House of Commons

Treasury Committee

Oral evidence: Tax after coronavirus, HC 664

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Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Mr Steve Baker; Anthony Browne; Felicity Buchan; Ms Angela Eagle; Julie Marson; Siobhain McDonagh; Alison Thewliss.

Questions 143 - 204

Witnesses

I: Richard Hughes, Chairman, Office for Budget Responsibility; Andy King, Member, Budget Responsibility Committee, Office for Budget Responsibility; Professor Sir Charles Bean, Member, Budget Responsibility Committee, Office for Budget Responsibility.

II: Stuart Adam, Senior Research Economist, Institute for Fiscal Studies; Alan McLintock, Chair, Indirect Taxes Committee, Chartered Institute of Taxation; Charles Seaford, Senior Fellow, Demos.

Examination of witnesses

Witnesses: Richard Hughes, Andy King and Professor Sir Charles Bean.

Q143 **Chair:** Good afternoon and welcome to the Treasury Committee's latest session on tax after the coronavirus. We have an interesting split session today, starting with the Office for Budget Responsibility and then moving on to a panel of experts around the issue of value added tax. I am going to start by asking the three panellists representing the Office for Budget Responsibility to introduce themselves.

Richard Hughes: Good afternoon. I am Richard Hughes from the Office for Budget Responsibility.

Andy King: I am Andy King, another committee member at the OBR. I lead on fiscal issues.

Professor Sir Charles Bean: Hi, I am Charlie Bean. I am the so-called economic expert at the OBR and I am a professor at the London School of Economics.

Q144 **Chair:** Welcome to the Committee. Thank you for joining us today. I am going to start by putting my first question to Richard. We know that the fiscal sustainability report projects that public debt may rise somewhere between 90% and 113% of GDP next year due to the current crisis, but if you look further out to the full 50-year projection period, you get figures in the range of 320% to an eye-watering 520% of GDP. Can you run through for us the main drivers of those figures there and give us an idea of how much fiscal policy would need to tighten over the decades to keep that debt stable?

Richard Hughes: All the figures that we give you this afternoon are going to be based on the fiscal sustainability report scenarios. We are in the middle of doing an update to our economic and fiscal outlook to be published in the middle of November, but it would not be right for me today to give you a running commentary or sneak preview of that. Based on the scenarios set out in the FSR, you are right that over the longer term you see a rising debt to GDP ratio, driven by a rising primary deficit over the next 50 years, primary deficit being the difference between non-interest spending and revenues. Much of that is driven by a rise in the age-related spending items within spending.

There is a very modest decline in the tax to GDP ratio over our 50-year forecast horizon driven by an ageing population and the fact that pension incomes are less taxed than those of people of working age, but the vast bulk of that increase in the spending to GDP ratio is driven by age-related spending. It goes up by about 9% of GDP from 15% of GDP in 2024-25 to around 25% of GDP by 2070. About half of that increase is due to increases in the unit cost of healthcare and social care. The cost of providing health services and social care per person is going up for a number of reasons.

Then the other half is driven predominantly by demographic pressures. The population of people who need healthcare and social care is also going up. Of that 9% of GDP increase in primary spending over the next 50 years, the increase in unit cost of healthcare accounts for about 5% of GDP and then demographic pressures and an ageing society add another 4% of GDP to that.

Q145 **Chair:** That is very interesting. Thank you very much. Andy, taking the three heaviest-lifting taxes, VAT, national insurance and income tax, what kinds of increases might we have to look at in just those taxes, as a hypothetical example, to make sure that the public finances were stable? What sort of amounts might we have to lever in from those taxes? What would it look like?

Andy King: There are quite a lot of priors, even in the hypothetical question there, because you are asking where you would like to get the debt ratio in the future. In the FSR, for purely illustrative reasons, we looked at what would be required to get the debt ratio back down to 75% of GDP. There is nothing magical about that number. It was just the number at the end of the March Budget forecast, so an indication of what the Government had previously been aiming for.

Q146 **Chair:** Back in 2012 we were down at 75% or thereabouts. Why was the report hooked on that 75%?

Andy King: The level in the fifth year of the March Budget forecast was also 75%, so it was a revealed preference of the pre-coronavirus fiscal setting that the Government had chosen. As I say, there is nothing magical about that, but the analysis in the FSR suggested that, on the central scenario, to get debt back to that level on a decade-by-decade basis you would be looking at roughly 3% of GDP tightening per decade. Remember, that is not tightening in the sense of the budget deficit falling. That is what would have to happen to stop the budget deficit from rising such that debt follows the explosive paths you have seen there.

As you probably know, Parliament has requested that the OBR does not engage in hypothetical policy costings, but I read that the Institute for Fiscal Studies has looked at, roughly speaking, what a percentage point increase on the three large taxes you mentioned would raise in a normal year, as it was described. The number the IFS came up with was roughly £20 billion, which is roughly 1% of GDP in current terms. That gives you some idea of the orders of magnitude at play. The OBR's job is, whenever the Government propose policy measures, to look at those afresh each time. If you were talking about larger changes, those ready reckoner-style orders of magnitude might not be appropriate.

Q147 **Chair:** Charlie, could you tell us a bit about the gilt interest rates that are assumed within the projections and what the consequences would be? What would it look like if they increased by 1% or 2% across the period? How difficult would that look?

Professor Sir Charles Bean: In terms of what we condition our projections on, that it what is in the market curve out until the end of the five-year horizon. Beyond that for our long-term projections we assume that long-term rates rise up in line with nominal GDP to end with the long-term interest rate a bit above the rate of nominal growth by about 0.2 percentage points. That reflects the historical average.

I would like to stress that there is a lot of uncertainty about that. There has been downward pressure on long-term interest rates in recent years. We do not fully understand why that has happened. Therefore, there is uncertainty about where they go in the future, but the assumption we build in is basically a gradual reversion to the historical average.

What it means for the evolution of the debt to GDP ratio depends a lot on whether this is just a change in yields or a change in yields accompanying a higher growth rate. Pretty much, the two move up one for one together, so R minus G, in the jargon, is unaffected. That is neutral for the path of the debt to GDP ratio, but if the nominal growth does not recover but yields rise, so the R minus G opens up, that will lead to more upward pressure on the debt to GDP ratio for a given primary deficit.

Q148 **Chair:** Could you speculate what a 1% or 2% figure might look like in terms of the debt across that period?

Professor Sir Charles Bean: On a debt to GDP ratio that is 100%, if you add one percentage point to the interest rate, that will be adding one percentage point each year, other things equal, to the debt stock.

Richard Hughes: In chart 5.7 in the FSR, we did an update of the sensitivity analysis of the debt stock to changes in interest rates. It showed that it is true, at the limit, that if you add a 1% interest rate to a debt stock of 100% of GDP that costs you around 1% of GDP. This debt has a maturity of around 15 years, so you only get about a third of that in a given forecast period. In chart 5.7, we show that it ends up costing you about a third of a percent of GDP within the forecast period, so that is going to be somewhere in the ballpark of £10 billion by the end of the five-year period.

It shows that our public finances are now more sensitive to interest rate rises than they were before the coronavirus shock, because we have a higher debt stock. They are also more sensitive because the average maturity of our debt has been getting shorter, because a lot of the financing that the Government have been doing in recent months has been very short term and because the Bank's quantitative easing operations replace long-dated gilts with short-dated central bank reserves. It is also making our debt stock more sensitive to those changes in interest rates that you were referring to.

Q149 **Chair:** Andy, could I turn to you and ask a bit about the fiscal risks report and the focus on tax reliefs as medium risks? Which reliefs might be especially problematic?

Andy King: Tax reliefs were briefly mentioned in the first edition of our fiscal risks report and we then looked at them more closely in the 2019 edition. There were many reasons for doing that. One is that the estimates for the reliefs that HMRC publishes show that they are large in fiscal terms. They are more opaque than public spending, but often do an economically similar job. A tax relief and a subsidy can both be used to incentivise something or otherwise. Because they are opaque and are managed differently to how public spending is managed, it is possible for the cost of them to rise without it being immediately obvious. The risk is there because they are large. It is also more of a concern because the dashboard does not immediately flash when you are going off course.

We listed many other reasons that one might worry about the risk, including complexity and the fact that reliefs create boundaries in the tax system that taxpayers can either push for avoidance reasons or challenge HMRC on the legal interpretation of. They can simply divert activity to challenging the tax system rather than normal business. There are lots of reasons why we might be concerned.

We did not particularly single out reliefs that are more or less of a risk. We certainly looked at some of the larger ones. There are two examples that might be helpful. R&D tax credits are a relatively large tax relief. They have been evaluated both by HMRC and outside. They are judged to work, in the sense of incentivising research and development spending, but the cost of them has been rising quite quickly.

The amount of spending that is tax relieved is now higher than the amount of R&D spending that the Department for Business records, which is worrying. Their definitions are different, so it is not easy to tell what is going on, but there is that nervousness that they are incentivising both R&D and the rebadging of activity to get access to a generous tax credit. That is one example and that is a forecast issue for us, as well as a policy issue for the Government.

Another is entrepreneurs' relief, where, unlike R&D tax credits, the evidence suggests that it acts less as an incentive to inspire people to entrepreneurial activity and more of a reward at the end of an entrepreneurial career of a lower tax rate if you did well. Up until recently where the limit on this was £10 million, a lot of the cost was concentrated among wealthier people selling their business.

We look at that kind of incentive when we are considering the Government's costing of changing the threshold, because the greater the incentive factor, the less revenue you raise when you raise the tax, effectively, by cutting the threshold. As ever, it is not for us at the OBR to be commenting on what are good or bad tax reliefs, although unusually HMRC has renamed entrepreneurs' relief to business asset disposal relief, making it literally a BAD relief in this instance.

Chair: I suspect that will make it easier for them to take further actions to cut back the generosity of the scheme.

Andy King: It is a strategic renaming.

Chair: I wish I had more time to question you on this, because it is important. The Treasury needs to do a lot of work to look at value for money and transparency across all those reliefs, but I have to move on.

Q150 **Ms Eagle:** Charlie, I enjoyed you calling yourself a so-called economic expert. I wonder, given that the Chancellor announced in his speech at the Conservative Party conference that it was his sacred duty to balance the books, and taking into account this tax lock that it is in the Tory manifesto, which prevents him increasing national insurance contributions, VAT or income tax, how on earth he is going to fulfil his sacred duty.

Professor Sir Charles Bean: In some sense that is a question for him rather than us.

Ms Eagle: Answer it theoretically.

Professor Sir Charles Bean: We do not give advice on how to do it. If you lock down three of the big tax revenue raisers, that means you have to do rather more on other tax sources or squeeze down on spending, which will be challenging. It is worth saying that, at the current juncture, one should not think that there is a great urgency in closing the deficit. It is entirely appropriate, given the large and very unusual shock the economy has been subject to, for the Government to run a large deficit so long as the virus emergency persists. That is something pretty much all economists would agree with.

As one goes beyond the emergency, it will be appropriate to stabilise the public finances and potentially start building in fiscal space to recognise that there will be future bad shocks further down the road. We have seen two once-in-a-lifetime shocks in the past decade, the global financial crisis 10 years ago and the Covid shock. If we are subject to more of these going forward, one wants to be able to take appropriate fiscal action.

The general rule with Government debt is basically to allow it to rise when there is a bad shock, in wars and things like that, and during the good times to gradually bring down the debt to GDP ratio, which will create the space for further action in the future. The question of how quickly you do that is a question of balancing off the immediate costs of doing so against the risks of doing it slowly, because if you leave the debt to GDP ratio at a high level along comes another bad shock requiring fiscal action; it ends up ratcheting higher and higher; and in a worst case scenario you may find that it then becomes difficult to finance the debt on the market. That is when you see countries finding themselves cut off from the capital markets.

Q151 **Ms Eagle:** I want to ask Andy about the fiscal risk report that you produced, where you identify the issue of a disappearing tax base and various reasons why the tax base is disappearing. I am particularly interested in a couple of them: first, digitalisation and the fact that services are being driven increasingly on to platforms. It is not clear where value is being created, but it is clear a lot of very large companies with very high turnovers in the UK are paying tiny amounts of tax. What could we do in terms of tax policy to capture some of that value and maintain our tax base?

Andy King: Sadly, this is definitely beyond the OBR's remit for us to speculate on. We tried to review the different ways in which digitalisation affects both the tax base and tax administration. The kinds of things you describe are putting pressure on more traditional tax bases, so clearly online retail versus bricks and mortar retail has various implications. Where businesses generate value without charging a price at the moment of delivery to the customer, that is very difficult to measure and tax. There is a big international agenda on it.

Q152 **Ms Eagle:** How, for example, did you model the proposed digital services tax, even though there is now doubt that it might be introduced?

Andy King: That was one of the more complicated pieces of policy costing technology that I have looked at in my tenure in this role. Some of the larger companies simply report their turnover in the UK. Others had to be explored via increasingly innovative ways of trying to understand what their business in the UK might be worth. For the larger companies, the types of things that are taxed by the digital services tax were reasonably well known.

Ms Eagle: Is it turnover or sales, for example?

Andy King: Yes, it is turnover that is being taxed. One of the interesting things from our perspective is the way it has been passed on to the customers or the suppliers who use the platforms, so the incidence of the tax is not on the multinational companies. They have passed it on to those who generate the turnover.

Q153 **Ms Eagle:** Another one of the areas where there is a lot of disappearing tax base is the different employment statuses that we have at the moment, so self-employed, apparently self-employed and employed. Again, given that we are in such a dynamic situation where there are massive increases in apparent self-employment, how do you model the tax take in those circumstances?

Andy King: This has been on our radar for some years. It is one of the areas that HMRC models quite well. They have lots and lots of information about all these different taxpayers and the different tax rates, and the incentives that that generates are well known. Our forecasts incorporate modelling of how the incorporation behaviour will continue. They assume that more people will set up as company owner-managers over time; that that will support corporation tax revenues and will reduce income tax and national insurance; and that the net effect of that is to reduce tax receipts overall.

Q154 **Ms Eagle:** Richard, the 2017 fiscal risks report got a 140-page response from the Government when it was published by the OBR. The one that you put out in 2019 probably merited a lot more, but it got a 400-word written response from a Minister. After a piece of work that huge, should you have got a better, more serious response from the Government?

Richard Hughes: The fiscal risks report and the Government response were designed to set up a dialogue between the Government and the OBR about the sources of fiscal risks and what the Government were doing to address them. In turn, the OBR could then review and assess the extent to which those risks were being mitigated by Government action.

It is understandable that, in the midst of the kind of economic shock that we are facing at the moment, the Government did not have a lot of time to devote to providing a separate response to the fiscal risks report this time around, of the sort that was provided back in 2018. A lot of the measures that the Government have been taking and that have been set out in the summer economic update and the winter economy plan are managing the risks to the economy, which ultimately is the source of where Government raise revenue and the source of longer-term costs to the public finances. In that sense, the Government's policy response has been risk management in action.

As and when the economy returns to some sort of normality and policymaking returns to some sort of normal rhythm, we would hope to see a more substantive Government response to the fiscal risks report, not least so that, when we do our next update, we have something that we can actually assess and evaluate in terms of the policies and management actions being taken to try to reduce those risks.

Q155 **Rushanara Ali:** Good afternoon. I have some follow-up questions to Angela and the Chair's questions. On the fiscal sustainability report, I will start with Professor Bean. Can you talk us through how the latest restrictions to activity, the winter economy plan and a possible second wave might affect matters looking ahead?

Professor Sir Charles Bean: There is a lot of uncertainty here and I should remind you of what Richard said at the outset. We are in the process of undertaking a forecast at the current juncture, so this is the sort of thing we are working on, but it would be inappropriate to give a running commentary.

In terms of how the economy has developed during the course of this year, initially there was relatively good news about the rebound from the lockdown as the lockdown measures were unlocked, so that activity is probably a little less than like 10% below where it would otherwise be. You have probably had Andy Haldane before you saying "so far so V". Indeed, it looked pretty much like our upside scenario up until the start of the autumn. High-frequency indicators have flattened off a bit, suggesting the pace of recovery is slowing, but the key thing is the resurgence in cases and the potential re-imposition of lockdown measures on either a local or, in the worst case, a national basis.

Q156 **Rushanara Ali:** Professor, if I could interject, after "so far so V", what does the shape look like? Where do you see it going if we are in second wave territory?

Professor Sir Charles Bean: It is reasonable to think that, at a minimum, this is going to put the recovery on hold for a while.

Q157 **Rushanara Ali:** For how long do you see that happening?

Professor Sir Charles Bean: This depends on the course of the virus itself. I am not an epidemiologist, so I am not going to make predictions there. It will depend upon the non-pharmaceutical interventions the Government makes—the policy responses. On top of that, it will also depend on how individuals, consumers and businesses respond. You might expect that, with heightened risks of catching the virus, consumers are going to be more wary of going to restaurants, bars and shops, even if they are open. It is reasonable to suggest that there will be some hiatus in the recovery. It is very difficult to know how long and how potentially deep that is at this stage, until we see how effective any measures are in bringing the resurgence in cases back under control.

Q158 **Rushanara Ali:** This may be too simplistic a question, so forgive me, for both you and Richard Hughes. Do you think there is a case for more interaction, interdependence of thinking, between what the OBR does and the health dynamics of all this, given the deeply connected nature of this crisis and the knock-on effect on the economy, indebtedness and the rest of it? You rightly pointed out that you are not an expert on the medical side, but how much of that is going on, in the discussions, as you look towards a November report?

The public, our constituents, do not think about these issues in siloes. They are not concerned about timings for reports. They want to know what is going to happen to their jobs, the national debt level, public sector borrowing, the taxation levels they might face, how their businesses are going to cope and so on. Sorry to put it very simplistically in terms of the thinking out there, but that is what is going on. Could you elaborate on how your thinking is being shaped, given the nature of this crisis?

Professor Sir Charles Bean: We try to follow reasonably closely how the medical and scientific thinking is developing. Going to the origin of your question, we are not intimately involved, so we are not at SAGE or anything like that, but a lot of the scientific analysis is put into the public domain. There is also a lot of work in the economic sphere by academics on this. The explosion of work by economists analysing the impact of the pandemic is a marked contrast from the financial crisis. We draw on that and the analysis coming out of that, informing our assessment.

In terms of actually saying where things will go, this is something where one has to recognise the uncertainty. We can portray a range of likely outcomes, as we did in the summer with FSR, with an upside and a downside scenario. I would want to continue to emphasise that we cannot say where this is going to go, but we might be able to say something useful about the range of possible outcomes.

Richard Hughes: To supplement that, you are right that the course of the virus is the crucial conditioning assumption for where the economy and public finances are going to go next. That is why we continue to think of forecasting in terms of scenarios. There is an upside scenario, with the rapid development of an effective vaccine that can be quickly rolled out to the population. That would return the economy more or less to its normal state ex ante, with very limited scarring on economic activity and long-term tax revenues, and limited implications for sustainability.

There is also a downside scenario where that vaccine is not rapidly developed, social distancing measures have to stay in place and the consequences for consumer and business behaviour last for the longer term. That is reflected in our downside scenario, which we did in the FSR. We are going to continue to think in those terms as we produce the EFO, so long as there is this level of uncertainty about the course of the virus itself and the Government's public health restrictions, so that you, the public and the Government can test the resilience of their policy response against those different scenarios. There is so much uncertainty about the outlook. It is important to think about the resilience of policy to those different scenarios and not just how policy is performing on a central forecast of the sort we have provided in the past.

Q159 **Rushanara Ali:** I have one question with two subsets, because this is my last one. This is for all of you, so come in as you please. Professor Bean talked earlier about two shocks in the last decade and building in risks to plan for future shocks. Climate change and potentially other forms of viruses are other major areas of risk. I was really struck by an image in a magazine about the many kinds of viruses that might be coming our way in the future. There could be all sorts of shocks that come more regularly.

What would you say is needed? What kind of thinking is needed, within Government, OBR and elsewhere, to prepare for those shocks and the cost implications of them, given that the Covid shock has been such a big surprise? I think everyone has been taken by surprise, whichever end of the political spectrum they might come from.

In relation to businesses, corporate indebtedness as a result of the Covid crisis is rising and is likely to rise. Do you expect to analyse the impact of this in the public finances in the future for the FSR or the fiscal risks report going forward?

Richard Hughes: Maybe I can start off on your question about how to prepare for future shocks and then Andy can address the point about business debt. In terms of how to prepare for or anticipate future shocks, some work was done by the IMF a few years ago about where fiscal risks and shocks to the public finances come from. They found that they are quite varied. They can depend on your neighbourhood and what part of the world you are in. In some cases, it is natural disasters. In other cases, it is recessions. In the longer term, it could be very different things, like climate change, as you say.

They found that, on average, a typical recession added about 10% of GDP to a country’s debt stock. A financial crisis added about 20% of GDP to a country’s debt stock. Recessions came along about once a decade and financial crises came along about once every 20 years. Those are the kinds of shocks that Governments need to anticipate when planning their longer-term debt to GDP ratio and the scale of shocks they can face from those two historical sources of shocks to the public finances.

Things like pandemic viruses, fortunately, do not seem to come along as frequently as recessions or financial crises. Based on our own forecasts, they are already adding 20% to the debt to GDP ratio. Again, it comes back to building in some resilience to your fiscal policy over the long term, aiming to have lower debt than you might otherwise have on a central forecast.

Q160 **Rushanara Ali:** I have one supplement to that. Do you think our Government and, given your international perspective as well, the world community are doing that adequately? Should we be looking to do more work on that?

Richard Hughes: The world is clearly becoming more conscious of the risks to the fiscal outlook. What has benefited advanced Governments all around the world has been the fact that their borrowing costs have been declining over time. They have not really felt the pain very much of their debt to GDP ratios going up because the cost of that debt, measured as a share of their total outlays, has been going down. Whether that can be sustained going into the future comes back to a question about what the long-term path of interest rates is.

We have already seen a big benefit coming and more fiscal space being given to Governments to deal with shocks from the fact that the cost of their higher debt is actually lower, but can that be sustained in the longer run? Maybe time is up or maybe not. A lot of people said time was up 10 years ago and it was not. Governments bought a bit more time with even lower interest rates, but that is a big question confronting all economists at the moment.

Andy King: The general way we would think about the rise in corporate indebtedness is that it affects businesses’ decisions. On average, you would expect it to weigh on business investment, and that in turn weighs on productivity. The lesson of certain economies after the financial crisis was that, with very low interest rates as well, the cost of forbearance is low per borrower but can be high for the economy by locking resources into place. We do not know at this stage how much resource we will need to move around the economy but forbearance of those with high debts is one way of ensuring that they do not move. It is all part of what will be a journey of discovery about how much scarring there is after this recession, in terms of the economy's potential to grow.

Post this crisis, the Government have guaranteed a very large proportion of new lending this year to companies, so there is a much more direct route from high indebtedness to the public finances, if those guarantees are called.

Q161 **Siobhain McDonagh:** My questions look at the long-term spending pressures that drive the OBR's projection of a 50-year rise in public debt. I have a couple of questions for you, Andy. The fiscal sustainability report projects that, on current policy, primary spending would rise from 37% of GDP today to between 47% and 51%. Can you summarise the main long-term pressures on public spending in the UK and to what extent they are policy driven or driven by demography and other factors outside the Government's direct control?

Andy King: As Richard mentioned, in the central scenario there you have a 9% of GDP rise, of which around 5% is based on our assumptions about non-demographic pressures in the health system. Innovation in health tends to push up costs, whereas in most businesses it pushes down costs, either because more things can be treated or because they can be treated better but the cost of each treatment is higher. You get the health outcome but the costs rise. The rest, the other 4%, is demographics: in health, because of the cost of care at the end of lives, and in the pensions system, for obvious reasons.

These are, to varying degrees, within the Government's control. You have seen the Government take action on pensions by linking the state pension age to longevity. That means, essentially, that the fiscal cost of rising longevity is shared now in a sort of automatic way. On health, in the report we are trying to say that the broad sweep of history is that these kinds of pressures on health spending are accommodated by Governments. If that were to continue and history was a good guide to the size of those pressures, these are the numbers you would see.

Historically, they have been accommodated by bearing down on other forms of spending, particularly defence spending, if you take a long view. As you look forward, that may be more difficult. There may be fewer things that you can bear down on. We are not saying what the health system should cost in 50 years. It is where you would get to, given historical trends.

Q162 **Siobhain McDonagh:** Because the cost projections are based on other cost pressures rather than demography, should we see this as a cause for optimism? Healthcare costs need not spiral upwards if cost inflation can be got under control. What confidence do you have in the NHS's long-term plan of aims for efficiencies and cost control? Is it your judgment that such efforts are likely to fail, as they have done in the past? What would have to happen for you to change that assessment?

Andy King: We do not look at the individual efficiency measures in things like the NHS plan. In health spending, essentially you are talking about running to stand still, so the efficiency measures have to continue in order to make the space for the cost-increasing innovations, the trends in chronic diseases and many other things. Healthcare, and particularly social care, is such a labour-intensive activity that the scope for productivity gains is limited.

To say that cost pressures push health spending up as a share of GDP is not to say that efficiency measures do not work. It is that, each time an efficiency measure works, it gives more space to treat more people or to afford better treatments. Ultimately, it is a political choice, how much is spent, how many treatments are available, how many MRI scanners there are—these kinds of things. The total cost versus the individual efficiency measures can be separated.

Q163 **Siobhain McDonagh:** Richard, could you spell out the consequences for the current and future Governments of not allowing public spending to rise as a share of GDP as you project? Would that necessarily entail reducing the promised coverage and/or quality of public services?

Richard Hughes: It is not for us at the OBR to assess the consequences of different policy choices in terms of their welfare impact. We focus on questions around sustainability and longer-term cost. I would make a broader point about historical patterns in tax and spending. It has been easier up until now for Governments to accommodate increases in age-related spending and the cost of healthcare, because other items in the budget have allowed them to do so. They have been able to accommodate rising healthcare spending because, as I mentioned, interest rate costs on their debt have been falling, both because debt stocks have been falling and because interest rates have been falling.

That has created some fiscal space for them to accommodate the increase in healthcare spending without having knock-on effects for either other areas of spending or requiring what would otherwise have been tax rises needed to finance them. You have also seen two peace dividends come through in the post-war years, the first from the end of the second world war and then again from the end of the cold war. Defence spending is now down to around 2% of GDP and there are commitments at the level of NATO and others not to reduce it further.

A lot more of other spending in the Government budget is looking more rigid and less accommodative if you are going to absorb the kinds of spending pressures Andy was talking about elsewhere in Government spending. It means the Government have less fiscal space at current levels of taxation to try to deal with those pressures.

Q164 **Felicity Buchan:** I want to follow up on a number of the Chair's questions. Richard, on debt to GDP, you are projecting that that trends upwards. Is there a level that we should be worried at? I know that Andy mentioned that the target of 75% was not your recommendation. Do you think that Government should have a target for debt to GDP?

Richard Hughes: On the question of the danger level of debt, many people much smarter than I am have got themselves into trouble by naming particular figures, including Reinhart and Rogoff saying 90% of GDP was the threshold beyond which Governments face debt spirals because of rising debt stocks and rising interest rates. We clearly have not seen that with the projections in the aftermath of the coronavirus shock. That comes back to the fact that interest rates have been very accommodative and markets have enabled Governments to finance their debts at historically low interest rates.

Other indicators, like the debt interest to revenue ratio, give you a sense of the burden of that debt on the public finances. That number continues to fall, despite the fact that debt stocks are increasing. As we mentioned at the outset, that exposes the Government to changes in the interest rate, both because the level of debt is higher and because the maturity of debt is getting shorter, so our debt stock is getting more sensitive to interest rate shocks. There are reasons for us to be more concerned about the level of debt because of that sensitivity to shocks.

Q165 **Felicity Buchan:** On that point, you mentioned that maturities are getting shorter and there is more floating rate debt. That seems counterintuitive to me, because I think we should be terming out debt, given how low interest rates are, indeed to as long a maturity as possible almost. What do you think?

Richard Hughes: That has been the Government's strategy up until now. This comes back to the interaction between monetary and fiscal policy. The Government have been issuing fairly long-term debt, but the Bank of England's quantitative easing operations and asset purchases buy up that debt at the long end of the yield curve and replace it with floating rate debt issued by the Bank of England in the form of central bank reserves, essentially deposits that banks can put at the Bank of England. Through that transaction, the average maturity of debt is shortened quite considerably.

That is obviously helping to keep the debt market liquid and it is the way in which the Bank of England provides its own form of monetary support to the economy. The effective maturity of the debt issued by the public sector as a whole, both Treasury and Bank of England, is shortening as a result of that.

Q166 **Felicity Buchan:** Let me ask you about the time horizon for repaying some of this debt. What do you think the time horizon ought to be? It seems to me as though it is a bad time at the moment to raise taxes. We are clearly looking at low long-term growth rates, but I completely agree with you that, in the long term, public finances need to be sustainable.

What is the appropriate time horizon?

Richard Hughes: I should say that it is not for me to advise the Government on their fiscal policies or targets. Looking at the historical experience of debt reductions in advanced economies, debt reduction is a long-term game. It happens over the course of decades, not overnight, with some very rare exceptions.

After the financial crisis, countries that had acquired a large sum of financial sector assets sold those off and managed to reduce their debt to GDP ratio more or less overnight by selling off some assets and paying off debt. The Government of Iceland issued an exit tax on people wanting to take their capital out of Iceland and escape Iceland's capital controls. They used the proceeds of that tax to pay down debt very dramatically in the course of one year.

Those sorts of options are not typically available to a Government in the normal course of Government business. The way in which debt has to be brought down over the longer term requires getting the long-run rate of trend growth up, running a series of primary surpluses over a longer periods, or, in some cases, as we saw in the post-war years, generating inflation surprises to reduce the nominal value of your debt over time. All those effects are things that unfold over the course of decades, not things that happen over the course of a few years.

Q167 **Felicity Buchan:** If I am hearing you correctly, over the course of decades there are basically three ways to do it. It is fiscal surpluses, whether that is taxes or cutting back spending, growth and inflation. Let me move on to Charlie. We have talked about quantitative easing and you show in one of the charts in your report that quantitative easing—purchases of gilts—has actually exceeded the DMO issuance. Should we be concerned about that in terms of fiscal sustainability? If the Bank of England was not there, do we think that we would be able to refinance all this debt comfortably over time? To the extent that QE may be unwound over time, you could have a situation where you have two effective sellers of gilts, the DMO and the Bank of England. Should we be concerned about that?

Professor Sir Charles Bean: The key thing to stress here is that the ability of the Government to sell its debt rests on the confidence of the buyers of that debt that it will be repaid in full at an expected real value, so it will not be inflated away or anything like that. That, in turn, rests on both the commitment of the Government to meet their obligations and confidence in the institutional framework and everything. I regard that as the central thing that supports the Government being able to sell their debt. That is the key reason why the UK has not had to pay more to sell its debt and so forth.

As far as QE goes, my interpretation of the rationale for the QE this year is that it was less of a monetary policy action of the sort we took when I was on the MPC during the great recession after the financial crisis, where we were trying to stimulate aggregate demand because we could not cut Bank rates any more. The Bank's actions earlier on this year, particularly February/March time, and the commitment to buy more debt was much more in the nature of a financial stability operation. At the time, investors basically wanted cash. They were selling equities and bonds.

As it happens, what they have ended up buying through this year is of the same order as has been issued, but I would not want to view that in simplistic terms and say, "The Bank has been bailing out the Government by buying the debt". This is not monetary financing as I would think of it. In due course, I would expect the Bank to be running down its holdings of the gilts it has acquired. That may mean you have, as you say, two sellers, both the DMO and the Bank. That will mean that the Bank needs to be mindful and co-ordinate with the DMO about an appropriate rate of sales when the time comes. That in itself does not concern me. The key thing is that the UK preserves its reputation for honouring its debt when it falls due.

Q168 **Felicity Buchan:** Let me go back to Richard. We are clearly looking at an environment with negative gilt yields at the moment. Should that affect our thinking on fiscal sustainability? I know in your projections you have looked at a gradual reversion to historical interest rates. The Bank of England has been saying that it is projecting low nominal rates going forward of the order of 2% to 3%. Do you have a disagreement there with the Bank of England, or is this simply the basis of your projections?

Richard Hughes: It is an assumption that we use to try to keep our projections comparable from one FSR to the next. In the long run, the return on assets ought to reflect the return you can get from the economy as a whole. When you look back at the pattern of what is called R minus G, the difference between the real interest rate and the real rate of growth in the economy, there have been periods where it has been positive. There have been periods where it has been negative.

In the long run, we find a small gap of the order of 0.2% between R and G. Generally speaking, over the broad sweep of history, they follow each other. We are in exceptional times at the moment with very low interest rates for a number of reasons, partly reflecting flight to safety concerns and people wanting to hold on to safe assets and liquid assets. How long that will last is a big question. It is not something that you would want to base Government policy on in the longer term, if you look back at the broad sweep of history.

Chair: That ends this part of the session. It has been very interesting and helpful. Thank you to our three panellists for joining us today. These are difficult times for the country and very difficult times for forecasting in particular, whether you are a so-called forecaster, Charlie, or a real forecaster. We will look forward with great interest to your forecast in November. Please keep in touch and we will look forward to seeing you appear before us again. Thank you very much indeed.

Examination of witnesses

Witnesses: Stuart Adam, Alan McLintock and Charles Seaford.

Q169 **Chair:** I am now going to move across seamlessly to our VAT panellists and welcome them. I will start by asking if they could introduce themselves briefly to the Committee.

Alan McLintock: Good afternoon. My name is Alan McLintock and I am chair of the indirect taxes committee at the Chartered Institute of Taxation.

Charles Seaford: Hello, my name is Charles Seaford and I am a senior fellow at think tank Demos.

Stuart Adam: I am Stuart Adam. I am a senior research economist at the Institute for Fiscal Studies.

Q170 **Chair:** You have seen how we have operated. I should have said this at the start. If at any point you want to get in on a particular question and you are not being brought in to the discussion, raise your hand and I will endeavour to bring you in at that point.

I will start with a question to Alan focused on the recent Government announcement about the abolition or proposed abolition of VAT RES and the airside extra statutory concession around VAT. That has ignited quite a lot of concern, particularly among UK retailers, many of whom feel they rely on this incentive for overseas visitors to visit us and do their shopping in this country. Why do you think the Treasury took the decision to abolish these two benefits that are there at the moment?

Alan McLintock: There are probably about three main reasons. The first one is the increased cost to granting the VAT benefits to EU citizens after Brexit, because we cannot discriminate between one type of non-UK citizen and another. There is the increased cost of the reliefs for EU visitors. There is the scalability of the scheme and how unwieldy it might be with an increased volume. There may perhaps be a concern that it is a very expensive relief that may be targeted at a very small part of the business environment and the geographical environment. Is the benefit primarily received in central London? I am not saying that is right or not, but it may have been part of the thinking as well.

Q171 **Chair:** If you look across the rest of the world, what kind of schemes are out there? Is our abolition of these reliefs likely to make us, in a sense, uncompetitive because a lot of other countries are offering them?

Alan McLintock: I am more familiar with the European Union. EU member states can certainly have this relief. I imagine most have some variety of it. Therefore, I would think that it is not impossible and it is even likely that certain other countries around the world have something similar. I am not aware, for example, that the United States has anything of this ilk.

It may depend on whether people come into the UK or come to visit London for the VAT relief or for other reasons, Big Ben et cetera. If you take away a relief that is benefiting retailers by about several hundred million pounds, it has to have an impact on what tourists spend. Those that come primarily for the shopping may go elsewhere. If you are coming to see Big Ben, you are likely to still come as well. I am not sure how much behaviour will be driven by this, but there certainly has to be a behaviour change, because it is a quite significant reduction.

Q172 **Chair:** Let me switch to Stuart on this issue of impact. What view would you have as to whether the removal of these reliefs is likely to have the kind of impact that many, certainly if you read the press reports, seem to fear? What would your view be?

Stuart Adam: To be honest, it is not something I have looked in any detail. One thing to bear in mind is how far this might just reflect the prices that are charged. That is much more of an issue if we are talking about shops in airports, for example, where the question of how far any tax benefits get reflected by charging higher prices in the first place is more of an issue than if you are talking about shopping for souvenirs in central London, for example. There, you have to charge the same price excluding VAT wherever the person has come from. You need to be a bit careful with that.

Secondly, on the scale of things, this issue of cross-border shopping, what happens at airports and people shopping in different countries is important for the traders concerned but is not that big in the context of the overall system. I do not have figures to hand, but we should not overplay the importance of the issue.

Q173 **Chair:** Would that be your view too, Alan? I sensed from what you were saying that you feel that, in the wider context of the other things that are driving footfall into the UK, this would not be a huge element of what is going on.

Alan McLintock: It definitely has to have some impact. Those businesses that have been impacted have produced different studies. I cannot say whether those studies are estimations that may or may not play out. Yes, if you are coming for UK culture, the Tower of London and Big Ben, you will not get that in Milan. Will we see a drastic change in footfall? Luxury-end shops that have particularly benefited from the exemption may see a significant drop, but, at a UK level and possibly at a wider London level, I do not know. Time will tell, but it is subjective, I think. There is no hard and fast analysis.

Q174 **Chair:** The Treasury obviously consulted on this, but did not, I think, consult on what it has actually done, which is to abolish these reliefs altogether. Does that concern you, just in terms of how policy is pursued?

Alan McLintock: Absolutely, yes. The consultation documents indicated that it was minded to extend the reliefs to EU passengers. It did ask, among many other questions, what the impact of withdrawing it would be. The whole steer and flavour of the consultation was about it continuing on. If at that point, in HMRC's mind, it had viewed that ceasing it was the key objective, or a key likely outcome, it should have been flagged far more obviously than it was. It feels that the consultation did not really address that option.

Q175 **Chair:** In your experience, is that very rare, in other words that consultations on these kinds of matters would normally cover the option that is finally decided upon?

Alan McLintock: It should be an obvious best practice. You have a mixed bag. Consultations do not come out of the same consultation shop in HMRC, but from the experts underneath. You have consultations where HMRC is absolutely up front, very receptive, taking on board comments, making changes and you come away thinking, "This has been an absolute delight to be engaged in". You have consultations where you think, even if the outcome is flagged, they are not really listening to you. They are not really taking some of the points on board. Consultations are a mixed bag.

Chair: I am conscious that I have not brought Charles in at all. Charles, is there anything you wanted to add to this part of the discussion?

Charles Seaford: We did opinion research on tax reforms. We did not research this in our work. I guess if we had done everyone would have supported the change. The one thing that people really objected to is different rules for different people. That is what the public do not like. That does not mean it should be done or should not be done. I am just saying what the reaction of the public would probably have been.

Q176 **Chair:** I think, Alan, if I am right, under WTO rules or what have you, we would not be able to have different rules for different people, would we? It would have been applied to the EU 27.

Alan McLintock: It is discriminatory. If you were to try to discriminate against EU citizens, it would come back and bite us elsewhere. There are business VAT refunds that rely on reciprocity and different other things. If we did that, it would come back and bite us.

Q177 **Chair:** Just so that I am clear, in the absence of any agreement to the contrary with the EU 27 as part of our departure, am I right in saying that the Government, if they wanted to keep these reliefs, would have to, as a matter of international law, apply them equally to the EU 27 as well?

Alan McLintock: I am not familiar with the precise WTO rules. Whether there are such rules or not, if we chose to deal with it differently, I think it would come back and impact us in a way that we did not like elsewhere.

Q178 **Felicity Buchan:** I am concerned that this change will be negative for the economy and for Treasury. Global Blue has done a survey of 3,000 high-spending international visitors: 62% have said that they would not still visit and 95% have said that they would spend way less. If that is a representative survey, does that influence your decisions? I am conscious that non-EU visitors spent £18 billion in the UK, of which only £3 billion was duty free, so there was another £15 billion spent on hotels and restaurants. If you think of the 20% VAT on that, you are looking at £3 billion of potential loss to the Exchequer.

Alan McLintock: I am not sure I can really comment on what individuals or sections of those inbound tourists say they will do. There must be a negative impact for those businesses that use and rely on the relief today. That goes without saying. To what extent does a customer footprint arrive in the UK solely to take advantage of the relief? That is a different thing. I can absolutely understand that some of these visitors will spend less money because things have got 20% more expensive and if they are visiting other European countries at the same time. Again, I do not know of the economics. Do some of these luxury items have a single price across the whole of Europe, or are there already currency and other fluctuations in there?

There will definitely be an impact, but to what extent, given the popularity of the UK and London as a tourist location and the many other things that bring people in? Is this relief the only thing that brings people into the UK? If they are coming into the UK anyway but they will spend less, they will still need hotels et cetera. I cannot give you insight into what the outcome will be.

Q179 **Felicity Buchan:** It is interesting that, immediately we made our announcements, France reduced its thresholds for duty free spend from €170 to €100. I hear anecdotally that Italy is delighted, thinking that it is going to encourage an awful lot of these travellers to go to Milan. Do you think this is a good time to be doing this, given the fact that hotels and the high street are on their knees and that we are trying to project an image of global Britain?

Alan McLintock: I think you will find that, when it comes to narrowing or withdrawing a relief, there is never a good time. The same comments will largely be made whatever period it is. At this time, the retail sector is suffering a lot and this will pile on more pressure. The answer is yes. It is a bad time for anything to happen to British business, but that is a timing issue. That is different from if the relief should stay or go and what the long-term impact of withdrawing the relief will be on the UK.

Q180 **Felicity Buchan:** I guess my concern is that the Exchequer does not get this relief back, the £500 million, but it simply goes and sails to France and Italy. While retail in London is clearly affected, I do not think it is a London issue. There are lots of high-end retailers in Edinburgh, Leeds and Bristol. If you think about manufacturers of luxury goods, they are across the country. They are in Scotland, making cashmere, and goodness knows what everywhere else. I guess I am concerned about the impact throughout the UK and to the Exchequer in terms of the tax take.

Stuart Adam: I wanted to come in briefly. This is not my expertise and, without wishing to put him on the spot, hopefully Alan can correct me if I am wrong. A couple of times you have mentioned restaurants and hotels. I think I am right in saying that the retail export scheme only applies to goods, not services, so hotels, restaurants and things would not be affected anyway, unless people did not come to the UK at all.

Q181 **Felicity Buchan:** Let me interrupt there for the sake of clarity. I am not saying in any way that it is affected by the actual tax scheme. I am saying that these visitors are coming to the UK for the duty free shopping and spending £15 billion in our hotels and restaurants. I have been approached by not only airports and retailers that are concerned, but by hotels and restaurants that think this will have a major effect on their visitor numbers at a time when they are already running at 10% to 20% occupancy.

I have another question, on scalability of the scheme. I understand that industry has offered to digitise the scheme at no cost to Government. There is also the potential to put in a minimum threshold, as France has, although it has just lowered its own. Alan, do you think that would be workable?

Alan McLintock: Digitisation is the way to cut fraud. If you are concerned that there are a large number of EU citizens with the right to reside in the UK who should not be eligible for this scheme because they are habitually living in the UK, it feels like digitisation that tracks entitlement to a refund with the refund claim itself would absolutely be the way to cut fraud. It would not cut the cost of the scheme. It might cut the cost to HMRC of implementing the new scheme. I certainly would applaud and say digitisation is the way forward. If that does not need to be funded by the Government and there are acceptable controls over the ownership and direction of it, that feels positive.

Q182 **Felicity Buchan:** As a final question, Alan, you mentioned that you thought Treasury was motivated by concerns of the increasing cost of granting this to EU visitors. Is there an argument here that we should be encouraging EU visitors? It is not necessarily a bad thing to encourage them to come to spend time in our hotels, visit our attractions and spend money in our shops. Indeed, I have seen industry analysis that shows a net positive, even given the relief, in encouraging those additional EU visitors.

Alan McLintock: That is a cup half full, cup half empty. If the economics are that the relief drives far more expenditure, expanding the relief would seem to be a good thing. If you think the relief costs money, it is going to cost a lot more money. The answer there will depend on what side of that line you are already on. I am not sure I have the answer to that question.

Felicity Buchan: Thank you so much for that discussion.

Q183 **Julie Marson:** I would like to continue on VAT, but in a bit more of a general sense. I would be very interested in a range of views. It is not unheard of for VAT to be called upon to fill in black holes in times of crisis. I would be interested in your views about how appropriate and sensible that is in view of the coronavirus crisis and particularly in comparison to other ways of seeking to raise significant tax revenue.

Stuart Adam: First, I do not think we should be looking to raise taxes at all at the moment. The economy is much too weak. I will take it that you were talking about the longer term, when we are two, three or four years down the line and thinking about how we fill the fiscal hole we are going to have. You are right: VAT has been used in the past, often when there is a specific crisis or issue to deal with. It is a reasonable option. It has pros and cons relative to others.

Thinking initially at least just about increasing the rate, rather than broadening the base, which is perhaps where I would be more inclined to look, it is not as progressive as increasing income tax, national insurance or most other taxes. Contrary to popular perception, it is not regressive, but it is much less progressive. It has an effect on discouraging consumption and therefore work, but it probably has less effect on that than income tax and national insurance does, and therefore somewhat less effect on growth.

One disadvantage of using it is that, because we have a lot of zero and reduced rates and exemptions, you will be increasing the bias between those things that are subject to VAT and those that are not. On the other hand, it does not have some of the disadvantages that other taxes have. It does not discourage saving. It does not encourage people to convert income into capital gains, to set up a business to avoid tax and all those kinds of things.

It is probably less damaging to international competitiveness, because, despite the conversation we have just been having about cross-border shopping, consumption is much less mobile across countries than, for example, taxable profits, wealth or income. It is probably a little better in that respect. As you can tell, there are pros and cons. It is a reasonable option. There are judgments involved. There are other reasonable options. We may end up needing to do more than one thing.

Alan McLintock: The median VAT rate in at least the European Union is 21%, with about half the member states being at 20%, 21% and 22%. At 20%, we are slightly below the median rate, so we think there is room to move up a little without being outside the pack. Germany is at 19%, so there would be a bit of a difference there. Moving our rate up and down is probably less open to challenge than dealing with the exemptions.

The VAT exemptions and zero rating are very significant. Food is about £19 billion. Construction and sale of new dwellings is about £15 billion. Domestic passenger transport is about £5.5 billion. There are obviously large amounts of tax being relieved there so you could look at increasing the tax base and taxing these. As we have just seen with the retail export scheme, there are lots of people and businesses that would be negatively impacted and would be lobbying hard against such a move. Extending the tax base or increasing the tax rate is probably where your choices are.

For things like healthcare and particularly financial services, it feels far more difficult technically to apply a rate of VAT. It would get very complex. You would probably have to do very narrow things, such as applying VAT to motor or contents insurance, rather than taxing it as a generality. Technically, food and passenger transport are the easy ones because you just apply VAT rate.

Q184 **Julie Marson:** Would you agree with Stuart on the timescales Stuart intimated? I am not sure many people would say now, but in two or three years' time.

Alan McLintock: That is a policy decision. Doing it right now, when UK plc is struggling so much, would feel like quite a hard blow. I would probably leave to Stuart or Charles the correct time in which you should apply tax rates in situations like this, but today does not feel like the right time.

Charles Seaford: What I am going to say is based on opinion research we have done, which took the form of deliberative groups and an opinion poll. Raising VAT by a penny in the pound was the second most unpopular tax change that we polled out of 16. The most unpopular was a social care tax. It got a net positive rating of only 3%—that is to say the total of those who supported it minus the total of those who opposed it. It was still a net positive, but compared with changes to income tax it was much more unpopular. A proposal to raise income tax by 2p in the pound while raising the personal allowance by £1,000 to £13,500, which would mean that those earning less than £20,000 paid no more tax, got a net positive of 41%. There is far more appetite in the country for raising more money from income tax than from VAT.

If we turn to exemptions, the ones like food are the easy ones technically, but they are the most difficult in terms of politics and what people think. In the groups, we got very strong objections to increasing on what are perceived to be essentials and eliminating exemptions on essentials.

We got some support for extending the tax base to what people thought of as luxuries or those goods and services that are bought by people who are thought to be able to afford it. In the poll, we got strong support for levying VAT on private school fees—not nurseries but private schools. We got a net positive of 49%, which is one of the most popular proposals we put forward. That would raise about £2.5 billion. We got a net positive of 57% for applying VAT to gambling stakes. We got a net positive of 26% for applying VAT to private medical fees. All those were strong net positives, but there was a total opposition to extending it to food or those things that people thought of as essential.

We did not really get a strong message on financial services. As well as being technically difficult, people could not quite understand what this would mean, so we did not get a response on that.

Q185 **Julie Marson:** Could I turn to the actual rate and go back to Stuart? Alan mentioned that we are around the median. Would you say we have reached maximum VAT capacity in this country at 20%, or would you say we have some headroom?

Stuart Adam: There is a question as to whether we have reached the limit of what people will accept. That is more of a question for Charles than for me. Politics aside, I do not see any economic reason why we have reached a limit. The international competitiveness and international comparison is less of a concern with VAT than it would be for something like corporation tax. We are currently middle of the pack. All the Scandinavian countries impose rates of about 24% or 25%. We could do something similar. Whether we should is another matter. We could do it. It would raise revenue. I do not see why we are near an economic limit to what we could do in any sense.

Q186 **Anthony Browne:** I have some follow-up questions about reliefs and exemptions. First, I want to ask a question related to Brexit. The only tax competence the EU really had was over VAT harmonisation and different bands. Obviously we have left the EU. We will leave the transition agreement at some point and presumably get more powers over VAT as a result. What do you think the Government should do with those powers? If you suddenly had complete power over VAT for the first time in 40 years, what would you do with it?

Alan McLintock: I would pick up the Office of Tax Simplification's reports, read through them and then implement them in full. Many of the OTS recommendations are not reliant on us leaving the EU, so I am not sure the chartered institute has a bag of tricks that we would love to do once we have broken free from the European Union primary VAT directive. I am sure Treasury have a lot of wish lists from businesses that want to see increased recovery or lower VAT rates.

We are probably focusing more on simplifying the tax system and getting better, more reliable guidance from HM Revenue and Customs. If the indirect taxes committee got together, we would have numerous ideas. If you got any group of VAT people or businesspeople together, you would get a raft of ideas, but there may not be a lot of overlap between each VAT individual's wish list, so nothing at the moment but a focus on simplification would be very helpful.

Q187 **Anthony Browne:** Stuart, if you were the Government, is there anything you would want to do now over VAT that you could not do before?

Stuart Adam: The obvious thing that people would look at it is that it allows you to introduce more zero and reduced rates. I would very much hope they do not do that, rather than moving in the other direction. The potential scope for more lobbying on that now worries me a bit.

Given free rein, I would take on financial services, which is something that is currently constrained by EU rules, where we get more freedom when we leave. It is technically more difficult; 30 years or certainly 40 years ago, people would have said, "It is impossible". Since then, quite a lot of work has been done on how you could do it and do it in a fairly broad brush way. It would still need a lot of technical work, consultation and all the rest of it. It would be a big and difficult job. That is arguably the biggest problem with our VAT system at the moment. If I could take on a big project, that would probably be it.

There are a bunch of other things on the administrative and operational side of VAT to do with leaving the single market, what happens with customs checks, consequences for missing trader fraud and things like that. We probably should not try to get into the detail of that now.

Q188 **Anthony Browne:** Charles, is there anything you would do?

Charles Seaford: I can only echo what Alan and Stuart have said. Simplification would be my No. 1 priority. This is based upon what the public have said. They find the complexity of every aspect of the tax system, including VAT, very unattractive indeed. If you can simplify it, that would be very good indeed. On the financial services, that is clearly a big prize. You would raise quite a lot of money, although you would need to be careful. To the extent that financial services are essentials, like insurance and so forth, we need to be careful not to be too hard.

Q189 **Anthony Browne:** When we joined the EU, we introduced VAT as one of the conditions of doing it. It was a replacement for the purchase tax that we had beforehand. Is there any argument at all for returning to purchase tax, or is VAT far preferable, in terms of raising a lot of money but doing it in quite an economically efficient way, as you pointed out earlier, Stuart?

Stuart Adam: If you were starting from scratch, either would be potentially a reasonable option, thinking specifically about a retail sales tax, not a turnover tax. Either would in principle be reasonable. I would probably still lean towards VAT, but, given that we have a VAT system up and running, I would not go near the upheaval of scrapping one and introducing the other with a bargepole

Q190 **Anthony Browne:** The costs of transition would be too great. Alan, would you agree?

Alan McLintock: I would agree. If you look over the last 20 to 25 years, almost every country in the world has implemented a VAT system. None of them is implementing sales at purchase tax systems. The US is pretty much a standalone. I would not look at that as a model of good tax.

Q191 **Anthony Browne:** And Canada as well, I think.

Stuart Adam: No, Canada has one.

Q192 **Anthony Browne:** Does it? Okay. It also has an ordinary sales tax. I wanted to follow up on the questions on simplification that you raised, which you have all said you want to do. VAT is an incredibly complicated tax. As somebody who has struggled with it a lot in various business ventures, I have often seen it as a job creation scheme for accountants, with all due respect to accountants, and tax lawyers. There are a lot of VAT cases in courts. A lot of small businesses go bankrupt as a result of mishandling their VAT. How would you introduce simplification and what are the key simplifications that you would do? There are literally hundreds and hundreds of pages of VAT guidance and it is unbelievably complicated. How would you go about tackling this?

Alan McLintock: There is certainly an issue about the quality of the HMRC guidance that is there and how reliable it is. There have been cases recently where people have followed the published guidance, or the HMRC's internal guidance that is published, and they have lost in court. The starting point is that the taxpayer should have clear guidance as to what the tax outcome of a transaction is and what their responsibilities as taxpayers are. They should be able to understand that from clear guidance that HMRC will stand behind.

Part of the problem today is that is not really the case. As chair of the indirect taxes committee, there has been a constant stream, throughout my tenure and before, of members of the committee complaining about HMRC guidance and its effects. My starting point would be that it is complicated enough. Let us have guidance that taxpayers can understand and rely on.

Q193 **Anthony Browne:** Stuart, how would you simplify the system?

Stuart Adam: In terms of underlying policy, VAT in textbooks ought to be a very simple tax. In practice, it turns out to be phenomenally complicated. That partly comes back to the zero rates and the exemptions. In terms of zero rates, everyone is familiar with the question: "Are Jaffa Cakes a cake or a biscuit?" and it has a certain comedy value. Beyond that, the boundaries all over the place are a real problem.

There are things like partial exemption, where a firm provides both exempt financial services and other taxed things. I guess Tesco might fall into this category for example. They need to figure out which of their inputs are associated with taxed products and therefore recoverable, and which are associated with untaxed products and therefore cannot be recovered. That issue about partial exemption gives rise to phenomenal complexities. If we did not have all these features of the system, it would not have all these complications.

Q194 **Anthony Browne:** You mentioned the exemptions. Stuart, in your earlier answer you touched on some of the more politically sensitive exemptions like children's clothes and food. It is going to be a brave Government that decides to tax children's clothes and food. I do not see that happening in the foreseeable future. Are there are other exemptions that are less politically challenging that a Government could tackle without such political risk, apart from school fees, which you mentioned already, Charles?

Alan McLintock: Every single one is potentially politically sensitive. Books, newspapers and magazines are about £1.5 billion, but then you are taxing education or literacy. There is vehicle supply to disabled people. Water and sewage services are £2.5 billion. Drugs supplies and prescription are £3.2 billion and you are taxing people's health. Every one has a bad PR news story attached to it. If you are going to go through the pain of that, there should be a decent amount of tax coming in at the other end. It is looking at the amount of tax you will claw back.

Stuart Adam: They are all politically difficult and I am not putting any money on them happening anytime soon. I would emphasise that, if you want to try to do it, how you do it also matters. First, there is actually being able to put the argument and make a clear, strong case. Also, there is thinking seriously about using part of the money for compensation. If we take the example of children's clothes, we have been making an argument at the IFS for years that, while it is true that it is a necessity and it is a bigger share of budget for lower-income households, it is also true that, overall, richer households still spend more on children's clothes than poorer households do, because they buy more expensive clothes.

Therefore, you could put VAT on children's clothes and use part of the revenue from that, say, to increase child benefit, so you end up with, for argument's sake, the poorer half of households being better off rather than worse off. It becomes a progressive reform. You are still raising revenue. You are doing it from the better half of households. You are getting rid of some complexity and strange features like why we encourage parents to buy their children more expensive clothes and less expensive toys, for example.

While I would want to broaden the VAT base, I am not sure I would recommend just doing it in isolation. You need to think about what you do alongside it, looking out for the downsides and compensating households. It is worth giving that some careful thought. If you can make that argument and make it more explicit, it has more chance of getting political acceptability than just saying, "Fine, we are going to whack VAT on food, children's clothes and domestic fuel".

Q195 **Alison Thewliss:** I have some further questions on VAT. Could you envisage any particular problems arising with this new freedom that the UK has over VAT? Are there any particular consequences or repercussions if they were to take particular actions?

Alan McLintock: It is difficult to answer that without knowing what actions might be taken. At this time, there is slight uncertainty as to how things are going to settle down legally. There is lots of discussion about what reliance we can still place on European Court of Justice cases that interpret the VAT legislation and what level of UK jurisprudence can be overridden. There is a bit about the certainty principle as taxpayers should have certainty over what the outcome of a transaction is or what they can rely on compared to the past. There is a little uncertainty that will no doubt settle down over time.

Other than that, it is in the back of some of our minds whether the European directive has been a control over HMRC that has stopped and we are going leftfield. If that control is taken off, is it not only an opportunity but also a sort of threat that suddenly things will start happening that would never have flown within the European Union environment? There is a bit about that, but we need to see specifics to understand whether this is good news, okay news or bad news.

Stuart Adam: The obvious danger is the one I referred to earlier, where it opens up scope for every sector of the economy to lobby for preferential VAT treatment. So far, the Government have been able to say, "The EU ties our hands". If they cannot say that, lobbying pressure may grow. That is particularly in the context of a weak economy. Lots of sectors can make reasonable arguments for saying, "Look, we are struggling. We need support". Every sector can make a good case for why it is particularly deserving. I am not convinced that preferential VAT treatments are a good way to support particular industries. I worry that we will end up with a more complicated, more distortionary system than we have at the moment.

Q196 **Alison Thewliss:** Particular anomalies that I have been heavily involved in include the tampon tax, for example, where action was said not to be possible because of our involvement. Are there other anomalies or difficulties within VAT at the moment that could be quite easily fixed like that?

Alan McLintock: I am not sure I have a list of them. The fact that things like the tampon tax can get done post-Brexit is fantastic, but I am not sure there is a lot of tax in it either. It should be small points of friction, small amounts of tax. It should be done quickly and easily. I do not know if it is more around to what extent HMRC needs to repurpose into something that is more business friendly and these things can get fast tracked through, be identified quickly and be approved or rejected quickly. I do not have a list of similar things.

Q197 **Alison Thewliss:** In terms of what you said about the certainty principle, how does relate to how we do budgets here in the UK? For example, the Chancellor will stand up and announce some idea. Doing that with VAT and playing around with VAT in that way could cause quite big discrepancies quite quickly. Do measures need to be put in place to safeguard against that kind of activity?

Alan McLintock: I remember some years ago Italy increased its VAT rate and gave three days' warning. The more warning you give taxpayers, the more time they and businesses have to prepare the systems and understand how it impacts them. It also gives clever advisers and taxpayers opportunities to say, "How can we circumvent? If VAT is going up, how can we do things now at the lower rate and avoid that VAT rate or postpone the effect of it?"

It depends very much on what you are doing. Increasing a VAT rate should theoretically be simple for business. You just change the table that has the VAT rate in it. That is quite a simplistic approach and there are lots of bad systems out there. If you are doing something far more fundamental, it can be tremendously difficult, expensive, costly and suck up huge amounts of business management time in making a VAT change rather than working on your business.

Q198 **Alison Thewliss:** Is there more that HMRC could do in preparation to prevent any of that VAT evasion and avoidance after Brexit?

Alan McLintock: After Brexit, all the international trade is still impacted by EU rules to the extent you are buying from, selling to or moving things through the European Union, so businesses still have to take care of that. I do not want to be seen to throw bricks at HMRC, because a lot of them do a very good job in difficult circumstances. I wonder if HMRC could be more business friendly.

On some things, if you apply for a non-statutory clearance, you get told, "The issue is clear. It is in the guidance" and they will not give you a ruling. Sometimes there is a 50/50 call on these things and you have business A and business B. Which one is going to take the risk? A simple yes/no from HMRC is not a loss of revenue or a gain of revenue. It is just saying you are derisking a commercial transaction and we can proceed and both be happy, rather than fighting over tax clauses. I just wonder whether there is scope now for HMRC to maybe focus on being more business friendly.

Q199 **Alison Thewliss:** I would like to explore a wee bit the calls for differential rates of VAT in different nations of the UK. That is something that certainly Scotland and perhaps Northern Ireland have called for, because of the particular needs of our two nations, which would not be possible under EU rules. Is this something that the UK should consider and allow? Could some of that power go to the Scottish Parliament to decide?

Alan McLintock: That is a policy decision. Technically, you would not see a reason against it. It depends on what you would be doing. If you are changing the rate of VAT on hot food, for example, nobody is going to travel down from Aberdeen to London to buy a pasty, so it would be consumption-based, where the changes would be very geographically fixed. If you applied a 2% differential in the price of a new car, that would probably come to a few hundred pounds and you would see somebody either travelling up to Scotland or down from Scotland to buy a new car, because the amount would be worthwhile.

It would depend on whether it was influencing business and buying activity outside the nation that had change the VAT rate. At a border there is always going to be that degree of fluidity, but how much past that border would it make a difference?

Q200 **Alison Thewliss:** Would it be useful perhaps in areas like hospitality?

Alan McLintock: Tax will drive the political objectives. If a nation had the ability to set its own VAT rates and, for example, one nation decided that it would include the retail export scheme and another nation said it would not, you could see that might drive some behaviours into that location. It might have some impact.

Otherwise, I view it mostly as systems, not to add undue complexity. The food legislation is horrendously complex. If you introduced another horrendously complex food VAT system, it would be a negative step. If you are fluctuating rates and keeping the changes relatively simple, it feels that that is much more technically manageable by business.

Q201 **Alison Thewliss:** You would say that some areas of VAT would be much easier to manage than others.

Alan McLintock: I think so. If you introduced a 25% VAT rate and the rate in Wales, England and Northern Ireland was 20%, I could see that driving a lot of buying behaviour from people residing in Scotland to travel out of Scotland to buy their hi-fis, cars and expensive items, and then take them back into Scotland. Then you get into whether to do some form of use tax. That is where your issue is. To what extent do you find that people start travelling out of Scotland to take advantage of a lower rate? To what extend would a lower rate in Scotland be viewed as eating taxpayer income in other nations? That is your quid pro quo really.

Q202 **Alison Thewliss:** We discussed in a previous session the Scottish Parliament having an assignment of VAT from the rest of the UK. Would that be a more useful power if we had an opportunity to influence how it was raised?

Alan McLintock: That is a political question, not a technical question, so I will leave that one.

Stuart Adam: In terms of devolving VAT policy, I guess there are two questions. First, should we be devolving more tax policy powers? Secondly, if you wanted to, is VAT is a good choice? I do not have a view on the first of those. I am not going to say take a view on that. That really is a political question.

Is VAT a good choice? To some extent, we come back to the issues we were talking about in an international context. You do not really want to start creating tax competition between parts of the UK. That is less of an issue with VAT than it would be for corporation tax. I really worry about different rate of corporation tax in Northern Ireland, for example, which is supposed to happen at some point. I worry less about VAT, but I worry more about VAT there than about devolved powers over income tax and property taxes, which are already devolved to a large extent.

I completely agree with Alan that, if you were going to devolve something, devolving rate-setting powers makes more sense than devolving the setting of the tax base. Having different tax bases across countries would start to get mind-bendingly complicated. One downside of having it vary across the regions or nations of the UK at all would be that it adds complexity. You think about firms making sales to customers in different parts of the UK as well as what essentially becomes cross-border shopping. There are clearly downsides, but, if you want to devolve more tax-setting powers, it is better than some and worse than others.

Q203 **Alison Thewliss:** That is useful. Thank you.

Charles Seaford: We did not research that specific question, but we did research the question, if there has to be a tax increase, of whether people in Scotland would rather the money went to the Scottish Government or the UK Government. It was quite clear cut: 61% would rather it went to the Scottish Government and 24% to the UK Government.

Q204 **Alison Thewliss:** That is quite stark, yes. Was there any further follow-up to that at all, on how people expected it to be spent?

Charles Seaford: No, we did not ask about that. We split it out between different voters. Of course, SNP voters were a little keener on it going to the Scottish Government than other voters, but all categories of voter had strong support for it going to the Scottish Government, except for Conservative voters, who preferred it going to the UK Government. All other categories preferred it going to the Scottish Government.

Alison Thewliss: That is very interesting. Thank you very much.

Chair: That brings us to the end of our discussion. Could I thank each of our panellists for what I think has been a very interesting discussion around the issue of VAT? It was a very narrow session, just on one tax, but a very important tax, one of the big, heavy-lifting taxes and one of the taxes that Government have already reached out to, in terms of tax reductions, to try to stimulate different parts of the economy. We have had a very interesting debate about the tax freedoms that will come presumably when we finally exit the transition period.

As I do not think has been mentioned, within the Government's own manifesto, there is a commitment to not raising the rate of VAT. There is probably going to be quite a lot of debate, going forward, around VAT and probably quite a lot of disagreements as well as agreements, in the way we have discussed today. I think the one thing we can agree on is Alan's observation that nobody is going to travel from London to Aberdeen to buy a pasty. I think we would certainly all agree on that. It has been a really helpful session. Thank you very much for joining us.