscript{118} HC Deb, 22 June 2010, Col 169
\textsuperscript{119} Institute for Fiscal Studies, “Still five more years of austerity to go?”, Autumn Statement presentation slides, December 2014
\textsuperscript{120} Q190
\textsuperscript{121} Q90
\textsuperscript{122} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, pp132-3, paras 4.92-4.93
assumptions given to the OBR by the Government took “total public spending to its lowest share of GDP in 80 years”.\(^{123}\) However, the OBR’s forecast spending for 2019–20 is less than one percentage point below that in 1999–2000, which was 35.9 per cent of GDP. The OBR’s forecast for current government receipts remains at approximately 36 per cent of GDP throughout the forecast period.

\(^{123}\) Office for Budget Responsibility, Economic and Fiscal Outlook briefing, December 2014, Robert Chote, p4
Fiscal consolidation and ring-fencing

63. The OBR’s assumptions for the period 2015–16 to 2019–20 assume DEL cuts to be the primary source of deficit reduction. Mr Chote said that “bulk” of the implied remaining fiscal consolidation arose from a “cut in resource departmental expenditure, which is basically day-to-day central Government spending on public services, grants and administration”. In total, DEL is projected to fall by 14.1 per cent in real terms between 2015-16 and 2019-20. Over the period 2010-11 to 2019–20, this implies a total cut to DEL in real terms of 22.2 per cent.

64. The Government has been following a policy of ‘ring fencing’ certain departmental budgets. In the 2013 Autumn Statement, the Government confirmed that expenditure on health, schools and Official Development Assistance (ODA) would “be protected in line with the policy set out at Spending Round 2013”. No change to this policy has since been announced.

65. The DEL-focused spending reductions, combined with a self-imposed requirement to continue protecting spending in health, education and overseas development aid lead to higher reductions in DEL spending outside of the ring-fence as Mr Johnson told the Committee, that “if you are going to protect big chunks of it like the NHS you need bigger cuts elsewhere.” IFS calculations point out that a real cut in non-ring-fenced departments of 26.3 per cent would be needed between 2015-16 and 2019-20 to match the Government’s assumptions and maintain the current ring-fences. This would result in a

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**Chart 1: Total public sector spending and receipts**

Source: ONS, Office for Budget Responsibility, Economic and fiscal outlook, December 2014, p183, chart 4.8

**Fiscal consolidation and ring-fencing**

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124 Q191
125 Institute for Fiscal Studies, “Alternative choices over the future spending squeeze”, Autumn Statement presentation slides, 4 December 2014
126 HM Treasury, Autumn Statement 2013, Cm 8747, p81, para 2.7
127 Q66
fall in total real terms spending in non-ring fenced departments of 41 per cent between 2010-11 and 2019–20. Commenting on the effect of ring-fencing on unprotected departmental spending, Mr Johnson, of the IFS, said:

Ring-fencing is clearly just a political decision about where you want to concentrate your resources. The impact of ring-fencing going forward, particularly if the NHS, schools and ODA continue to be ring-fenced, does make a very big impact on the cuts that will be required on the OBR figures in the non-ring-fenced departments. That is just an arithmetic outcome of the fact that a very large chunk of public spending is being ring-fenced.

66. Paul Johnson told the Committee that, even if the NHS had not been formally ring-fenced, “there is not a lot of appetite to cut it”. He also noted that there has been “strong lobbying from NHS England and others to increase” NHS spending, and that the Government had set out “an increase in spending on the NHS next year.” Mr Johnson did concede however, that the Schools ring-fence was an area that had received “considerably” less scrutiny.

67. This Committee has previously considered the effects of ring fencing. Its Report into the 2014 Budget warned that long term ring-fencing posed particular challenges to non-ring fenced departments:

[...] with each year that ring fencing remains in place, the size of ring fenced departments increases as a proportion of total departmental spending. The IFS has stated that by 2015–16, expenditure reductions of 21 per cent will have been implemented in areas other than the NHS, schools and overseas aid. Each successive round, seeking reductions from an already smaller non-ringfenced base, will be more difficult than its predecessor.

And in its Report on the 2013 Budget the Committee concluded that ringfencing “can lead to waste or worse and it can distort the balance of spending as a whole”.

68. The ability of the government to deliver the cuts to DEL outlined in the OBR’s spending projections may also be in doubt. Mr Johnson said that the Government’s spending plans would be “pretty difficult” to achieve without a negative effect on services. He said:

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128 Institute for Fiscal Studies, “Alternative choices over the future spending squeeze”, Autumn Statement presentation slides, 4 December 2014
129 Q57
130 Q60
131 Q60
133 Treasury Committee, Budget 2013, Ninth Report of Session 2012–13, HC 1063, 20 April 2013, p63, para 137
134 Q78
if you are cutting spending on something by 40%, it would be pretty impressive performance if it was continuing to perform at the same level that it was before you imposed 40% of cuts.\textsuperscript{135}

Overall, Mr Johnson noted that the cuts were possible to achieve, but that the method and quantum of service delivery could change as a result:

They are possible, but I think that will require significant change in the way things are delivered. If you look at the non-ring-fenced DEL budgets from 2010 to 2020, you are looking at average cuts of something like 40% on the OBR numbers. It is not to say that is impossible, but that will require a change in view about how they are delivered and what it is that is being delivered.\textsuperscript{136}

Mr Johnson had also previously said “If we move in anything like this direction, whilst continuing to protect health and pensions, the role and shape of the state will have changed beyond recognition”.\textsuperscript{137}

\textbf{Status of the OBR’s fiscal projections post-2015–16}

69. The spending figures published by the OBR for future years reflect assumptions of the current coalition Government. However differences of opinion exist between the different member parties of the coalition regarding the assumptions used by the OBR.\textsuperscript{138} For example, the Chancellor noted that he would deviate from the deficit reduction scenario set out by the OBR through sourcing some spending cuts from the welfare budget and generating additional revenues through tax avoidance measures instead:

\begin{quote}
I have already pointed out that, where I would depart from the OBR, I would find more savings in the welfare budget and additional savings in dealing with aggressive tax planning and avoidance[…].\textsuperscript{139}
\end{quote}

70. 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.
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.

A new Charter for Budget Responsibility

The Government published a new Charter for Budget Responsibility on 15 December 2014. It was agreed by the House on 13 January 2015. This revises both the Government’s existing fiscal mandate and the supplementary target, but does not change the Government’s ‘welfare cap’. The key changes are:

- A reduction in the target time period of the fiscal mandate. Under the new mandate, the government aims to balance the cyclically-adjusted current budget by the end of the third year of the rolling five year forecast period, instead of the fifth year as previously.

- An extension of the time limit by which public sector net debt as a percentage of GDP should be falling, from 2015–16 in the old Charter to 2016-17 in the new Charter.

- A rewording of both the fiscal mandate and the supplementary target: both are now described as “aims” rather than “targets”.

One feature of the fiscal mandate that has remained unchanged is the targeting of a cyclical measure of government spending—the cyclically adjusted current budget (CACB).

Measurement of the CACB relies upon an estimate of the amount of slack in the UK economy—the so called ‘output gap’. At the time of the 2014 Budget, the Committee reached the following conclusion on such cyclically adjusted measures:

After an economic shock, cyclically adjusted measurements are particularly uncertain. The current fiscal mandate is dependent on an unobservable output gap. It has been made even more unreliable as a consequence of the financial crisis.


142 Office for Budget Responsibility, Working paper No.3 Cyclically adjusting the public finances, Thora Helgadottir, Graeme Chamberlin, Pavandeep Dhami, Stephen Farrington and Joe Robins, June 2012
For most of the last 30 years, governments have been trying to devise a robust fiscal anchor. There have been successive Medium Term Financial Strategies; the Code for Fiscal Stability (modified during the crisis by the temporary operating rule); and the Charter for Budget Responsibility. The Government is now considering a new Charter for Budget Responsibility. Fiscal anchors have merit. But at a time when the credibility of pledges in all aspects of public policy has attracted greater scepticism than before, it will be more difficult to build confidence in the fiscal anchor deep enough to withstand an extreme event.143

74. The Committee questioned the Chancellor about the change of wording from “target” to “aim” in the new Charter. The Chancellor argued that “I do not think there is a substantive difference”.144 When subsequently asked why the wording had changed at all, the Chancellor responded: “I do not think there is some great reason why.”145

75. The Treasury Committee has recommended that new fiscal frameworks should be consulted upon publicly before implementation.146 In its 2013 Autumn Statement report, the Committee concluded:

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.147

The Government has held no public consultation on its proposed new Charter for Budget Responsibility. The Chancellor said that “the public will engage now in this conversation” and that “we can have a lively debate about it over the coming weeks”.148

76. On the purpose and usefulness of the Charter overall, the Chancellor said:

I think it is extremely important that the Government sets out the things that will guide its policy, explain if it is not able to meet those targets or aims, and I think the fiscal rules that we set out have been successful in holding us to the proposals we had to reduce public expenditure. It has helped us reduce the deficit by a half. We have met the fiscal mandate. Debt is going to fall, albeit a year late, but I had to explain publicly why that was the case. If I had

144 Q291
145 Q291
148 Q297
not set out that ambition publicly I would not have been held publicly to account for it.\textsuperscript{149}

77. 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.

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

79. 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.

Welfare spending—trends and prospects

80. In October 2014, the OBR published its first \textit{Welfare trends report} (WTR), an annual publication intended to provide information on the trends and drivers of welfare spending, including that spending which falls within the Government’s ‘welfare cap’ (see paragraphs 98–103).\textsuperscript{150} The Report contains far more detail about the OBR’s views on welfare expenditure than is available in the Economic and Fiscal Outlook.

\textit{Jobseeker’s allowance and tax credits}

81. The WTR stated that “we [the OBR] have been repeatedly surprised at the speed with which unemployment has fallen”.\textsuperscript{151} This has led the OBR to overestimate jobseeker’s allowance (JSA) expenditure in previous Economic and Fiscal Outlook publications. This was particularly apparent in the OBR’s March 2014 forecast: rather than fall 7 per cent between Q4 2013 and Q3 2014, as the OBR expected, the claimant count in fact fell by 23 per cent (see Chart 2, below). As a result, in its December forecasts, the OBR have revised down JSA expenditure by an average of £0.6 billion per year over the forecast period.\textsuperscript{152}

\textit{Chart 2: Successive OBR forecasts of the claimant count, March 2011 to December 2014}

\textsuperscript{149} Q298

\textsuperscript{150} Office for Budget Responsibility, Welfare Trends Report, October 2014, p3, para 1

\textsuperscript{151} Office for Budget Responsibility, Welfare Trends Report, October 2014, p60, para 4.25

\textsuperscript{152} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p152, table 4.29
Labour market trends have also affected tax credit expenditure, which accounts for almost seven times as much spending as JSA. The WTR notes that the OBR has underestimated tax credit expenditure in previous Economic and Fiscal Outlook publications. In the latest EFO, the OBR made relatively modest upward revisions to its tax credit expenditure forecasts, averaging £0.2 billion per year over the forecast period.

In explaining why tax credit expenditure had exceeded the OBR’s past forecasts, Mr Chote said that stronger than expected employment growth in the lower part of the income distribution was the principal driver:

Employment has grown relatively strongly but quite a lot of that has been people on relatively low earnings who would therefore be entitled to tax credits.

Mr Chote also agreed with the conclusion from the WTR that rising tax credit expenditure may be partly explained by the tougher JSA sanctions regime, introduced in 2012, encouraging people to declare themselves self-employed on low income rather than unemployed. Asked if some of the growth in self-employment was being driven by “non-genuine self-employed”, Graham Parker, a member of the Budget Responsibility Committee, said “we think so, yes.”

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153 Office for Budget Responsibility, Welfare Trends Report, October 2014, p12, figure 1.1
154 Office for Budget Responsibility, Welfare Trends Report, October 2014
155 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p152, table 4.29
156 Q231
157 Q232
158 Q237
**Housing benefit**

85. Housing benefit expenditure has also tended to exceed the OBR’s forecasts, although the December forecasts 2014 saw a downward revision (see Chart 3, below). The OBR’s underestimation of housing benefit expenditure in the past has reflected developments in both the labour and housing markets. Specifically, unexpectedly strong house price inflation, together with weaker than expected wage growth, have increased both the proportion of households that are renting and the proportion of renters that are eligible for housing benefit. Moreover, strong growth in private sectors rents, together with a rising proportion of claimants renting from the private sector, has increased the average housing benefit award.\(^{159}\) Mr Chote said:

> If you look at what has been going on with patterns of Housing Benefit expenditure, the fact that you end up with a shift in tenure with more people renting rather than owning and the Housing Benefit bill has gone up in part because the relative lack of social housing has meant that more people are in the private sector paying higher rents and, therefore being subsidised at a higher level in Housing Benefit.\(^{160}\)

**Chart 3: Successive OBR housing benefit forecasts, March 2011 to December 2014**

86. Since April 2013, the amount by which housing benefit paid to claimants who rent privately can rise each year is no longer linked to local rents. The Consumer Price Index

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159 Office for Budget Responsibility, Welfare Trends Report, October 2014, p174, para 9.27
160 Q161
now determines the maximum rate by which it can rise.\textsuperscript{161} Mr Emmerson, of the IFS, said that this may make housing benefit expenditure more predictable in future:

Because we have now CPI indexed the maximum amount you can get, the public finances are a bit less sensitive to what happens to private rents.\textsuperscript{162}

Nonetheless, the WTR identifies housing benefit as one of three largest sources of uncertainty to the OBR’s welfare expenditure forecast. Key factors in the current forecast are the proportion of households that are renting, productivity growth, and rent inflation.\textsuperscript{163}

\textbf{Pensioner benefits}

87. According to the WTR, around 55 per cent of welfare spending is paid to pensioners,\textsuperscript{164} with state pensions being the largest component and “by far the largest single item of welfare spending”.\textsuperscript{165} Over time, the state pension has become more generous in real terms, and more recently, in relation to living standards and economic output as well.\textsuperscript{166}

88. Paul Johnson explained that changes to the state pension and other pensioner benefits had helped to drive improvements to pensioners’ living standards:

30 years ago pensioners were much more likely to be poor than people of working age and there has been a fantastic change over that 30 years that now pensioners are less likely to be poor than people of working age and, indeed, for the first time about three years ago, on an after-housing-cost basis, average pensioner incomes are higher than non-pensioner incomes.\textsuperscript{167}

He expressed concern, however, that “policy thinking has not necessarily caught up with that reality”.\textsuperscript{168} Referring to the ‘triple lock’, which ensures the state pension is uprated each year by the higher of CPI inflation, average earnings or 2.5 per cent, he said:

If it goes on forever then the pension does not become infinite but it just grows forever. You do need to take a view about at what point you revert either to price or earnings indexation rather than the better of both.\textsuperscript{169}

\begin{itemize}
\item \textsuperscript{161} HC Deb, 6 December 2012, col 1031
\item \textsuperscript{162} Q111
\item \textsuperscript{163} Office for Budget Responsibility, Welfare Trends Report, October 2014, p8, Executive Summary, para 16
\item \textsuperscript{164} Office for Budget Responsibility, Welfare Trends Report, October 2014, p49, para 4.9
\item \textsuperscript{165} Office for Budget Responsibility, Welfare Trends Report, October 2014, p75, para 5.9
\item \textsuperscript{166} Office for Budget Responsibility, Welfare Trends Report, October 2014, p76, figure 5.1
\item \textsuperscript{167} Q112
\item \textsuperscript{168} Q112
\item \textsuperscript{169} Q113
\end{itemize}
Incapacity and disability benefits

89. The OBR’s forecasting of incapacity benefit expenditure has been complicated by policy reforms in this area, and it has tended to underestimate spending on these benefits. This has been partly due to unforeseen delays in the work capability assessment (WCA) programme, and partly because the results from those WCAs that have been completed have resulted in a lower proportion of people being assessed as fit for work than was originally expected. On the basis of the latest evidence, the OBR revised up its forecasts for incapacity benefits expenditure by an average of £0.7 billion over the forecast period.\textsuperscript{170}

90. Although expenditure on disability benefits has to date moved broadly in line with its forecasts, the OBR made upward revisions in its latest forecast (also by an average of £0.7 billion per year). This partly reflects its judgement that a higher proportion of individuals will be successful in their claims for Personal Independence Payment (which replaces Disability Living Allowance for working-age individuals) than was originally assumed.\textsuperscript{171}

91. Uncertainty over the impact of policy reforms continues to present risks to the OBR’s central forecast: the WTR identified incapacity and disability benefits as two of the three largest sources of uncertainty to its overall welfare expenditure forecast (the third being housing benefit).\textsuperscript{172}

Chart 4: Successive OBR incapacity benefits forecasts, March 2011 to December 2014

Source: Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, supplementary fiscal tables; Office for Budget Responsibility, Welfare Trends Report, October 2014, Chart 4.5

Chart 5: Successive OBR disability benefits forecasts, March 2011 to December 2014

\textsuperscript{170} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p152, table 4.29
\textsuperscript{171} Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p155, box 4.7
\textsuperscript{172} Office for Budget Responsibility, Welfare Trends Report, October 2014, p8, para 16
Universal credit rollout

92. The rollout of universal credit (UC) has been significantly delayed by the difficulties faced in designing a single IT system that can cope with the complexity of paying out a range of working-age benefits to widely differing households in frequently changing circumstances.173

93. The OBR states that “there remains considerable uncertainty around the delivery of such a complex and wide-ranging change”.174 While the OBR has incorporated the first part of the rollout (to 2015–16) into its central forecast, it questions the schedule beyond this point, stating that it would be “premature to assume that the digital solution will be ready on this timetable”. Instead, the OBR assumes that the rollout will be delayed “a further six months beyond the new plans”. Compared with the Government’s schedule, this results in 2.2 million fewer people onto universal credit in 2016–17, 2.9 million fewer in 2017-18, and 1.6 million fewer in 2018-19.175

94. The additional delays to Universal Credit rollout assumed by the OBR result in a small downward revision to spending forecasts, and, according to the WTR, the delays are “not a major factor” in the welfare expenditure forecast.176 Mr Chote explained why:

If you delay the rollout of universal credit the gainers do not gain until later and the losers do not have to be paid transitional protection in the meantime.177

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173 Office for Budget Responsibility, Welfare Trends Report, October 2014, p66, box 4.2
174 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p155-6, box 4.8
175 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p156, box 4.8
Savings to the welfare bill since 2010 and prospects for the next Parliament

95. Economic developments, particularly in the labour and housing markets, together with implementation difficulties, have meant that the welfare savings originally expected by the Government and the OBR have not materialised in full. Welfare reforms that were originally expected by both the Government and the OBR to yield savings of £19 billion have in fact resulted in only £2.5 billion of savings.178

96. The Chancellor has said that the sharp reductions in departmental spending that the OBR assume will occur after 2015–16 can be mitigated by further welfare savings: “the composition of the spending reductions would be different from that set out by the OBR because I would have a higher welfare component.”179 The IFS have calculated that £21 billion in welfare savings would be needed over the course of the next Parliament to achieve this objective.180

97. 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.

The welfare cap

98. In the 2014 Budget, the Government introduced controls over some elements of annually managed expenditure (AME) on welfare.181 Specifically, this ‘welfare cap’ requires forecast expenditure for each of the following five years to be within limits set by the Treasury. The OBR is required to assess whether forecast welfare expenditure falls within these limits. It provided the first such assessment in its December 2014 Economic and Fiscal Outlook.

99. If forecast spending exceeds the level of the cap, this need not mean that the cap is treated as having been breached. Whether it has in fact been breached depends on whether or not the changes to forecast spending that cause the cap to be exceeded arise from a discretionary policy change on the part of the Government. In the case of such changes, there is no leeway, and a breach occurs if forecast spending exceeds the cap. In the case of

177 Q164
178 Institute for Fiscal Studies, What is happening to spending on social security?, 17 November 2014
179 Q304
180 Paul Johnson—Introductory remarks at the Institute for Fiscal Studies Autumn Statement briefing, 4 December 2014
181 HM Treasury, Budget 2014, p26, para 1.76
all other changes to forecast spending (e.g. a revision to the OBR’s labour market outlook),
the cap is only breached if forecast spending exceeds the stated cap plus a 2 per cent
“forecast margin”.182

100. A letter from the Chancellor to Mr Chote, published at the time the welfare cap was
first proposed, states that in making its assessment, the OBR can decide whether changes to
welfare spending arise from movements in the forecast or from discretionary policy
changes.183 In practice, however, the distinction between discretionary policy changes
(subject to a ‘hard limit’) and other sorts of change (subject to the forecast margin) may be
unclear. The OBR said that “there are grey areas, notably operational changes resulting
from Ministerial decisions or responses to legal challenges” adding that “these require
careful consideration”.184 Such measures may be deemed by the OBR to be discretionary,
but may not necessarily appear in the Treasury’s own table of policy decisions. On this
occasion, the Treasury agreed to include all measures that the OBR deemed to be
discretionary in this table, making for “a simpler assessment of performance against the
welfare cap than might otherwise have been the case”.185

101. Mr Chote has also made clear in a letter to the Chancellor that the OBR will be
“transparent where our judgement about what constitutes discretionary action differs from
the presentation on the Treasury scorecard”.186

102. Although the OBR revised up their forecasts for welfare expenditure, these revisions
fell within the 2 per cent margin for all five years of the forecast. The discretionary policy
changes resulted in downward revisions to the welfare forecast. Thus, the OBR judged that
the Government were on track to meet the welfare cap commitment.187

103. 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.

183 Letter from George Osborne to Robert Chote, 3 December 2013
184 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p201, para 5.17
185 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p201, para 5.18
186 Letter from George Osborne to Robert Chote, 4 December 2013
187 Office for Budget Responsibility, Economic and Fiscal Outlook, December 2014, p201, para 5.19
4 Taxation

Anti-avoidance measures

Table 6: Costing of avoidance, tax planning and fairness policies and OBR assessment of uncertainty costings

<table>
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<tr>
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Source: HM Treasury, Autumn Statement 2014, December 2013

104. In Autumn Statement 2014, the Government announced further measures to reduce tax avoidance, evasion and aggressive tax planning. Separately, in his statement to the House, the Chancellor committed himself to delivering “at least another £5 billion” in revenue over the next Parliament as a result of further anti-avoidance measures, yet to be announced. The individual policies are summarised in Table 6 above.
105. The Committee’s Report on Autumn Statement 2013 recommended that the OBR should do “all it can to report on whether yields [from anti-avoidance measures] were attained as originally costed”.\textsuperscript{189} In response to this recommendation the OBR provided an evaluation of all anti-avoidance measures in the latest Economic and Fiscal Outlook. The OBR found that the performance of the anti-avoidance measures—those implemented between 2011–12 and 2013–14—has been mixed, with “some yielding more and some yielding less than expected”.\textsuperscript{190} They noted that:

\[\ldots\] there has not been systematic bias across the costings: while the shortfall from the UK-Swiss tax agreement means the total yield from the measures considered was below expectations, across other measures there were both upside and downside surprises.\textsuperscript{191}

Although it found no evidence of systematic bias across the costings, the OBR’s analysis showed that in cash terms, owing to the large shortfall on the UK–Swiss tax agreement, “significantly less has been raised in total than originally expected”.\textsuperscript{192} Our Report on Autumn Statement 2012 had expressed concerns over the sums expected to be raised from the UK–Swiss tax agreement:

In the case of the tax repatriation from Switzerland, the proceeds may not meet expectations if assumptions about the potential tax liabilities and expected behaviour of those affected prove not to be valid.\textsuperscript{193}

106. Table 6 shows that the OBR’s uncertainty ratings of tax avoidance measures are predominantly medium-high or above, with the largest measure—the restriction on banks being able to offset losses for tax purposes—being classified as “very high”. We asked Mr Chote whether weighted adjustments should be applied to costings with particularly high uncertainty ratings. He told us:

In effect, that happens already. With anti-avoidance measures, typically you apply something called an attrition rate to the central forecast, so I think if you take the example of the diverted profits tax, that has an attrition rate assumed eventually of 45%, so you basically assume that by the end of the forecast horizon, people will have found other ways of doing the things that they were doing at the beginning and that therefore eats away at the revenue that we expect these measures to raise.

He added:

\textsuperscript{189} Treasury Committee, Autumn Statement 2013, Ninth Report of Session 2013–14, HC 826, p43, para 75
\textsuperscript{190} Office for Budget Responsibility, Economic and Fiscal Outlook, Cm 8966, December 2014, p105, box 4.2
\textsuperscript{191} Office for Budget Responsibility, Economic and Fiscal Outlook, Cm 8966, December 2014, p105, box 4.2
\textsuperscript{192} Office for Budget Responsibility, Economic and Fiscal Outlook, Cm 8966, December 2014, p105, box 4.2
\textsuperscript{193} Treasury Committee, Autumn Statement 2012, Seventh Report of Session 2012–13, HC 818, para 77
You are right to point out that avoidance measures tend to be at the higher end of that uncertainty spectrum, not least because you typically find it quite hard to understand the likely behaviour of people who have already demonstrated their willingness and ability to change their behaviour quite dramatically in response to the precise incentives set out by the tax system as well. So I do not think it will be appropriate for us to look at the uncertainty rating and then take something off that, because at the end of the day, although it is uncertain, it is still our best central forecast.194

Mr Chote noted that instead of eliminating uncertainty, the inclusion of an attrition rate could itself be a source of uncertainty:

The attrition rate is built into the central forecast, and if a measure has a particular attrition rate, that may be one of the things that you worry about in terms of the uncertainty.195

107. Chart 6 below compares, on an aggregate level, the uncertainty of all revenue raising measures against all spending measures announced in Autumn Statement 2014:

**Chart 6: distribution of OBR uncertainty ratings for all revenue raising and spending policies in Autumn Statement 2014**

Source: Office for Budget Responsibility, Economic and Fiscal Outlook, 3 December 2014, Table A.1-A.2, pp 212–215

Note: some policy announcements are not included in the above chart because they have not been assigned an uncertainty rating by the OBR. The value of excluded measures is -£715 million.

108. 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.

109. 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.

110. 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.

Restriction on bank losses

111. In his speech to the House introducing the Autumn Statement, the Chancellor said
that the current rules allowing banks to offset all their losses against taxable profits meant
that “some banks would not be paying tax for 15 or 20 years”.196 He added that “the banks
got public support in the crisis and they should now support the public in the recovery”.197
Under current law, if a company makes a trading loss, which is not relieved against other
income or surrendered to another group member, this “unrelieved loss is carried forward
to subsequent accounting periods” and can be offset against taxable profits thereby
reducing the amount of Corporation Tax payable.198 These unrelieved losses can be carried
forward indefinitely, as long as the company continues to carry on trading.199 Autumn
Statement 2014 states that:

The government will restrict the amount of a bank’s annual profit that can be
offset by carried-forward losses to 50% from 1 April 2015. The restriction will
apply to losses accruing up to 1 April 2015 and will include an exemption for
losses incurred in the first 5 years of a bank’s authorisation.200

112. This policy is forecast to raise £3.5 billion over the next Parliament—the single largest
revenue generating measure in the Autumn Statement. The OBR has assigned this policy a
‘very high’ uncertainty rating. It explained that the yield from this measure was based on

196 HC Deb, 3 December 2014, Col 311
197 HC Deb, 3 December 2014, Col 311
198 Corporation Tax Act 2010, section 45
199 Corporation Tax Act 2010, section 45
“uncertain assumptions around the profitability of banks over the scorecard period”.201 It added:

If the banking sector makes higher or lower than expected gross profits over the next few years then the yield from this measure could be considerably higher or lower.202

113. We asked Paul Johnson, Director of the Institute for Fiscal Studies, whether raising £3.5 billion from this policy was realistic. He said:

The first thing to say is, whether it raises £3.5 billion in the next five years or not, that is not, on the basis of the way the legislation is currently drafted, going to be £3.5 billion in total additional. That is just money brought forward because of the way the tax is designed. […] It looks a bit like a windfall tax on a particularly greedy bank.203

114. In its written evidence to the Committee, the ICAEW was concerned that the measure would create “uncertainty and lack stability”. It added that “businesses relying on established law when planning cash flows may justifiably ask: who will be next in line for an unexpected levy?”204 The Charted Institute of Taxation largely agreed, saying:

The restrictions on the brought forward losses of banks amounts to a sort of ‘windfall tax’ on the banking industry. As has been observed many times before windfall taxes lead to substantial instability across the tax system, and should be avoided.205

115. Our report on the Principles of Tax Policy outlined the importance creating certainty and stability in the tax system:

Tax policy is only one of the factors on which businesses and individuals make their decisions, but lack of stability and clarity about the direction of travel in tax policy will, over time, undermine the competitiveness of a tax system and make it impossible for businesses to plan. If tax policy is to support growth, then the direction of travel of tax policy should be clear.206

116. In our Budget 2012 Report, we recommended that:

[...] the Government restrict its use of retrospective legislation to wholly exceptional circumstances, which should be narrow and clearly-defined. The Treasury should set these out as soon as possible for consultation, along with

201 Office for Budget Responsibility, Economic and Fiscal Outlook 2014, December 2014, p218, para A.6
203 Q103
204 ICAEW, written evidence
205 CIOT, written evidence
206 Treasury Committee, Eighth Report of Session 2010–12, Principles of Tax Policy, HC 753, p21, para 60
an explanation of how gradual further extension of retrospection can be prevented. Any future retrospective tax measure must be justified against the agreed criteria: such justification must include clear explanatory statements to Parliament by the responsible Minister and should invite views from relevant professional bodies.²⁰⁷

*Autumn Statement 2014* states that the restriction over carried-forward losses “will apply to losses accruing up to 1 April 2015”.²⁰⁸ In the light of this, we asked Mr Johnson whether this should be considered a retrospective tax. He told us that it “is effectively retrospectively changing the rules around the treatment of losses”.²⁰⁹

117. *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.*

**Diverted Profits Tax**

118. The Government announced in the Autumn Statement a new Diverted Profits Tax (DPT) “to counter the use of aggressive tax planning techniques used by multinational enterprises to divert profits from the UK”.²¹⁰ The DPT will be applied using a rate of 25% from 1 April 2015 and is expected to raise over £1 billion over the next Parliament.

119. This measure will operate through two basic rules. The first rule counteracts arrangements by which foreign companies “exploit the permanent establishment rules”²¹¹ with the specific intension of avoiding or reducing the amount of UK tax payable. The second rule prevents UK companies, or foreign companies with a UK permanent establishment, from creating tax advantages by using transactions or entities that “lack economic substance”.²¹²

120. In their written evidence to the Committee, each of the three professional tax bodies—the Association of Certified Chartered Accountants, the Institute of Chartered Accountants of England and Wales, and the Chartered Institute of Taxation—questioned the Government’s decision to introduce the unilateral DPT ahead of the completion of the Organisation for Economic Cooperation and Development’s (OECD’s) work on base erosion and profit shifting (BEPS).²¹³

²⁰⁹ Q104
²¹⁰ HM Treasury, Autumn Statement 2014, December 2014, p80, para 2.142
²¹¹ A permanent establishment is created when a company carries out activities which create a taxable presence.
²¹² HM Treasury, Finance Bill 2015: draft legislation overview documents, December 2014, p102
²¹³ ACCA, written evidence; ICAEW, written evidence; Chartered Institute of Taxation, written evidence
121. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules artificially to shift profits to low tax jurisdictions, where there is little or no economic activity, resulting in little or no overall corporate tax being paid. Following recognition that the international tax system needed to be reformed to prevent BEPS, the G20 asked the OECD to recommend possible solutions. In September 2014, the OECD published a 15-point Action Plan to address BEPS which will be completed in three phases—September 2014, September 2015 and December 2015. The aim of the OECD BEPS project is to:

[…] create a single set of consensus-based international tax rules to address BEPS, and hence to protect tax bases while offering increased certainty and predictability to taxpayers.

122. The ICAEW welcomed the Chancellor’s leadership in tackling international tax avoidance but questioned how this unilateral measure will fit in with the OECD BEPS project. It said:

The target of this new legislation appears to overlap with the OECD BEPS Action Plan. The overall intention of BEPS is to align taxation with the location where economic activities take place and where value is created. It is also a key objective of BEPS that the 44 countries involved should act in concert and introduce the required measures in a coordinated way.

CIOT largely agreed:

We are concerned that the UK may well be developing a new tax in advance of agreement on new principles of transfer pricing and taxable presence […]. We would not welcome a tax which might be in conflict with internationally-agreed principles and which gives businesses no opportunity to modify their approaches in line with those new principles.

123. In an explanatory statement, the OECD highlighted the importance of multilateral action in tackling base erosion and profit shifting:

BEPS by its nature requires coordinated responses, particularly in the area of domestic law measures. This is why countries are investing time and resources on developing shared solutions to common problems. At the same time, countries retain their sovereignty over tax matters and measures may
be implemented in different manners, as long as they do not conflict with their international legal commitments.\textsuperscript{218}

124. The Committee asked the Chancellor what discussions were held with the OECD prior to the announcement of the DPT. He told us:

We are heavily involved in the OECD work. […] I think these changes are absolutely with the grain of where the international community is moving. I think we have been careful not to get too far ahead of that international work but nevertheless act to protect revenues.\textsuperscript{219}

125. Following the publication of the draft legislation of the Finance Bill 2015—released on 10 December—both the ICAEW and CIOT provided the Committee with additional written evidence on the DPT. The ICAEW described the draft legislation as “highly complicated” and that it is “likely to increase uncertainty”.\textsuperscript{220} It highlighted that the draft legislation consisted of “30 pages of draft clauses, nearly 50 pages of Explanatory Notes and a Guidance document of a further 50 pages”.\textsuperscript{221} CIOT agreed with this, saying that the legislation is drafted in a “very unclear manner”.\textsuperscript{222} It goes on to say that the DPT:

[…] potentially brings into scope a large number of transactions and it is unclear whether that is the intention. This structuring will mean that a large number of companies will need to be aware of the legislation and consider whether they fall inside it. Computation of the amount subject to the tax does not look straightforward to calculate, given that it is not based on any agreed international standards.\textsuperscript{223}

126. The Committee asked the Chancellor how long the DPT had been in preparation and whether it would work as intended. He told us:

I am confident it will work. We have spent a considerable period of time thinking about and planning this. By their nature, we are dealing with highly contrived tax arrangements that sometimes cover three or four different sovereign jurisdictions. By their nature, these are very complicated tax arrangements. […] I am confident that we will be able to tax genuine economic activity that happens in the UK, do it in a way that the UK remains one of the most attractive places in the world to bring your investment, to set up your tech business or other business and prosper.\textsuperscript{224}

\textsuperscript{218} Organisation for Economic Co-operation and Development, Base Erosion and Profit Shifting Project: Explanatory Statement, p3
\textsuperscript{219} Q327
\textsuperscript{220} ICAEW, written evidence
\textsuperscript{221} ICAEW, written evidence
\textsuperscript{222} CIOT, written evidence
\textsuperscript{223} CIOT, written evidence
\textsuperscript{224} Q325
127. The ICAEW told the Committee that it is “still difficult to see how this new tax will fit in with existing international arrangements, such as the more than 120 treaties UK has with other countries”.\textsuperscript{225} The Committee asked the Chancellor whether the new DPT would have any impact on the UK’s double taxation treaties. He told us he was “confident that that is not an issue”.\textsuperscript{226}

128. 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.

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

\textbf{Stamp duty}

130. \textit{Autumn Statement 2014} announced major changes to stamp duty land tax on residential properties, which took effect from 4 December 2014. Describing the changes in his Statement to the House, the Chancellor said that the old stamp duty was “a badly designed system that has distorted our housing market for decades”.\textsuperscript{227}

131. The reforms abolish the ‘slab’ structure of stamp duty, whereby successively higher rates were applied to the entire property price, and replaced it with a set of marginal rates applying only to the part of the price that falls within each band. The effect was to eliminate sudden increases in stamp duty that occurred at each tax threshold. (Chart 7)

\begin{itemize}
\item \textsuperscript{225} ICAEW, written evidence
\item \textsuperscript{226} Q328
\item \textsuperscript{227} HC Deb, 3 December 2014, Col 316
\end{itemize}
The reforms were also structured in a way that cut stamp duty payments for all properties below £937,000 (around 98 per cent of housing transactions), at a cost of around £800 million per year. The OBR forecast that, as a result, the level of property transactions will rise by 1.1 per cent and residential investment by 0.2 per cent.228 Asked about the impact of the cut to stamp duty on house prices, Mr Chote said:

we assume, or rather the costing assumes that for a one percentage point change in the average rate of Stamp Duty for a house or particular property there will be a 1.4% change in the house price, so it is geared by more than one.229

In effect, the savings to home buyers from lower stamp duty are expected by the OBR to be more than offset by a rise in prices. In a piece of written analysis, Mr Clarke, of Scotiabank, said that the stamp duty reforms would stimulate house prices, describing them as a “shot
of adrenaline into the housing market [that will] give the housing market a softer landing, and more likely fuel a mini growth spurt through next year”.230

133. The Institute for Fiscal Studies described the reformed stamp duty as a “clear improvement”, but questioned why changes were not also made to non-residential stamp duty, which retains the old ‘slab’ structure. Arguing against any sort of transaction tax on properties, they said that residential stamp duty was “a very bad tax transformed into a bad tax”.231 The Institute for Chartered Accountants in England and Wales also welcomed the changes to residential stamp duty, but said that the retention of the slab system for commercial property would “create confusion, uncertainty and potential for arbitrage, particularly given the now higher rates for residential property as compared to commercial property.”232

134. In its Report *Principles of tax policy*,233 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.

135. In Scotland, stamp duty land tax is being devolved from April 2015. The Scottish Parliament passed legislation in July 2013 for a new ‘land and buildings transaction tax’ (LBTT), which, like the reforms in the UK 2014 Autumn Statement, will replace the ‘slab’ structure of the old stamp duty with a marginal rate design.234 The Scottish Government subsequently proposed rates and bands for the new tax in its 2015–16 Draft Budget in October 2014.235 Since the announcement of the stamp duty changes in the Autumn Statement, the Scottish Government has proposed a new set of rates and bands for LBTT: the rates are lower than those originally proposed for properties between £250,001 and £325,000, and higher for those above £750,000.236 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.
Conclusions and recommendations

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)

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)

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)

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)

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)

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)

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)

12. The new Charter still relies on the OBR coming to a nominally authoritative view about the unmeasureable 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)

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)

**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)

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)

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)

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)
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)

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)

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)
Appendix 1: Institute of Chartered Accountants in England and Wales

The Treasury committee has six principles for tax policy: that it should be **fair**, **support growth and competitiveness**, **certain** (i.e. legally clear, targeted and simple), **stable**, **practical**, and **coherent**. We have assessed how the measures in the 2014 Autumn Statement match up to the principles.

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Detailed comments

**Pensions: reforms since Budget 2014**
- In principle we welcome the Government’s far-reaching changes to the pensions rules that should help to support improved flexibility and choice for pension savers and thereby encourage greater take-up.
• We remain concerned about the lack of stability and certainty in pensions. After extensive consultation, the previous Government completely recast the pensions rules and this was expected to remain unchanged for many years, but there have been extensive changes ever since, including reductions in the annual and lifetime allowances.

• We also remained concerned about the ‘advice gap’, uncertainty as to what constitutes regulated advice under the FCA and what a ‘default product’ may look like.

• Government should aim now to commit to providing a stable and certain pensions environment that encourages savers to plan with certainty.

**Diverted profits tax: potential 25% on UK based profits**

• We are waiting for further details of this measure, which are likely to appear on the 10th December with the publication of draft Finance Bill clauses. This in part explains the current yellow and red ratings we have assigned the policy. This is likely to change when we have more detail.

• We welcome the Chancellor’s leadership in this area, however how this unilateral action from the UK will fit with the OECD BEPs (Base Erosion Profit Shifting) project remains unclear.

• The target of this new legislation appears to overlap with the OECD BEPS Action Plan. The overall intention of BEPS is to align taxation with the location where economic activities take place and where value is created. It is also a key objective of BEPS that the 44 countries involved should act in concert and introduce the required measures in a coordinated way. The explanatory statement published by the OECD in September this year, to coincide with the publication of the first 7 BEPS deliverable papers, stated very clearly:

  BEPS by its nature requires coordinated responses, particularly in the area of domestic law measures. This is why countries are investing time and resources on developing shared solutions to common problems. At the same time, countries retain their sovereignty over tax matters and measures may be implemented in different manners, as long as they do not conflict with their international legal commitments.

• ICAEW has consistently supported the work of the OECD in this area in order to arrive at a durable solution that has international support.

• In terms of the Treasury Committee’s principles, we are concerned that it will be difficult to target this measure and how exactly the taxable profits might be calculated.

**Stamp duty land tax reform: new marginal rate system for residential properties**

• We welcome the abolition of the slab system for residential property in favour of a progressive system. This should help to reduce unfairness and distortions at the margins.
• We are however disappointed that the existing slab system is still being retained for commercial property. This will continue to create confusion, uncertainty and potential for arbitrage, particularly given the now higher rates for residential property as compared to commercial property.

• However, a change this fundamental is better introduced following consultation rather than as a headline seeker, particularly as the new Scottish Land and Buildings Transaction Tax proposals are similar, but different. The fewer tax shocks there are in an economy, the more stable it is likely to be.

Changes to business rates
• Business rates have become a major area of concern for retail businesses given increased competition from digital businesses.

• The Government has to date adopted a rather piecemeal approach to this area that does little to encourage certainty and stability in this area. We therefore welcome the announcement of a review of business rates.

Anti-avoidance measures
• We support reasonable and proportionate measures to address tax avoidance. It is essential that any measures are properly targeted, that uncertainty is not increased and that burdens for ordinary businesses not engaged in tax avoidance are increased.

• Given we have not seen any specific cases in the public domain about the operation of the GAAR, it would appear premature to consult on further penalties.

• Predicting increased revenues from tax compliance activity is notoriously difficult. The amounts actually collected have often been far less than forecast—for example the actual receipts from the Swiss tax agreement have been far lower than predicted originally.

• If past experience is a guide, the estimate of revenue from these measures is likely to prove optimistic. We would question how these figures have been calculated and question whether the benefit of them should be included in HM Treasury’s detailed forecasts.

• We are concerned that measures such as the restriction on bank losses create uncertainty and lack stability - businesses relying on established law when planning cash flows may justifiably ask ‘Who will be next in line for an unexpected levy?’.

Employer NICs: abolish for apprentices under 25s
• From April 2016 employers’ Class 1 National Insurance contributions (NIC) will be abolished (up to the upper earnings limit) for apprentices aged under 25. This is in addition to the announcement made at Autumn Statement 2013 that from April 2015 employers will no longer have to pay employers’ NIC on the earnings of employees aged under 21.

• Employers NIC brings in about £60bn or about one tenth of tax revenues. It is in effect a payroll tax and is a significant barrier to encouraging employment.

• The measure will help boost employment for this group of young people although restricting relief to apprenticeships may limit its appeal.
• The new NIC relief for those who employ young people under the age of 21 starts in April 2015 and increasing this age limit may have generated more employment for the targeted group. Further research is needed as to whether these measures offer value for money and also what happens when the NIC holiday expires.

• However, all of these changes will make the NIC system more complicated for employers to administer.

**Peer-to-peer lenders: bad debt relief & withholding tax**

• Allowing bad debt relief seems a sensible and fair measure. The future cost of bad debt relief will depend on the success rate of businesses using this method of finance, which are likely to be more risky than those financed by more traditional sources. The risk is that cost estimates may prove to have been underestimated.

• A system of withholding tax will remove some individuals from the self-assessment system, which is welcome, although the level of income anticipated in 2017/18 seems optimistic. It will depend on the businesses being sufficiently profitable to be able to service their debt and pay dividends.

**ISAs: transfers to surviving spouses**

• This appears a sensible change and should help to reduce compliance burdens as well as providing support for a bereaved spouse or civil partner.

**Enveloped dwellings: increase in charge for properties over £2m**

• We understand the Government’s policy aims but are concerned at the considerable changes that have been made in this area in recent years and the potential compliance burdens. The considerable increase in the annual charge for properties worth more than £2m was unexpected, but presumably linked to the changes to the stamp duty land tax rules and the introduction of a 12% rate for properties over £1.5m.

• Not all properties are held in companies to avoid tax and we question whether it may be possible to elect out of the ATED regime and instead be taxed on any transfer of the underlying property.

**Non-domiciles: increase remittance basis charge**

• The remittance basis charge (RBC) was introduced with effect from 6 April 2008. The RBC is a charge payable in order that a non-domiciled individual may benefit from being taxed on the remittance basis rather than the arising basis. Under the remittance basis a non-UK domiciliary is subject to UK tax only on foreign income and gains actually remitted to the UK.

• From 2008/09 there was a charge of £30,000 for those non-UK domiciliaries who had been resident in the UK for seven out of the previous nine years. From 2012/13 the charge was increased to £50,000 if the individual has been UK-resident in at least 12 of the 14 tax years immediately preceding that year. The Autumn Statement includes two changes set out below.

a) An increase from £50,000 to £60,000 for individuals who have been resident in at least 12 of the preceding 14 tax years.
b) A new charge of £90,000 for those who have been UK resident for at least 17 out of the last 20 years.

- In principle it is difficult to argue with the proposal to impose a higher remittance basis charge when a non-domiciled person has been in the UK for an increasing length of time, although it does raise the question as to whether there should be a point at which the remittance basis is withdrawn for a long term resident but non-domiciled taxpayer.

- We are concerned at the continued changes to the rules in this area, and the often considerable uncertainty faced in complying with the rules. This does create considerable compliance difficulties.

**Income tax: salary sacrifice and expenses, including umbrella companies**

- The government’s decision to look closely how some umbrella companies appear able to abuse the current employment tax and National Insurance expenses rules is sensible. Publishing consultation on this area in order to ensure abuse is targeted, but not at the expense of a greater administrative burden for compliant intermediaries is the correct approach. The Low Pay Commission should also be consulted in relation to this area.

**Office of Tax Simplification: review of benefits and expenses**

- Benefits and expenses are a complex area. The Government’s decision to accept the recommendations of experts in this area is sensible and the recommendations of the OTS are pragmatic and proportional.

- Putting the OTS onto a permanent and secure financial footing would seem a sensible next step.

**Other points**

**NI thresholds**

- It is disappointing to note that the employer and employee starting points for Class 1 NIC have been set at different levels, and by just £1 per week (£155 and £156 pw). This adds unnecessary complexity to the payroll process for little real gain to any participant in the process. We would recommend harmonisation at £155 or £156 per week for both. Last year’s thresholds were harmonised after three years of inexplicable divergence. We do not understand why there is renewed divergence.

**Postgraduate loans**

- A new system for post-graduate loan support is to lead to additional recovery of student loans by deduction from payroll. The Autumn Statement notes that the recoveries will be 9% of income over £21,000 to run ‘concurrently’ with recovery of undergraduate loans, which will also be 9% of the same earnings band. A deduction of 18% of earnings above the threshold will be a serious disincentive to take up the new loan.
Appendix 2: Institute of Chartered Accountants in England and Wales

Traffic light assessment—a postscript
1) Our original Assessment was submitted before 10 December, Legislation Day, when draft clauses, Tax Impact and Information Notes (TIIN), Explanatory Notes and other guidance was published to support, and provide details on, the measures announced in the Autumn Statement.

We set out below further observations on the Diverted Profits Tax.

Diverted profits tax: potential 25% on UK based profits
2) We gave the only red light in our assessment to this new tax but largely because there were insufficient details to provide a proper assessment of the measure and, on the face of it, it appeared to create considerable extra complexity and uncertainty for businesses.

3) It is clear that the draft legislation is highly complicated, is likely to increase uncertainty and we are concerned about whether it is practicable. We now have 30 pages of draft clauses, nearly 50 pages of Explanatory Notes and a Guidance document of a further 50 pages.

4) At this initial stage it is still difficult to see how this new tax will fit in with existing international arrangements, such as the more than 120 treaties UK has with other countries. There is also the ongoing work of OECD, which we highlighted in our initial assessment. The OECD work would appear to overlap with this new measure and, as we noted in the original assessment, we have signed up to act in concert with the other 43 members countries engaged in the BEPS work.

5) It would be helpful to better understand the main target of this new tax. It appears to be designed to encourage changes of business behaviour so that what are considered to be UK activities are brought “on shore” and are subject to the normal UK tax rate, which will be 20% from next April, rather than the more punitive 25% rate proposed for the new tax.

6) At this stage therefore we have identified the following further issues:
• How does this new tax fit in with our existing UK treaty network and how will foreign companies that pay this new tax get relief for that tax in their country of residence?
• Does the new tax comply with our obligations to respect the EU Treaty freedoms;
• What effect will the measure have on the ongoing OECD work in this area?

7) We also at this stage have a more detailed question about the provisions themselves.
• There is a relatively rudimentary transition to the new tax which basically comes into effect for accounting profits arising from 1 April 2015 and there is an apportionment for accounts that straddle that day (clauses 29). Given the aim of the
measure is actually to encourage behavioural changes we suggest a longer transitional arrangement or a form of grandfathering might at the very least be appropriate for third party long-term equipment contracts already entered into.

8) In summary, our earlier traffic light assessment remains largely unchanged at red pending the reaction from other key economies. If their reaction was broadly favourable we would change our overall assessment to amber.
Introduction

1) The Treasury Committee has invited comments on how Autumn Statement 2014 meets the Committee’s tax policy principles, as expressed in its 2011 report Principles of Tax Policy. The Chartered Institute of Taxation (CIOT) is pleased to submit some comments, which incorporate points from our Low Incomes Tax Reform Group (LITRG) and also comments from our colleagues at the Association of Taxation Technicians (ATT).

2) The Committee’s report identified six principles: Basic fairness;
- Supporting growth and encouraging competition;
- Certainty, including simplicity;
- Stability;
- Practicality; and
- Coherence.

3) We comment briefly under each of the principles but would stress that we are not giving a full analysis of the Autumn Statement. We could not hope to cover the whole range of measures in the Autumn Statement in a short memorandum.

Basic fairness

4) We believe that the abolition of the slab system of stamp duty land tax (SDLT) for residential properties scores highly in this category. The outdated and unfair slab system distorted property sales by creating huge ‘cliff edges’ at particular property values. Under the slab system, someone buying a property for £125,000 pays no tax while someone buying a property for £125,001 pays £1,250; someone buying a property for £250,000 pays £2,500 in tax while someone buying a property for £250,001 pays three times as much. Moving to a system where SDLT is charged at each rate on the portion of the purchase price which falls within each rate band will be both fairer and more sensible, preventing distortions in the market place and avoidance around the ‘break points’.

5) A number of measures were announced to combat avoidance and ensure that everyone pays their fair share of tax. Chief among these was the announcement of a number of proposed changes linked to the OECD’s work to reduce global tax avoidance through base erosion and profit shifting (BEPS). Subject to some concerns over timing (see below), we welcome this announcement and agree with the Government that international cooperation and global solutions are required to challenge tax avoidance across today’s global economy. No one has yet seen any detail on the proposed Diverted Profits Tax. We are concerned that the UK may well be developing a new tax in advance of agreement on new principles of transfer pricing and taxable presence—which is work that the G20/OECD expects to conclude in September 2015. We would not welcome a
tax which might be in conflict with internationally-agreed principles and which gives businesses no opportunity to modify their approaches in line with those new principles.

6) As in previous years, the opportunity has been taken to increase the personal allowance (to £10,600 for 2015/16 in this instance), taking more people out of the tax net. Although this is welcome, the increase will mean less for those on means-tested benefits than for those higher up the income scale, and will do nothing to benefit those with income below the current personal allowance. Take those who receive universal credit. Unlike the current tax credits system, universal credit is calculated on post tax income, meaning that much of the cash benefit from an increase in the personal allowance is lost. This is illustrated by the following example:

Conor is a lone parent claiming universal credit and working 25 hours a week. From April 2015 he will see his take home pay rise by £120 a year because of the increase in the personal allowance, but because his net income has increased by that amount he will also see a corresponding reduction in his universal credit payments of £78. Therefore he will only be £42 a year better-off in comparison with other basic rate tax payers.

7) If the Government’s intention is to benefit those on low incomes as much as those higher up the income scale we believe that it would be fairer to recognise how income tax changes interact with means-tested benefits. Changes to the work allowances within universal credit could have gone some way to alleviate this problem but the Government have announced that work allowances are to be frozen to April 2018.

Supporting growth and encouraging competition

8) There are a number of measures in the Statement which should support growth, not least the announcement that the Government will implement 51 of the 58 recommendations put forward by the Office of Tax Simplification (OTS) in its report on the competitiveness of the UK tax administration. In particular, we welcome the increases in the rates of relief for Research and Development (R&D) expenditure, and the announcement that small companies making their first claim for R&D tax relief will be able to seek advance assurance that they qualify. The rules for determining whether or not R&D has taken place are complicated and deter many companies from making a claim. The introduction of an advance assurance service, alongside new guidance and the promise of a consultation on the issues faced by smaller businesses, should make it a lot easier for companies to claim R&D relief.

9) We also welcome the announcement that, from 6 April 2016, employers will no longer have to pay NICs on an apprentice’s earnings up to the Upper Earnings Limit for apprentices aged under 25. However, we think that the Government should have gone further. Firstly, we think there is a good case for extending the exemption to other employments where the employer is providing a substantial (and measurable) level of training. Secondly, we question why it is necessary to impose an age limit. Finally, we ask why this measure cannot be introduced from 6 April 2015.

10) With regard to the proposed changes coming out of the OECD’s work on BEPS (discussed in more detail above), we would urge the Government to ensure that the timing of the changes is carefully planned so that they are implemented at the same time as in other countries to ensure that the UK is not placed at a competitive disadvantage.
The early signs are that the Government will take this on board as the consultation
documents indicate that the rules will be introduced in 2017, which will give time for
companies to adjust, and for co-ordinated introduction with other jurisdictions.

11) Finally, we would mention the devolution of corporation tax to Northern Ireland.
The power to set corporation tax rates would be an exciting opportunity for Northern
Ireland, and a rate cut would grab the attention of the international business
community. However, we would point out that economic competitiveness is not just
about tax levels. In a survey of our members in 2010, most respondents agreed that a cut
in corporation tax rates was the simplest and quickest way of making Northern Ireland
more competitive. But over a third thought that non-tax measures, such as better
infrastructure, were even more important.

**Certainty, including simplicity**

12) A number of measures referred to above score well under this category, including:
the advance assurance service for small companies making their first claim for R&D
relief, which will give companies certainty; and the commitment to implement the great
majority of the changes recommended by the OTS in its recent competitiveness review,
which should make it easier for businesses to comply with the administrative burdens
placed on them.

13) We would also mention the adoption of reforms to the rules for employee benefits
and expenses in line, again, with recommendations made by the OTS. Removing the
£8,500 threshold below which benefits in kind are not taxed with effect from April 2016
will result in some simplification and remove an element of unfairness, and we welcome
the exemptions from this measure for carers and ministers of religion. The introduction
of a new statutory exemption for trivial benefits that cost less than £50, for example a
bottle of wine given by an employer to an employee to mark an important event, is
another simplifying measure. However we regret that such a low limit has been set and
courage the Government to keep this figure under review so that it does not remain at
£50 forever. Additionally, while a statutory framework for voluntary payrolling will aid
simplification for employers and HMRC, it may be less beneficial for employees. We
would encourage HMRC to provide clearer guidance both for employers and
employees.

14) Finally under this category, we welcome the Government’s announcement that
there will be no changes for the time being to the current rules governing a non-resident
individual’s entitlement to the UK personal allowance. We were concerned that the
changes proposed earlier in the year would make the tax system unduly complicated and
place additional burdens on employers. In a similar vein, we welcome the Government’s
decision not to introduce a single settlement nil rate band for trusts created on or after 6
April 2014. Although billed as a simplification, we believe that this measure would have
caused complexity and confusion and we are glad that the Government has decided not
to proceed as planned.

**Stability**

15) Two major areas where the principle of stability has been ignored is the taxation of
the profits of banks and taxpayers in the oil and gas industries. To some extent we have
more sympathy with the latter because there is a frequently fluctuating global market based on finite natural resources and the tax regime needs to change from time to time to take account of this. However, the frequency of change in recent years gives the impression of making it up as we go along taking account of pressures from major players in the industry. The restrictions on the brought forward losses of banks amounts to a sort of ‘windfall tax’ on the banking industry. As has been observed many times before windfall taxes lead to substantial instability across the tax system, and should be avoided.

**Practicality**

16) We welcome the announcement that legislation will be introduced to strengthen the Disclosure of Tax Avoidance Scheme (DOTAS) regime, and that a new DOTAS taskforce will be created to improve the administration and enforcement of the system. However, we firmly believe that DOTAS should remain a fundamentally co-operative regime between HMRC and advisers, and that there is mutual interest in having a workable system. Our concern is that these proposals risk eroding that cooperation and that as a result the DOTAS regime will not operate effectively. We think it is essential that the system should contain sufficient protection for the vast majority of advisers who comply with the rules, and that it should not be cast too widely as to catch straightforward tax planning arrangements.

17) On the proposals to devolve the power to set corporation tax rates to Northern Ireland, we are concerned that firms that operate across the UK may face an additional compliance burden, requiring them to calculate the profits earned in Northern Ireland separate from those earned elsewhere in the UK. Also, there would be enforcement issues for HMRC, who would need to make sure businesses are not wrongly assigning profits to Northern Ireland to save tax. If the rules are to work as intended, the Government will need to do all it can to minimise the additional bureaucratic hurdles that are likely to arise as result of devolution.

18) Although we welcome the announcement that the Government will be consulting on the use of umbrella companies, we would caution that unless any resulting measures are very carefully thought out, the situation for low-income workers could be made worse than it is as present. Umbrella companies have been around for a long time and offer overarching contracts of employment, which allow some temporary workers to benefit from tax relief for home-to-work travel expenses. However, umbrella companies are unpopular with the Government because they use the underlying travel expenses rules in a way that was never intended. In its recently published report on this topic, LITRG set out how complicated the situation is and suggest that the Government takes a holistic look at what is driving workers to use these schemes.

**Coherence**

19) We welcome the further changes to the rules on pensions and savings under this heading, as we did in our report in March on the wider pensions and savings measures announced in Budget 2014. The announcement that annuitants who die before the age of 75 can now pass on their annuities tax-free to their spouse or civil partner levels the playing field between those taking their pension as an annuity compared with those who
take the drawdown route. In addition, the proposal to preserve the tax shelter for ISAs inherited by spouses or civil partners will level the playing field with those whose preparations for their old age took the savings route rather than the pensions route. Taxpayers will now be able to make an informed decision without being influenced by unequal tax treatment.

20) The changes to SDLT (see under Basic fairness above) score well under this category too. Rather than tinker around the edges, making small changes that are as likely to complicate matters as they are to benefit taxpayers, the Government has taken the opportunity to abolish the slab system and replace it with a rate structure that has greater coherence and logic to it.

Conclusion

21) We have mixed feelings on how well the Autumn Statement scores under the Committee’s headings. Most of the categories have measures that score well but there are a number of areas where we have concerns. On balance, we feel that a rating of 8/10 is appropriate, as much in response to what the Government has said it will not do as what it will do. We are pleased that the Government has listened to the feedback it has received and has decided to change its plans in a number of important areas including the proposals to restrict the entitlement of non-residents to the UK personal allowance (and, in an announcement made in the weeks before the Autumn Statement, to make significant changes to its proposals on new powers for HMRC to collect debts direct from taxpayers’ bank accounts).

The Chartered Institute of Taxation

22) The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it—taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

23) The CIOT draws on our members’ experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT’s comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

24) The CIOT’s 17,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.
Appendix 4: Chartered Institute of Taxation

1) Earlier this week, we submitted our comments on Autumn Statement 2014 to the Treasury Select Committee (TSC) of the House of Commons. This included initial comments on the new Diverted Profits Tax (DPT) based on the limited information available at that time. Following the publication of the draft legislation for Finance Bill 2015 we are now in a better position to comment on the DPT and would like to make the following points.

2) We cautiously welcomed the DPT in our report to the TSC, expressing some concern that the Government may place the UK at a competitive disadvantage if the new tax is developed in advance of international agreement on new principles of transfer pricing and taxable presence.

3) We see no reason to change these comments. Although we believe that the objectives of the DPT are reasonable, we would caution the Government against the introduction of a tax which might be in conflict with internationally-agreed principles and which gives business no opportunity to modify their approaches in line with those new principles.

4) Having now seen the draft legislation for the new DPT, we would make the following additional comments. The legislation is drafted in a very unclear manner. It seems to us that it potentially brings into scope a large number of transactions and it is unclear whether that is the intention. This structuring will mean that a large number of companies will need to be aware of the legislation and consider whether they fall inside it. Computation of the amount subject to the tax does not look straightforward to calculate, given that it is not based on any agreed international standards. As you know, UK transfer pricing is based on the OCED approach and the OECD’s current Transfer Pricing Guidelines have been enacted into UK law. This new tax will affect some UK-based multinationals as well as those based in the US and elsewhere.

5) We would be grateful if you could consider our additional comments above under the principles of ‘Certainty, including simplicity’ and ‘Practicality’.

Yours sincerely
Patrick Stevens
Tax Policy Director

The Chartered Institute of Taxation

6) The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it—taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax
Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

Formal Minutes

Wednesday 11 February 2015

Members present:

Mr Andrew Tyrie, in the Chair

Rushanara Ali          John Mann
Steve Baker            Jesse Norman
Mark Garnier           Teresa Pearce
Mike Kane              Alok Sharma
Mr Andrew Love         John Thurso

Draft Report (Autumn Statement 2014), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 135 read and agreed to.

Papers were appended to the Report as Appendices 1, 2, 3 and 4.

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

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

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 24 February at 9.45am]
Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the Committee's inquiry page at www.parliament.uk/treascom.

**Tuesday 9 December 2014**

*Alan Clarke*, Head of UK and Eurozone Economics, Scotiabank, *Kevin Daly*, Senior Economist, Goldman Sachs, and *Jamie Murray*, Senior UK Economist, Bloomberg Economics  

*Paul Johnson*, Director, Institute for Fiscal Studies, and *Carl Emmerson*, Deputy Director, Institute for Fiscal Studies

**Thursday 11 December 2014**

*Robert Chote*, Chairman, *Stephen Nickell CBE*, and *Graham Parker CBE*, Members, Budget Responsibility Committee, Office for Budget Responsibility

**Wednesday 17 December 2014**

*Rt Hon George Osborne MP*, Chancellor of the Exchequer, and *James Bowler*, Director, Strategy, Planning and Budget, HM Treasury
Published written evidence

The following written evidence was received and can be viewed on the Committee’s inquiry web page at www.parliament.uk/treascom.

1. Association of Certified Chartered Accountants (AUT0001)
2. Institute of Chartered Accountants in England Wales (AUT0002; AUT0007)
3. Chartered Institute of Taxation (AUT0003; AUT0006)
4. Confederation of British Industry (AUT0004)
5. Office for Budget Responsibility (AUT0005)
6. Kevin Daley, Senior Economist, Goldman Sachs (AUT0008)
7. Federation Of Small Businesses (AUT0009)
### List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the Committee’s website at [www.parliament.uk/treascom](http://www.parliament.uk/treascom).

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