

Treasury Committee

Oral evidence: Autumn Statement 2013, HC 826

Tuesday 17 December

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Members present: Mr Andrew Tyrie (Chair), Mark Garnier, Mr Pat McFadden, Mr George Mudie, Mr Brooks Newmark, Mr David Ruffley, John Thurso

Questions 237-352

Witnesses: **Paul Johnson**, Director, Institute for Fiscal Studies, and **Carl Emmerson**, Deputy Director, Institute for Fiscal Studies, Paul Smee, Director General, Council of Mortgage Lenders, **Stephen Glaister**, Director, RAC Foundation, and **Peter Atherton**, Equity Research, Liberum Capital, gave evidence.

Examination of Witnesses

Witnesses: **Paul Johnson**, Director, Institute for Fiscal Studies, and **Carl Emmerson**, Deputy Director, Institute for Fiscal Studies, gave evidence

Q237 Chair: Thank you very much for coming to see us, which is a pretty regular occurrence at this time of year. Can I begin by asking you about ring-fencing? It does strike many of us that there is now so much in a ring-fenced environment that any further spending retrenchment—and most agree that there will have to be some, although political parties vary in supporting the degree—will have to borne by a smaller and smaller denominator, a smaller and smaller unring-fenced area. Have you done some number-crunching on that and can you give us some indication of the scale of this problem?

Paul Johnson: We looked at this specifically after the spending review, so figures through to 2017-18 rather than 2018-19, which we heard about last week. The scale of the ring-fencing within departmental expenditure limits, health and schools, is getting on for half of the total. Our calculations then suggested that, if the reductions across DELs had been equally spread, that would have been just under 20% in all areas, but it is going to be a third in the normal ring-fenced areas and obviously zero in the ring-fenced bits. We have not done the sums yet, but with an additional year that third must be pushing up towards a 40% cut in the non-ring-fenced areas, as opposed to nothing in the ring-fenced areas. It is an enormous scale of cuts there.

That is within the DELs. Within the Social Security budget, if you continue to ring-fence pensions—

Chair: We will move on to that, but why don't you go into it here?

Paul Johnson: —you have pensioner benefits that appear to be largely ring-fenced there, north of £100 billion a year of ring-fencing. If you are to save, as the Chancellor was suggesting, a significant amount more from the welfare budget and you do not touch that, then, if you are looking at £10 billion out of the £80 billion or £90 billion on working-age

welfare, that is a 15% cut or something of that range, as opposed to what you might have if you did it across the whole budget. You would have obviously a smaller cut. By keeping pensions, health and schools, which are three of the very biggest chunks, entirely unaffected while taking a lot out of the rest, the effect of ring-fencing is to dramatically change the shape of what Government is doing.

Q238 Chair: You will already be able to make some assumptions about what parties are likely to say with respect to ring-fencing in the run-up to an election, won't you, because many of these statements have already been made, "We do not want to touch X, we do not want to touch Y"? You said you had not done the number-crunching yet but, making some basic assumptions about the ring-fenced items to which you have just alluded on DEL, would you be prepared to send the Committee a note with those as firmer numbers so that we can get a sense of the scale of the gearing that is going on here?

Paul Johnson: On the DELs, we can do that. As I said, we have done that through to 2017-18. If we make an additional year's assumptions going forward on schools and health, then we can certainly provide those numbers.

Q239 Chair: It might be helpful too if you could show us how the ring-fencing historically has increased, if you look at it on a very long-term perspective; look at public expenditure control over a 25-year period, for example. I wonder whether you might be able to help us with that. There does seem to be a secular, steady increase in the amount of ring-fenced items in British political discourse.

Paul Johnson: What we can show is the extent to which health particularly is taking a bigger and bigger chunk of the budget. I am not sure that prior to 2010 you can identify those bits that are specifically ring-fenced. It is pretty much everything that you ask.

Chair: But it is not only that, it is that there are more areas that are ring-fenced than used to be the case or where pledges have been made that are sufficiently firm that Governments cannot make savings in practice, even if they subsequently feel they need to, from those areas without breaching promises.

Carl Emmerson: Over the longer run, we have often seen Governments been more generous to, say, the NHS than to the rest of public spending. I do not think I would necessarily describe that as ring-fencing, but it is a budget decision that has been made.

Q240 Chair: Budget decisions are very different from ring-fencing. Ring-fencing is not taking a budget decision and then saying, "Next year we will take another budget decision with a rolling programme, and we may have to alter that". Ring-fencing is saying, "We are not going to touch this. This is ring-fenced for a period", often described as a Parliament, and it is the ring-fencing that I am asking the IFS to help give greater transparency to.

Paul Johnson: I struggle to understand that, going backwards. I do not think I could identify anything that was specifically ring-fenced as opposed to anything that was rising in the normal way prior to 2010, but it is pretty clear that from 2010 and with assumptions going back—

Chair: Look at pledges made at election time and you will get an idea of what the scale of the ring-fencing is.

Paul Johnson: We can talk about that later. I am not sure that I could see a way of distinguishing what is and is not ring-fenced, but we can clearly describe how the shape of the state has changed over that period.

Chair: I was going to pursue the social security point a bit further, but instead I might hand over to Pat McFadden, who might be looking at the same area.

Q241 Mr McFadden: Just on this theme about the future path, we discussed this with the Chancellor when he was here last week; I do not know if you had a chance to see the session. You have said in your post-match analysis that, if the Chancellor were to keep going on his current path, he either has to make deeper departmental cuts than has been the case up until now or take an extra £12 billion out of the welfare. Can I ask you what this might look like if you took £12 billion out of welfare? For example, given the welfare changes that have already happened, is it possible to do that while maintaining the protection for pensions and pensioner benefits that have existed up until now?

Paul Johnson: We said was that you need to make that £12 billion out of either annually managed expenditure generally or increased taxes but, if the Chancellor decides to go down the welfare route, £12 billion is of the order of 15% of the non-pension age bill. By not indexing for inflation those benefits over a period of years, you could get that kind of money if you get a couple of per cent a year over a Parliament. It is that sort of scale, I guess. It is saying, “We are going to stop indexing these benefits for five years”. That would be one way of doing it and that is clearly going to leave everyone on those benefits worse off.

Q242 Mr McFadden: Freezing them in cash terms, you mean?

Paul Johnson: Yes. That would be one way of making that kind of across-the-board cut, but clearly, on top of the cuts that have occurred, however you do it on the working-age side is going to be very painful and you will clearly—

Mr McFadden: If you freeze benefits in cash terms for five years, you would—

Paul Johnson: No, I am not suggesting this is a policy you should pursue. I am illustrating the scale of what this would be.

Mr McFadden: The effect of that would be to impoverish people on jobless benefits and a number of other benefits to a very serious degree.

Paul Johnson: It would make people a lot worse off.

Carl Emmerson: Another way to think about the scale is that the total impact on the public finances of the welfare cuts we have heard about already is £24 billion, so what does £12 billion feel like? Well, half as much again. That is a way to think about what you would be looking at?

Q243 Mr McFadden: In terms of the discussion you were having with the Chairman on the reshaping of what the state does, a lot of this discussion is a very political one about, “One party says this or the Government says this and challenges the Opposition to match it”, and so on. Obviously you cannot get drawn into any of that, but in terms of that political discussion, which must seem to people affected by these cuts at least a very strange way to talk about their livelihood, if I can put it no more strongly than that, do you think the reshaping of the state and the degree to which that is happening is being lost in this political battle that is being waged over spending? Do people understand what is going on?

Paul Johnson: I do not know the extent to which they understand it. One observes that the protection for health is politically popular and has been over a long period and that the demands on the health service are growing, so there is a remarkable degree of political bipartisanship around some of this. What is much harder to get a handle on is the extent to which people recognise the long-run effects in terms of reductions in things like infrastructure spending, but also in a lot of the areas of local government and justice and the environment and so on. I do not think we do have an adequate political discussion about the trade-offs. Trade-offs are a difficult thing to have a public discussion about, but the trade-offs in the long run clearly are very substantial. In a sense, it is not too late to have that discussion because, if you look at the Office for Budget Responsibility’s long-term forecast, the prospects are to continue down the same route that we have been going down as the demands on health and

pensions continue to rise as a result of demographic change and if the size of the state remains the same then everything else gets squeezed even further.

There are three bits to this story. This is something that has been happening for the last 30 years. It is something that has been accelerated somewhat over this period as we have had this specific ring-fencing and it is something that it is projected will continue. We are in the middle of a period. We are not towards the end of this happening, so there is time.

Q244 Mr McFadden: The size of the state is not remaining the same, is it? It is reducing at the same time as these dynamic effects are taking place?

Paul Johnson: It depends what you mean by the size of the state but in terms of Government spending in total as a proportion of national income, no, that is staying fairly constant. The proportion of Government spending going on public services is falling, in part because debt interest spending is rising but also because pensions and other elements are rising.

Q245 Mr McFadden: Can I ask about a couple of individual items? You talked about the student loan book in your post-match analysis as well and one or two of the other sort of spending things. The student loan book is being sold to pay for lifting the cap on student numbers. The Chancellor said in his Autumn Statement that he could pay for the lifting of the cap by selling the student loan book. Is that right?

Paul Johnson: In terms of the way the public finance numbers are put together, it is sort of right in practice. In principle, it makes very little sense. Obviously the reason you can sell the student loan book is because it is worth a certain amount of money each year into the future. So in the long-term public finance sense, it is probably at best a neutral transaction. There is no more money for the state there and obviously lifting the student loan cap increases spending year by year. Economically, it does not make a lot of sense as a way of describing how you are paying for it. In terms of the way that the public finance numbers are put together, it will look okay, but in reality it is not right.

Mr McFadden: But how long does it look okay for? The thing I have in my mind is if you sell something, you get a one-off receipt for it, but lifting the cap on student numbers is a cost year after year after year.

Paul Johnson: Exactly, yes.

Q246 Mr McFadden: How can this pay in perpetuity for the lifting—

Paul Johnson: In an economic sense, it does not.

Mr McFadden: It does not? We want to be clear about this. Are you saying it does not?

Paul Johnson: Yes.

Q247 Mr McFadden: Can I ask you one final thing? There is an argument going on about living standards and whether or not they have increased or reduced. You have said, “It is almost certainly significantly lower now”—that is the standard of living—“than it was in 2010 and will surely be below its 2010 level by the time we get to the election in 2015.” Can you tell us what is happening to people’s living standards?

Paul Johnson: There have been very significant falls in real earnings as a direct but delayed result of the 2008 recession, essentially. Real earnings have fallen 6% or 7% on average up until now. That is not going to recover in full. It would be astonishing if that recovers in full by 2015. In addition, of course, as a result of the repair job after the recession in terms of the public finances, taxes have risen and benefits have been cut.

It would be extraordinary if in 2015 living standards or average incomes were higher than they were in 2010, but in one sense it is not terribly surprising because we had this immense recession in 2008. That did not affect people’s living standards immediately because

there was a delayed response and also Government support, and so the effect that we are seeing on living standards is a delayed effect of what we saw in the 2008 recession combined with the extremely slow rate of economic growth that we have seen since then.

Q248 Mr McFadden: You mentioned a 6% or 7% fall. Can you quantify this for someone on average earnings? What is the real impact of that on them over a period of a year?

Paul Johnson: Whatever 7% of £25,000 is; it is about £1,500 gross, I guess, but that is just gross earnings. There have been tax changes and so on. The increase in the personal allowance will have helped. If they are a mortgagor, that has helped them a lot. If they are not, they will be worse off. Obviously it is very different for individuals, but the numbers we have—there are only good numbers up to 2011-12—is a reduction of 6% or 7% in average incomes, I think, since the recession.

Q249 Mr McFadden: Your expectation on this is that by the time of 2015, people will still be, therefore, in real terms, worse off than they were in 2010?

Paul Johnson: Yes, and also no better off probably than they were in 2001, because we had a period of very slow income growth even up to the period before the recession, so we will have something like 15 years of no real increase in living standards over that period.

Q250 Mr McFadden: No real increase in living standards for how long?

Paul Johnson: It looks to us like about 15 years. There is obviously uncertainty around this, and I am thinking about people in the middle. You have this very slow level of increase in living standards up to 2008 and then you have this fall after 2008, or at least after 2010.

Q251 Chair: The country is paying back its debts, is it not?

Paul Johnson: The country is paying back its debts. It is recovering very slowly from the deepest recession in 100 years. What does a recession mean? It means national income goes down. If national income goes down, household incomes go down. Until we are past the level of economic output we were in 2008 and growing strongly, we are not going to be seeing incomes growing.

Chair: But it is a consequence of having been the biggest boom and, therefore, the biggest bust; so it is amplified by the fact that it derives partly from mistakes of the financial sector and mistakes of financial regulation.

Paul Johnson: Clearly the whole mess that we are in reflects the state of the financially-driven crash, which has taken us a long time to get out of.

Q252 Mr Ruffley: Mr Johnson, your last answer to Pat McFadden, that must assume, must it not, that there are no reductions in personal income tax?

Paul Johnson: Obviously, if there were substantial reductions in personal income tax, that would make a difference to income. It would take a big cut to get us back.

Q253 Mr Ruffley: Your statement is assuming no policy change in income tax?

Paul Johnson: None beyond what has already been announced.

Q254 Mr Ruffley: Just so we are clear about that. I would like to ask questions about dynamic tax modelling, the paper that the Treasury put out on the dynamic effects of cutting mainstream corporation tax from 28% to 20%. Of the eye-catching forecasts that they make, one is that in the long run, which I think is 20 years they are defining it as, GDP would be up between 0.6% and 0.8% and investment would be up anywhere between 2.5% and 4.5% and there are other predictions that they make. Could you tell me, Dr Emmerson, whether you think the modelling assumptions are robust? Are they ones that you would say are reasonable?

Carl Emmerson: When you are trying to cost a tax change like this, first of all you clearly want to look at just the static costing, because we can perhaps be—

Mr Ruffley: Of course. I am talking about the dynamic effects, which I have just rehearsed.

Carl Emmerson: To do that, you need a careful estimate of the size of the tax base and that is your starting point. You then start to think about how behaviour might adjust and you clearly want to include that as much as you can, otherwise you would not do some tax cuts that might well be sensible. Then, of course, you are trying to build in assumptions and it gets harder. It gets much more difficult to know exactly how behaviour is going to adjust and, when you are trying to model forward these kinds of models over a longer period of time, you have to build in more and more assumptions and it is more and more difficult to know whether what you are doing is right. That does not mean it is an exercise you should not do. I think it is a worthwhile exercise.

The assumptions they have made certainly do not look unreasonable, but there is a lot of uncertainty there and it is a very difficult thing to do. I would not want to say, “Oh, that is definitely the right answer”. That is, for sure, not the place we are in, but it is a worthwhile exercise. Clearly you have to be very careful, because if you change those assumptions, you could get a different answer and the pay-off is over a very long time. It is not like you can do the change and then see a year later whether it has worked out. You have to wait 20 years before you get the full response if the model is correct. Clearly there are risks there and there are a lot of uncertainties. I think it is important to remember that.

Q255 Mr Ruffley: What is the use of it then?

Carl Emmerson: If you ignore those effects entirely and you just looked at the static effects, you might decide that certain tax cuts are not worthwhile because they would be too costly. You would be ignoring the fact that some tax cuts that we would like to have that can benefit people perhaps do not cost the Exchequer as much as we think. We do want to think about those models. I think you want to compare them to the static results and you want to think carefully about the assumptions you are making and I do not think the assumptions they are making are particularly unreasonable.

Q256 Mr Ruffley: Yes, but if you are a policy-maker, if you are sitting in the Treasury, you would not want to necessarily wait 20 years.

Carl Emmerson: It is a difficult judgment. If you just did this change, you are going to be borrowing more money for a long period of time before you get the full benefits from this dynamic change. Are you prepared to take that risk? That is a judgment you would have to make and it is a difficult one.

Q257 Mr Ruffley: How is a similar model used by the Congressional Budget Office? Are you aware of—

Carl Emmerson: I am not familiar with what modelling they do on this.

Mr Ruffley: Mr Johnson, are you?

Paul Johnson: I am afraid I do not know.

Q258 Mr Ruffley: Would you ever consider using it in your extremely eminent pieces of work post-Autumn Statements in the future, post the Budget? Dr Emmerson, I think the word you used was “useful”. Would the IFS ever consider putting numbers out that use dynamic tax modelling?

Carl Emmerson: We have done. We did a report a couple of months ago on universal credit where we looked at the static effects, the winners and losers, what it does to work incentives. We also used the models we have of labour supply and how they might adjust in a dynamic sense to the change incentives that universal credit will bring.

Mr Ruffley: You could do it for any Budget changes?

Carl Emmerson: We could. I would stress that the work we did on universal credit was using models that we had built at IFS over a number of years and to model universal credit took us several months to do. It is not something we would be able to turn around in a very quick period of time.

Mr Ruffley: No, sure.

Carl Emmerson: We have more than one of these models and in some cases they give contradictory results and it is very difficult to know what is driving that. These models are very difficult to understand. “Why is this model saying this group will respond more strongly and this group less strongly?” becomes very unclear.

Q259 Mr Ruffley: Mr Johnson, you have done it for universal credit. Why not for income tax at the IFS?

Paul Johnson: In the past we have done a number of pieces of work looking at the labour supply effects of income tax changes and at the moment, in fact, we are looking retrospectively at the impact of the 50 pence tax rate in terms of incomes for the Government. This is work that we do. As Carl says, it is absolutely not something we can begin to turn around in the day or two after a Budget or Autumn Statement, because these are complex things to do. Yes, they are important things. They are what matters for tax policy in terms of our work in the structure of the tax system, and we looked the *Mirrlees Review* and so on. It is that long-term behavioural stuff that matters and drives the financial tax system.

Q260 Mr Ruffley: No, sure, but the Chancellor himself described this, when I asked him last week in this forum, as a quiet revolution. In many people’s eyes, you at the IFS are the font of all wisdom and objectivity when it comes to the effects of changes in fiscal policy, whoever is in power. I am just asking you, if you do it for universal credit, don’t you think you should be working up models? I take what you and Mr Emmerson are saying, that you cannot do this in a weekend. I get that and I certainly understand you could not do it in the two or three days or even a couple of weeks after a Budget when tax changes are announced. I get all that, but why aren’t you, as the font of all wisdom in many people’s eyes, on tax changes getting ahead of the game here, listening to what the Chancellor is saying when he says it is a quiet revolution and saying to us here today that this is something you will start working up and taking seriously?

Paul Johnson: I think we have been doing that for 20 years and we have done an awful lot of work.

Mr Ruffley: It is hardly ever reported though, is it?

Paul Johnson: This stuff is harder to report, in some ways, than the more straightforward stuff, but as Carl—

Mr Ruffley: I do not get the sense that you have gone out of your way to talk about the dynamic effects of tax changes. You are quite keen to put out lurid stories about what the effect of welfare cuts and spending constraint might be. You get lots of coverage for that, don’t you, Mr Johnson? I am just asking you, will you undertake to this Committee to start, when there are tax changes in Budgets, to dynamically model those effects so that the public can be elucidated by your wisdom on this subject?

Paul Johnson: I am telling you that we have been doing this for the last 20 years. We have put out big reports on the future of the tax system, which has stressed the long-term dynamic nature of the changes.

Mr Ruffley: On Budget measures?

Paul Johnson: Of the way in which you can change the tax system and the effects of potential tax changes.

Mr Ruffley: No, on Budget measures, Mr Johnson. Do not elide the point. When did you last do a dynamic bit of modelling on a set of Budget changes?

Q261 Chair: I am just going to ask Mr Johnson to give his answer to the question. Have you looked at the specific Budget measures?

Paul Johnson: We have not modelled—

Mr Ruffley: No, you have not.

Paul Johnson: —specific Budget measures, partly because individual Budget measures will be a very big piece of work to do and complex to do, but I agree important to do and we do significant parts of this modelling?

Q262 Mr Ruffley: Will you do it?

Paul Johnson: Will we do what?

Mr Ruffley: The important piece of work; the complex piece of work that you just described.

Paul Johnson: As I said, we are doing significant amounts of this. I am not going to commit to—

Mr Ruffley: You are not?

Paul Johnson: I am not going to commit to modelling precisely whatever happens in the next Budget in terms of dynamic effects.

Mr Ruffley: Why not?

Paul Johnson: Because I do not know yet what it will be and whether we will be able to do it.

Chair: We might come back to this in due course, I think.

Mr Ruffley: Sorry, I have not quite finished on that question.

Chair: Okay. On that particular point, I think you get a feeling for where Mr Ruffley is coming from.

Mr Ruffley: On that particular point.

Chair: You have another question?

Q263 Mr Ruffley: Yes, I have. Child benefit: you are very keen to model the effects of universal credit, as Mr Emmerson said. Have you looked at the proposal floated by a member of the No. 10 policy unit to have a two-child policy, as it has been called in the popular press; to not pay child benefit and not pay child tax credits for those families who are in receipt of those benefits if they have more than two children? The reason I ask that is you are, again, the font of all wisdom on future spending constraints, aren't you, Mr Johnson, and you make all sorts of claims in projections, which we all enjoy reading, I know. Are you going to look at the cost of that and what difference that will make to the welfare Budget?

Chair: I am going to make this the last question, so answer in your own way.

Mr Ruffley: It is the last question.

Paul Johnson: We could pretty straightforwardly look at the impact of that, yes.

Q264 Mr Ruffley: Could you produce that for the Committee?

Paul Johnson: I think we could do that.

Mr Ruffley: Thank you.

Q265 Mr Newmark: Again sticking with taxation, I want to look at both ends of the spectrum. If we look at the top end of the spectrum, increasingly the tax take relies on a small percentage of people. Whereas I think two or three years ago about 28% of tax take was reliant on 1% of the taxpayers, it has now gone up to roughly 30%, I think. I look at France and there becomes a tipping point in which people do not simply circumvent the system by looking at tax avoidance measures; they simply leave the country and move shop. Given the leveraged effect of that, i.e. a fraction of that 1% that leaves can have a dynamic effect in

terms of the tax take—I am just curious—have you done any work on that or is that something worth looking at, given the risk to the Exchequer in terms of the impact of effectively squeezing that top 1%? I appreciate, to the public out there, they are right to think, “Yes, people are more well-off should be paying their fair share”, but a lot of these people are very mobile people and they can simply leave the country, as we have seen in France. Have you done any work on that? Is that worth looking into?

Paul Johnson: In order to look at that, you need to look at the effect of reforms and how that changes people’s behaviour and we are specifically looking at the 50 pence rate. I think you are right. Not in the tax system as a whole, but in the income tax system we are very, very dependent on a very small group of people. If you look within the top 1%, the top 0.1% is paying a very large portion of the total.

Mr Newmark: Exactly right.

Paul Johnson: I guess there are two sources of concern there. One is we are dependent on a small group of people. If they change their behaviour, then the Exchequer loses a great deal of money and, therefore, it is important not to take risks with that.

Q266 Mr Newmark: Again, I am trying to understand philosophically where you guys come from. I am a fan of Professor Laffer. There is an enormous amount of evidence out there that the lower you push taxes, the more the Exchequer collects taxes. Do you think it is worth at least the Government considering driving down the top end of taxation in order to obviate the risk of that 0.1% perhaps, or 0.5%, of people beginning to think about leaving the country?

Paul Johnson: I think the HMRC and the OBR broadly had it right, as far as we can tell, when they said that with the 50 pence rate we are kind of around the top of that Laffer curve and that is essentially their thinking behind taking it down to 45. My guess would be taking it from 45 to 40 would lose money rather than gain it, but probably not huge quantities. That is something one would need to keep under review.

Carl Emmerson: The work we have looking at how people responded to the 50 pence rate is going to look at not just how much they responded in total, but what the nature of that response is. If people respond by taking their income in a different form, perhaps putting a bit more money into a pension, that is not quite as bad for the public finances because the money into a pension will come out and be spent and there will be VAT paid, but if they leave the country—

Mr Newmark: But people at the top end are more than—

Carl Emmerson: If they leave the country then the response is very different, and you are not just losing income tax revenue. You are losing VAT revenue and a load of other tax revenue as well. We are thinking carefully about what exactly the nature of the response is of these people not just in terms of their income tax bill, but is their behaviour changing in some other way which might have a knock-on impact on the tax?

Mr Newmark: Yes, there is a multiplier effect on—

Carl Emmerson: This gets very complicated because it also says that, if you increase the top rate to from 40 to 50 and then you put it back from 50 to 40, you might not end up in the same place. You might have permanently lower revenue as a result because people might have changed their behaviour in some way, perhaps decided to employ a tax accountant or do something that will persevere. The response may not be symmetric.

Q267 Mr Newmark: Certainly at 45%, we still have one of the highest top tax rates in the world today, I think; certainly in the G20.

On the other end of the spectrum, when we look at the impact of the cap on welfare, it seems to be driving people off welfare into work. Is that what you are seeing there or not at

all, do you think? I am trying to understand when I look at the take-home pay of people and the fact that there seem to be a lot more people on lower pay, part of that group, my 30,000 feet analysis, looks like some of those people who have been driven off welfare because of the welfare cap are getting into the job market, which I view as a good thing because they are now not living on welfare, they are becoming part of the working population, but it is also driving down the perception and the reality that take-home pay for a lot of people is falling.

Carl Emmerson: The welfare cap affects a relatively small number of people. It is certainly true that those affected will have a much greater incentive to be in work as a result of the change, and I would not be surprised if some are choosing to work as a result. In terms of the evidence, I think it is far too early to say whether there has been an effect on that group. The effect cannot be big overall because so few people are affected by it. It is also going to be a very complicated thing to ever be able to answer. I know you would quite like a definitive answer. DWP started writing to people months in advance of this happening, which is a very sensible thing to do but it means their behaviour could have changed before the cap even came in. That makes it very hard to work out how much of this behaviour change is because of this policy versus some of these people would have got a job anyway. Disentangling that is going to be very hard and I know that—

Q268 Mr Newmark: But certainly part of the work you guys are going to be doing, I am assuming, at least for the next 18 months, will be monitoring the impact of this or not, or is that not part of your remit?

Paul Johnson: I think there is a broader point here that is important. It is clear, I think, from work that we have done that over the last few years changes to the welfare system more broadly has made a difference to labour supply. If you look at lone parents, for example, as to the rules about the age at which your children are before you have to start looking for work have changed, so more lone parents look for work and so more have moved into work. Relative to where we were a decade or two ago, I think the numbers of people that have been on incapacity benefits and so on who are moving into the labour market is looking much more positive. In general, I think you are right. Part of what is going on in the labour market is that the labour supply of people on benefits has held up much more robustly this time round than, for example, in the 1980s. There is enough evidence to suggest that some of that is to do with the way in which the welfare system has been reformed over that period, and we are looking at some of these things specifically.

Q269 Mr Newmark: You think there are some benefits, at least in part, in what Iain Duncan Smith is doing: looking at a glass half full, not half empty?

Paul Johnson: Also, to changes that have been made over a longer period. Yes, these things do seem to be having the effect that you would hope in terms of the dynamic response, in terms of labour market attachment.

Carl Emmerson: Another reform we have been looking at in great detail is the increase in the female state pension age, which is happening at the moment. You would not typically think of that as a benefit cut, but it is telling some women, “You will not get your state pension at 60. You will get it a bit later”. We are finding pretty strong evidence that is having a big impact on the number of women who are working and, in fact, some of their husbands are working as a result of this change, too.

Q270 Mr Newmark: But you would not disagree, given people are living much longer nowadays, that is a sensible strategy? I think there is a consensus among all parties that there needs to be something done with that and certainly the Government has done the right thing and I suspect the Labour Party will not change that. If I can touch on one specific tax

cut, which is the cut on NIC for under 21-year-olds earning £113 a week. Do you think this is a good method, a helpful method for reducing youth unemployment?

Paul Johnson: It will clearly help employers of young people. It will be a significant reduction in what they have to pay. We do not know the scale of the impact, but I am sure it will have some impact—

Mr Newmark: It certainly helps employers. Do you think given it will help employers, that will feed into reducing youth unemployment a little bit faster than would have been without this policy?

Paul Johnson: It will probably have some effect of that kind. It will have other effects. It will make—

Q271 Mr Newmark: My next question is the other rather negative side. Do you think then people will be smart about saying, “We are going to sack that 21-year-old or 22-year-old and hire somebody under 21”? Is that likely to happen or not, do you think?

Paul Johnson: I think it is extremely unlikely that people will be sacked on that basis, but it may well be that 20-year-olds get preferred to 22-year-olds in a way that they would not have done previously.

Q272 Mr Newmark: How much benefit do you think this policy is likely to be passed on to workers on higher pay at all, if any?

Paul Johnson: From that particular change?

Mr Newmark: Yes.

Paul Johnson: Hard to think of a modelling in which it would make a lot of difference to workers on higher pay.

Q273 Mr Newmark: You think basically the companies will keep the extra bit of money for themselves in terms of improving their profit margins?

Paul Johnson: Or it may increase the pay that they give to young people or it may just mean they are hiring more people.

Q274 Mr Newmark: Again, I am trying to think if there is a dynamic situation in which—

Paul Johnson: We usually think of the long-run effects on this paying of wages.

Mr Newmark: —you are paying a little bit less, because you are hiring a young person and, therefore, you are able to pay someone a little bit older a little bit more money?

Paul Johnson: I think more likely you will be hiring more young people and paying those young people more than you otherwise would have done. Again, I do not know, but I think most models would suggest that will be the effect.

Q275 Chair: You made an interesting remark earlier, where you said, “Don’t take risks with the top 0.1% of the income tax system”. Isn’t that what you have said?

Paul Johnson: Yes.

Q276 Chair: Do you know what the yield is?

Paul Johnson: I have that number back at the office. I cannot remember it at the moment.

Chair: I have seen it, but I cannot remember what it is.

Paul Johnson: It is substantial.

Q277 Chair: Has any work been done by you on the interrelationship between straight-line implementation of the intentions, at least, of the EU bonus cap against that yield?

Paul Johnson: No.

Q278 Chair: I would be grateful if you could produce that number. It is widely held that there are big dynamic and behavioural effects in there that will negate the intentions of that cap, which is why I phrased the question I did.

Paul Johnson: You may well be right. I am not sure that it is within our capacity to answer that question specifically.

Chair: I think it is an important and interesting policy request and it is an approach that the Banking Commission rejected in favour of something much more flexible.

Paul Johnson: I think there are certainly—

Chair: Not on those grounds; on behavioural grounds, on grounds of improving—

Paul Johnson: There is certainly plenty of evidence that when you try to control the way in which people are paid, this either just kind of means they are paid in other ways or it has negative effects.

Chair: I am asking you not for this difficult dynamic stuff here. I am asking you for the simple bit, but I agree that that is not—

Paul Johnson: I am not sure there is a simple bit, but—

Chair: I think there is a simpler bit.

Q279 John Thurso: First of all, I want to ask you about growth and the impact of growth on both sides of the public finances and what, if any, work you have looked at. There is a chart at the back of the Autumn Statement that shows all the various forecasts and, of course, as the growth forecasts were going down, so all the good news was going out. Now the reverse is happening, which is, as the growth forecasts were going up, they are going in the opposite direction. How much growth, more than that which is being forecasted, is needed to return to the equilibrium that existed pre-crash? In other words, if we get back to trend growth, what does that do if you are not changing anything else? How much slack is there in the numbers that can be reversed from growth alone without changes to either taxes or spending?

Carl Emmerson: The headline growth forecasts were revised up in the autumn statement. The OBR did not particularly change its view of the fundamental strength in the economy, so the underlying public finance numbers were not improved in the Autumn Statement. We think, if anything, they were very slightly worse, but basically unchanged from the Budget. The underlying picture facing the Chancellor was not any different. I guess the most significant thing is that he has chosen to put in another year of consolidation in 2018-19, not because he has a bigger problem to deal with but because he wants to aim for a lower level of borrowing. He wants to eliminate the deficit entirely, which is one thing that is reducing the risks to his plans.

What matters for the public finances is not some extra headline growth, it is whether you get structural sustainable growth. The ballpark figure there is that if you have an extra 1% of GDP, so that is about £15 billion extra in the economy, you would strengthen the public finances by about £10 billion.

John Thurso: That was what I was looking for. I asked a rather odd question, but you have given me the answer. 1% growth is £15 billion into the economy, and £10 billion comes into the public finances.

Carl Emmerson: £15 billion extra in the economy. About £10 billion of that would reduce the deficit.

Q280 John Thurso: If you were looking long term and you felt you could add that extra 1% over a period of time, that would give you some options in what was available, because presumably some of your expenditure, particularly on social security and so forth,

would be going down and your tax receipts would be going up and that would give you headroom to make some choices.

Carl Emmerson: If there was some way of boosting the size of the economy, that would certainly—

Paul Johnson: Of course, the reason that by 2018-19 it will still not feel great is because, on current projections, we will still have lost a very large part of the economy compared with what trend growth was before 2008.

Q281 John Thurso: What you underline in those answers is that, in looking at the economy going forward, rebuilding growth rather than a sustainable growth and the rebalancing of the economy remains an absolutely vital challenge to any Government. That is the critical point.

Paul Johnson: Without question.

Q282 John Thurso: Can I come on to specifics on tax as well? I remember I was struck by the analyses that you were doing in 2010, as I recall, on the impact of VAT, both in terms of the distributional analysis and so forth. I think quite properly, putting up VAT, which is an immediate money in—it is a very sound way of increasing the tax take—from 17.5 to 20 at the start of the rebalancing was probably a good idea. At some point it would also be a nice idea to reverse that because it would not only signal the end of that period but also, presumably—and this is my question—would have the reverse impact on the distributional analysis. I wondered if you had done any work at all on that.

Paul Johnson: There are several parts to that. How you look at the distributional effect of VAT, it is not obviously a regressive tax for two reasons. First, it is obviously not charged on food and other essentials. Secondly, if you look at how well-off people are according to the amount they spend, then VAT looks, if anything, a proportional tax and certainly over one's lifetime you would expect it looks more like a proportional tax. I do not think one should overdo the idea that VAT is in itself a regressive tax.

If you are going to look at changing VAT, in terms of thinking about the dynamic effects on the economy, it is entirely clear to us that a better way from that dynamic point of view of raising VAT will be to have something that involved some VAT at least on those essentials, food and fuel and so on. That would have a negative effect, which you could offset elsewhere, but having half of spending at 20% and half of spending at 0% is quite economically damaging. There are other things that one might want to look at. Politically, I understand entirely why that is not on the agenda.

John Thurso: I was wondering that if you thought we had that level of political courage, good luck to you.

Paul Johnson: But I do think it is worth putting on record that we have the narrowest VAT base, I think, in the OECD, certainly in the EU. We have a very narrow VAT base.

Q283 Chair: You have a number of suggestions for the politicians, do you, for this?

Paul Johnson: Not ones that they will find comfortable.

John Thurso: I think we start with pasties, don't we? Yes.

Carl Emmerson: The other question you were asking about, whether we could reverse part of this consolidation, if we have had a permanent hit to our economy, that is a permanent hit to the public finances. You need some permanent combination of tax rises and spending cuts to deal with that. We are not trying to deal with a debt problem that means we can just pay off a bit of the debt and then it is okay. What we are trying to deal with is a permanent deficit problem. We need some combination of permanent spending cuts, permanent tax rises. It is not about, "Oh, 10 years of this, then we just start reversing it all". It is there forever in expectation.

Q284 John Thurso: What I am looking at is, if you look at the taxes that raise money, there are three taxes that raise 65% of the money. That is income tax, national insurance and VAT. That is £350 billion-odd in the 2012-13 outturn out of £580 billion or something and the other 20 measures make up the rest. These are your three big ones, but we have been discussing the income tax side of it and national insurance and I was just looking at VAT as the other one of the big three. Obviously, if one was in a position to put VAT back from 20 to 17.5 there will be consequences, I assume, within the economy. It will have some impact on growth. It will have some impact on inflation. I am wondering if anybody has done any work on this or dynamic modelling on that particular case.

Paul Johnson: The consensus probably is in terms of what is the dynamic effect of different taxes. If you wanted to reduce taxes and the only thing that you were concerned about was the long-run dynamic effects, a headline rate of corporation tax is probably a good one to start and a headline rate of VAT probably is not because, if you look at the OECD evidence and so on, consumption taxes tend to be less damaging economically than taxes on corporate profits or indeed taxes on income. As I was saying, that is slightly muddled in the UK context by the fact we have this extremely narrow base for VAT, but I think if the only thing you are concerned about were these dynamic considerations then it would not be VAT that you would be cutting. It probably would be something like the headline rate of corporation tax or stamp duty of one kind or another.

Q285 John Thurso: The other area I wanted to ask you a question about was the comments that you have made in relation to public sector pay where I think you noted that the fall relative to private pay would be 8% between 2012-13 and 2018-19. Some of us were around long enough ago to remember the last time there was a difficulty in the public sector in recruiting. Do you think that is going to be a problem going forward; that we will reach a stage where recruitment into the public sector will become a problem again?

Paul Johnson: This is one of the things in the OBR report that we were surprised by, because there is a big change relative to what they thought back in March. What we were saying on the basis of their numbers back in March was, despite this apparently extremely tight set of settlements in the public sector, it looked like the public sector pay would essentially return to its pre-recession level in 2015-16. In a sense, there was space for more squeeze if you felt where it was in 2007 was roughly right. It appears that public pay has been more under control in the last year than was expected, and if that continues, then it will fall back relative to the private sector.

There is lots of uncertainty here, but if it is falling back relative to the private sector with what looks like a relatively robust labour market, probably localised and probably for particular areas, it may translate into some additional issues about recruitment. I am not aware that there is much evidence of that being an issue at the moment. It is very difficult to know at what point that might kick in, but I think, if you look back over decades, you do see these waves of public sector pay where it goes down relative to the private sector, problems are created and then it comes up again and so on. We may be in a different kind of labour market situation at the moment, but clearly this is something that Government will have to monitor pretty closely.

John Thurso: Thank you very much.

Chair: Thank you very much for giving evidence to us this morning. I am afraid we have left you with a few chores to do back at the ranch, but I do not think anything beyond your skills. It is possible we may have a few other questions, but we will come to you with those in writing. Thank you very much indeed. We will go straight on to the next session.

Examination of Witness

Witness: Paul Smee, Director General, Council of Mortgage Lenders, gave evidence

Q286 Chair: Thank you very much for coming to give evidence to us this morning, Mr Smee. Can I begin by asking you what might be considered a somewhat technical question about securitisation? Did you see Andy Haldane's speech on securitisation and his view that it was seen too much as the villain of the piece?

Paul Smee: I did see his comments and I have some sympathy with his views. If you look at the way in which UK securitisation behaved during the course of the market crash in 2008, the UK-based mortgage loans did not cause a problem. There is some evidence that the securitisation—

Chair: The problem came from?

Paul Smee: It essentially came from loans constructed in the States, but they obviously have affected the confidence that investors have in the securitisation market. I think there has been some evidence that institutions can now go to the securitisation market in the full knowledge that the quality of what they put within their securitisation will come under significant scrutiny and they are now raising funds by that means.

Q287 Chair: You are confident that the securitisations are safe this time around?

Paul Smee: I believe that they are, because I think the scrutiny that is being given to them by those who invest in them will ensure that they are and the institutions that are taking these securitisations to market are of the highest calibre as well.

Chair: We have heard that last bit before.

Paul Smee: I take your point.

Chair: Some of those went over the cliff, didn't they?

Paul Smee: Less in the UK than elsewhere. I do think that most of the securitisations that came out here delivered on what was intended on of them.

Q288 Chair: I would like to turn to Help to Buy. We have already had a preliminary exchange on this issue, that is this Committee with you, and I want to address the question: is this a supply or a demand problem and, in any case, are we going to get to the point in a three-year scheme where we can expect much supply to kick in? That is question one and I will ask question two at the same time. If we do not expect a great deal to kick in in that period, is it not reasonable to suppose that the lion's share of the effect of upwards of £12 billion going into the mortgage market is going to be reflected in higher house prices than otherwise be the case and, therefore, negate part of the intended benefits of the scheme?

Paul Smee: To take the supply point, this relates more to the equity loan side of Help to Buy in that that is specifically targeted at new build. I understand that in the first six months of the scheme in excess of 6,000 properties were purchased under it, and I think that is—I am sorry, 4,450.

Chair: It is not like you to make a mistake of fact, Mr Smee. You are always absolutely right

Paul Smee: I was right the first time. It is 5,300. I misread my briefing note. I apologise to the Committee: 5,300. Anyway, there have properties that have been built for sale under this scheme. My anecdotal conversations with builders suggest that the way in which this is moving is encouraging them to bring forward their plans for constructing new supply. Now, they do not put numbers on that and I think it would be fair to say it is unlikely, from the forecasts and the comments they have been making to the market that there will be a vast increase in their plans. Of course that is in the building sector of the economy, rather than the housing finance sector. I certainly think that in the mortgage market there will be no constraint of availability of funds to enable the equity loan scheme to be successful.

Q289 Chair: That supply is going to come on-stream sometime, whether it is relatively small or large. When is it going to come on-stream?

Paul Smee: It will be over a period of time.

Chair: We have not yet had that information.

Paul Smee: I think you would have to ask the builders if you wanted anything more accurate than over the next few years. They are bringing it forward.

Chair: You are close to this market. I am trying to get an impression whether we are talking about a year to 18 months or four years.

Paul Smee: I think you are talking over the lifetime of the three years of the scheme, you will see supply being brought forward.

Chair: The majority of it is going to be back-end loaded?

Paul Smee: I do not know whether it is a majority. There will be quite a bit that is back-end loaded because there is a pipeline and builders have to take that into account.

Q290 Chair: I am trying to draw some elementary conclusions about supply and demand in the housing market and I am trying to establish whether if supply increases, construction is stimulated and comes on-stream at the back-end of a scheme that is then being withdrawn, we might create, exactly as I have seen written by others, the circumstances where we have some sort of cliff edge.

Paul Smee: I think that is undoubtedly a risk and that is why I have been talking for some time about the need for a proper exit strategy that avoids this cliff edge, both under the mortgage guarantee and equity loan, which can give rise to unusual activity toward the end of the scheme and then no activity thereafter.

Q291 Chair: I asked the Chancellor whether he had been giving thought to a taper when he came to see us, and what is your preference for that taper?

Paul Smee: I think there are several ways in which a taper can be addressed. For example, you could increase the cost of accessing the scheme, which would make the source of funds under Help to Buy less attractive to lenders, so they might cease to put loans into the scheme.

Chair: In which case this would not be a fee. The word “fee” would no longer be at all reasonable, would it? It would then be a penalty.

Paul Smee: Yes, indeed. You would set the fee at a level to discourage usage.

Chair: At a penal level.

Paul Smee: Yes. The other way you could do it is gradually—

Chair: Ratchet down the numbers.

Paul Smee: —ratchet down the loan-to-value to that fewer loans were covered, or a combination of both, or you could decrease the maximum price of a house under the scheme.

Chair: Mr Newmark has some more questions about the housing market.

Q292 Mr Newmark: When I think back to ancient times when I first bought my house, there was no way I could get a loan-to-value more than 70% and pushing it was maybe 80% and I certainly could not get more than three and a half times my salary or take-home pay for buying a house—that was a very long time ago, I guess, at the way you are looking at me—but somewhere along the route we sort of lost the plot. High loan-to-value mortgages have, at least in part, been blamed for the severity of the financial crisis that we saw fairly recently. The Chancellor seems to still like them, even though part of the problem was these very high loan-to-value mortgages, and he has defended them, saying that they were not exotic weapons of financial mass destruction. Do you think blame was wrongly placed on these products after the crisis?

Paul Smee: To go back in history a bit, there has been a tradition of high loan-to-value mortgages being available, particularly for use by first-time buyers. I think this was a consequence of the financial liberalisation back in the 1980s.

Mr Newmark: When I was looking, John Charcol was perhaps one of the most aggressive, but there was no way I could get, let us say, an 85% loan-to-value, even from them. 1987 I am going back to.

Paul Smee: A bit later on the mortgages starting creeping up, quite often mitigated by a form of mortgage guarantee insurance, which in the early 1990s was part of the market. Loan-to-values then came back a bit. They became much rarer following 2008. 95% has never been a mainstream product. It disappeared from the market roughly around 2010 and I think the way in which this scheme is being constructed is to encourage it back, against the background of very changed regulatory requirements on the granting of these loans. The target audience for those getting these mortgages are those who very clearly can afford to service the loans and may even be in a position where they are paying more in rent than they would on the loan.

Q293 Mr Newmark: Yes, but isn't there a grand assumption there that interest rates are going to remain low for a very long time? What happens if interest rates start to become more normalised, at around the 4% to 5% mark certainly?

Paul Smee: One of the important new features of the regulatory regime is you have to stress-test people's repayments against an increase in the mortgage rate and, of course there was a recent announcement from the FPC that they would be asking for a regulatory requirement for the forecasting to include their own forecasts of where rates were going.

Q294 Mr Newmark: Do you think, given the way things have changed at least, the risk of repossessions and things like that are far lower, given the new regulatory environment, given the stress-testing of people's incomes and their ability to pay and so on, we are unlikely to see a repeat of what went on a little earlier?

Paul Smee: I think there is a much tighter control and much tighter evaluation of people's ability to pay loans. One would expect that to lead through into fewer people getting into stressed situations.

Q295 Mr Newmark: If I can go on to the buy-to-let, to what extent does the buy-to-let market influence the housing market in general and how has this changed since the financial crisis?

Paul Smee: The buy-to-let market is a small-ish percentage of overall lending, even in depressed market conditions, 10% to 15% typically. Its impact on the market as a whole can be exaggerated.

Mr Newmark: You do not think it is pushing out first-time buyers or anything?

Paul Smee: I do not think so. I think it is giving an alternative form of tenure and I think definitely, as perhaps some of those who are currently investigating the possibility of higher LTV mortgages, are those who are currently in rented accommodation. There may be a bit of competition there, which could be good for the market.

Q296 Mr Newmark: Do you think there is a risk of a higher default rate with these type of purchasers?

Paul Smee: We see no evidence of that at the moment, I have to say.

Mr Newmark: There is no evidence now, but obviously, as interest rates increase and so on, do you think there is a higher risk of the buy-to-let group defaulting?

Paul Smee: I see the point. Of course, a lot of the buy-to-let landlords are individuals with perhaps one or two properties who do not have institutional loans. There may be a risk. What I would say, though, is that the evaluation of a buy-to-let mortgage does look at the rental coverage and we do not think that the demand for rental accommodation will collapse as a consequence of any other initiative at the moment. It will be a choice of tenure that becomes available. I do not think we are anticipating anything dramatic happening.

Q297 Mr Newmark: Just going back to my initial question on average income multiples for first-time buyers, this does obviously seem to have been increasing. Do you think that income multiples will continue to rise in the medium term or do you think they will be fairly static now in this new cautious world we are in?

Paul Smee: I think what is happening under the regulatory requirements is that there is an analysis of the affordability of loans that takes into account not just the income side but the expenditure side of a person's circumstances, which does not necessarily translate to a fairly rigid loan to income multiple.

Q298 Mr Newmark: If I am hearing you clearly then, it sounds like while the Government is trying to loosen things up a bit, to try to get people back on to the housing ladder and everything, you are getting two things going on at once. You are getting the buyers themselves being a little bit more cautious than they were historically before they tried to put their first foot on the housing ladder and, at the same time on the other side of that equation, you have the lenders themselves who are being a little bit more sophisticated and thoughtful than they had been in the past before lending the money, even though the Government is doing everything possible to try to encourage them to do so.

Paul Smee: If I can start with the Government's objectives, I think the Government wants people to get on the housing ladder at an earlier point; when they can afford to service the payment, but not when they have saved up a significant capital sum towards their house. As I understand it, that is the purpose behind the mortgage guarantee scheme.

On the question of caution, we want people to take out mortgages that they can afford and I think there was an element in the middle years of the last decade where everybody believed that house prices were just going to go up forever and that was lenders and borrowers alike, and I think that caused the exuberance—there are other words you could use to describe it—that went on in the market that caused people to feel that they could borrow evermore and lenders to feel they could lend evermore with no consequence.

Mr Newmark: Commercial property people as well, for that matter.

Paul Smee: Indeed so, yes.

Q299 Mr Newmark: That is why the commercial property bust. Anyway, going on to the housing boom itself and house prices, some commentators in commerce believe that the Help to Buy mortgage guarantee could lead to a new housing boom. The Council for Mortgage Lenders' recent market review seemed more relaxed about such a prospect. Why is that?

Paul Smee: I think there is two elements to it. The first is affordability will kick in because of some of the living standard issues that were raised by Mr Johnson in his evidence; real incomes not increasing as much; people will be constrained by affordability in ever bidding higher for houses. Second, I do think this regulatory regime will have an impact.

Q300 Mr Newmark: Do you think the affordability issue is one reason why the uptake for Help to Buy has been a little slow?

Paul Smee: The mortgage guarantee element of Help to Buy has not started yet. We have warehousing going on with a couple of banks that have been active for a few months. We do not have a market in it and will not have until the beginning of January, when the scheme formally launches. I think on the equity side, the shared equity element of Help to Buy, there has been a reasonable start; certainly on target to meet the targets set for it at the time it was announced.

Q301 Mr Newmark: I am trying to understand the reticence perhaps of mortgage lenders at the moment who have not, to use a phrase, piled in to try to and run with this great opportunity that has been provided for them.

Paul Smee: Come 1 January, the four major banks and two challenger banks will be fully involved in the scheme. At the moment, I think what you have is, first, we have to devise the rules of the scheme and a lot of work had to go into setting up the framework. I am afraid you then have things like IT constraints at a time when the industry is adjusting its systems for MMR and I suspect that is why a lot of potential lenders felt that they did not have the controls in place to embark on the warehousing early phase of Help to Buy.

Q302 Mr Newmark: Do you think there is a disconnect though between supply? We have seen construction go up. House builders are very excited now and they are busy trying to build houses. The Government is providing this great opportunity for people to buy, get their foot on the ladder, but the supply at the moment has not quite caught up or may not have caught up with the demand, which could effectively turbo-charge house prices, at least in the short run.

Paul Smee: I am not sure about turbo-charge and I go back to my point that the controls on affordability are significant.

Mr Newmark: Turbo-charged let us say in the south. Obviously as you get further north it is still flat, yes.

Paul Smee: There are very different markets here.

Mr Newmark: Can I keep going, Chairman?

Chair: One more question. Perhaps other colleagues want to come in.

Q303 Mr Newmark: Regarding Help to Buy, the mortgage guarantee, the Council of Mortgage Lenders has said that it expects the scheme to appeal particularly to households who, but for a deposit constraint, would be able to get on to the housing ladder under their own steam. Do you think that the design of Help to Buy limits its appeal to other segments of the market?

Paul Smee: The evidence so far is that first-time buyers are those who have been expressing interest in these warehouse loans. If you look traditionally, historically, those who have been drawn to the 95% LTV band have been the first-time buyer. I would be surprised if, when the scheme is fully up and running next year, we did not see most of the loans going towards the first-time buyer end.

Q304 Mr Newmark: Do you see a public policy benefit of a scheme like this?

Paul Smee: I can see why the Government has chosen to use a tool of this nature to get people on to the housing ladder.

Chair: I will have another go at that. Do you think it is a good idea?

Paul Smee: I think that it has good features, but I would be very concerned—and I have said this from the outset—

Chair: It has very good points, as you say, yes.

Paul Smee: —if it went on beyond its three-year lifespan. I do think this should—

Q305 Chair: With the taper. You want a taper though, don't you?

Paul Smee: I would like it tapered.

Chair: So you want it to go on beyond three years with a taper?

Paul Smee: No, I would want it to finish after three years because I think you are—

Chair: You would like it to be tapered sooner?

Paul Smee: I would like there to be a decision on how it was tapered soon, yes.

Q306 Chair: Hang on, you want the scheme to finish in three years?

Mr Newmark: He wants the scheme to finish in three years and he wants the taper to begin sooner than later.

Paul Smee: The taper should be determined soon. I am not saying when the taper should start.

Chair: But before three years are up?

Paul Smee: Before three years, so that the scheme can close after three years, which I believe is the intention, because I do not think that this sort of intervention in the market would be justified beyond the three-year point.

Chair: Okay, we have some guidance there from the Council of Mortgage Lenders.

Q307 Mr Mudie: Mr Smee, when I was coming down on my late train, I had time to go through emails and I noticed the Post Office have brought out a two-year very low offer on mortgages, 1.88% or something for two years, but when you look at the detail, there is a hefty arrangement fee, which has troubled me for some time. If I go to buy a car, the man is so pleased to see me coming in to buy the car that he sells me it without an arrangement fee. When the Chairman buys his Old Masters, the same happens. When he buys his expensive antique furniture, the same happens. Why do you—

Chair: He is referring to Lord Thurso rather than Andrew Tyrie.

Mr Mudie: He has inherited them, yes. No, but it is a serious point for kids who are trying to meet that deposit, legal fees, surveyor's fees and you hit them with a four-figure sum, is it, for providing with a service that brings you money.

Paul Smee: I cannot comment on the individual offer. What I would say is that is a reflection of choice within the market. To get a really cheap interest rate, and 1.88% is a very good rate, there will be some form of complex financial structure behind it.

Mr Mudie: No, but forget that one for a second. That is only bait to get them in and then they increase the arrangement fee. You all have an arrangement fee. Why? I do not go into any shop where they say, "Oh, you want to buy this? Well, I will have to have an arrangement fee".

Paul Smee: There are certainly deals that are available in the market where there is no arrangement fee.

Q308 Mr Mudie: Which major building society offers one of those and to whom?

Paul Smee: I will not make a guess, I will send you a note giving you some names, but there is a choice within the market and there is a pay-off between a slightly higher interest rate and no arrangement fee.

Mr Mudie: Why do you do it then? Why don't you just put it on the rates?

Paul Smee: Because it suits different types of purchaser. There will be purchasers who have a lump sum, for whatever reason, where it makes a lot more sense to them to pay the lump sum up front and get a—

Mr Mudie: But why then is it variable? Why, when I walk in and the Chairman walks in, he puts his 50% deposit down and I am scratching around to afford my deposit, we get hit with the same arrangement fee?

Paul Smee: But you will probably be going for a different deal. If I was talking to a constituent of yours about this, I would say, “Go and talk to a broker”, who would work out for you which was the better deal.

Mr Mudie: Not many of my constituents would do that.

Paul Smee: Okay then.

Q309 Mr Mudie: When there were complaints about bank charges and the regulator looked at it, he, or they, compared the charge against the actual cost to the institution. Do you not fear that at some stage the regulator will wake up to this practice that loads the customer with a charge for you providing a piece of business that you make money out of?

Paul Smee: We are always alert to any concerns by the regulator and I take your point, if those charges are unreasonable. I think there is an element of swings and roundabouts in this. There are certain deals that are available, but they would not be quite at such an advantageous interest rate as 1.8%. If the consumer shopped around, he would be able to find a deal that possibly cost more in interest—

Mr Mudie: But you cannot tell me a mainstream lender—and you run the place—that does not charge an arrangement fee.

Paul Smee: I cannot.

Mr Mudie: It sounds as though you have to dig very deep to find somebody who does not. You are all putting this additional charge on at the beginning that is injurious to people who are struggling to get on the housing market, get this deposit more than ever, and you are still putting this fee on. Don’t you think it should be rethought?

Paul Smee: I would not wish to get to a point where there was no choice available. I do not think I would have to dig very deep. I just have to dig rather deeper than the notes I have in front of me to come up with some names, but I will provide you a note on this that I hope will draw out to you the point I am trying to make about the swings and roundabouts.

Q310 Chair: This mortgage broker market is very competitive, is it?

Paul Smee: Yes.

Q311 Chair: Can the customer, in practice, on current information, avoid a brokerage fee by using search engines?

Paul Smee: There are ways. Yes, indeed, they could if they had internet.

Chair: So the algorithms behind the search engines are sufficiently sophisticated to be able to work out the answer that you have just suggested can be posed, which is the balance between the interest rates and the brokerage fee?

Paul Smee: Yes, I think that is the case. Yes.

Chair: I am sure the Council of Mortgage Lenders can provide us with the evidence to support what you have just said.

Paul Smee: Indeed.

Chair: But I think that is an interesting illustration and check on the level of competition in the market.

Q312 Mr McFadden: I just want to ask you, Mr Smee, about what is happening out there in the market right now. The OBR, in their report published alongside the Autumn Statement, forecast that house prices will rise by 5.2% next year and 7.2% in 2015. Is that broadly in line with your own view?

Paul Smee: We do not do a separate calculation of this. I certainly would not argue with the OBR on that point.

Mr McFadden: I do not mean just about arguing with the OBR, but you know the market. You know where it is going.

Paul Smee: I have no counter-evidence of that, so I would think those are reasonable.

Q313 Mr McFadden: So far, rises have been concentrated particularly in London and the south-east and you said, in a slightly throwaway remark to Mr Newmark a few minutes ago, there were two markets in the UK or there were very different markets, the London market and the non-London market. Do you expect the trend by which prices grow much faster in London and the south-east compared with the rest of the country to continue for the next few years?

Paul Smee: I have to say I do. As we look around the country, I think there are very different phenomena within the housing market and different dynamics playing out. In some areas, it is a question of supply, the need to increase supply. In some particular places there may be an overhang of supply. I do know that, when I was talking to the Welsh Assembly and talked to them about risks of housing bubbles, they were very quick to tell me that they would like some activity in the housing market before I started talking about a bubble. It is very different views.

Q314 Mr McFadden: What we have then is a picture where property is already much more expensive in London and the south-east than elsewhere and you are also saying that prices will, on a percentage basis, probably rise faster in those areas too. So we will have a further pulling apart of the UK property market over the next three or four years. Is that what we should expect?

Paul Smee: I think that is a definite possibility, yes.

Q315 Mr McFadden: Within the nations and regions themselves, can you tell us a bit about what is happening there? Let us leave London and the south-east to one side. Are there particularly different things happening in, say, Scotland, the north of England or the west midlands, which I represent? What is going on there?

Paul Smee: I think what we are seeing is increased activity that started in London, moved out to the south-east and is continuing to move out. I have been told that the activity is lagging behind in the northern region. I think there are some issues, particularly because of overhang, in the Birmingham area but you can also see very vibrant property markets in areas such as Manchester or Leeds, for example. In the Welsh property market, I see that prices are moving ahead there. In all areas, I think it would be fair to say that there are issues to do with supply and we have long advocated that there should be an increase in house building. It is quite a complicated picture.

Mr McFadden: There will be significant variations within regions as well?

Paul Smee: There will, yes.

Q316 Mr McFadden: What about momentum of this? The OBR has given us figures, as I began my questions, for the next couple of years. They think it will not run out of steam, but the rate of increase will fall a bit after 2015 and go back to 3% or 4%. I think that is what is in that table. Do you also take that view or do you think there is lasting momentum in this?

Paul Smee: What we do is we forecast gross lending and we have said that, while there will be an increase in lending in the course of next year to just under £200 billion from this year's total of about £170 billion, we do not see as sharp an increase in 2015. We think it will just cross the £200 billion mark and I suspect that is for the same reasons as the OBR, because we see affordability constraints kicking in. It would be nice to think we saw supply kicking in at some point as well, but we do see affordability coming in plus some of the regulatory constraints to which I have referred and indeed timing constraints. I think one of

the features of the new regulatory regime is that it is going to take a lot longer for an individual to get a mortgage because of the amount of evidence that is now required to be assimilated.

Q317 Mr McFadden: When it rises, this gross lending figure feeds through into prices, of course, because there is just more money in the system for what is always, in the UK, a limited number of properties. Is that basically how it works?

Paul Smeë: An element of price increase will come from that, yes, but obviously we will also be lending for new supply as well. A lot of this is return to the market because we have had a period where people have not been moving on from homes and I think that is what will catch up over the next year in a more active market.

Q318 Mr McFadden: We had evidence from Scotiabank who said there is pent-up demand of three years and that its effect would diminish over time. Do you agree with that?

Paul Smeë: There is pent-up demand. I have not seen that particular forecast, but three years seems right.

Q319 Mr McFadden: I appreciate you have a job to do, you represent the Council of Mortgage Lenders. This is a very British recovery, is it not? Our trade balance is still in negative territory. We have had a big currency devaluation in the last five or six years, but we have not seen a significant growth in exports on the back of it. Here we are again that when we get a bit of economic growth, which is much delayed but much welcome, it is heavily dependent on property prices, borrowing against property and the consumer confidence that people get from increased property prices. We have been in this movie a lot of time before, haven't we?

Paul Smeë: I would like to think that this was different. You have spoken about pent-up demand. Clearly there is a very deep-set British desire to own their home and I think that desire has been suppressed over the last few years and I suspect we will see more people wanting to own their own home. Our research on this is absolutely consistent. People's tenure of choice is to own their own home. Whether we can do this in a way that does not bring in some of the problems associated with previous booms is the key question. That is why we have consistently said how important it is to get up supply.

I think there is certainly now a healthier feeling within the market, from borrowers as well as lenders, that house prices are not a one-way bet and we have a system of regulation that is built to make people pause before they over-borrow. Indeed, in many cases we prevent them from over-borrowing. I would hope that those factors will inhibit this becoming a boom and bust in the housing market. How that plays on other parts of the economy, I leave to others.

Mr McFadden: Time will tell. Thank you.

Q320 Mark Garnier: Can I turn to the issue of repossessions? Your figures suggest we have had the lowest number of repossessions since 2008, but I think you only started collecting figures in 2008. Is that right?

Paul Smeë: I am sorry. I missed that.

Mark Garnier: I think you only started collecting the figures in 2008 on repossessions. Is that right?

Paul Smeë: No, we have collected them from before then.

Mark Garnier: Okay. But, none the less, they were the lowest you have since 2008?

Paul Smeë: They certainly are, yes.

Mark Garnier: What do you think is behind that?

Paul Smee: First of all, I think the lenders' attitude has contributed. There is a very careful management process, which the industry has signed up to, to manage people who are in arrears. There is much more sophisticated approach to identifying people with problems at an early stage. Second and overwhelmingly, we have had a very long period of flat interest rates, which clearly assists in helping people avoid getting into trouble.

Q321 Mark Garnier: Forbearance, the first part of your answer. Is this healthy forbearance or do you think there is a problem brewing in the background? Let us not beat about the bush. These are the lowest interest rates we have seen in 300 years.

Paul Smee: Indeed.

Mark Garnier: If you are a lender, it is quite an attractive proposition to finance a zombie household or a troubled household, let us say, at 50 basis points rather than lock in what could potentially be quite an unpleasant loss. It is interesting because in your answer you did talk about early identification of troubled households, which is obviously also important. Nonetheless, do you think we have too much forbearance in the system? A lot of people are talking about this. Do you think we might have too much forbearance in the system, which means that when interest rates start rising, it is going to start revealing quite a lot of holes in households?

Paul Smee: First of all, the most recent study of how many loans were subject to forbearance suggested that there were between 5% and 8% of mortgages. That was done by the regulator.

Mark Garnier: By value?

Paul Smee: I think that was by number.

Mark Garnier: Okay. The number that I have been using is 8% by value on £1.2 billion worth of mortgages. There was about £100 billion worth of—that was a Bank of England number, I think.

Paul Smee: The estimate, which was again done by the regulator, was that about 5% of those households would have been in arrears for more than six months had they not been in forbearance. There are two thoughts on this. First, just because you go into forbearance does not mean you stick in forbearance and I think this has been a system by which people have been helped over a difficult point rather than a state of life into which they have existed.

The second question that you raised concerned indebtedness and what happens when interest rates rise and clearly this is something we are planning around and thinking through. The evidence that we took when we did a major research study a couple of years ago was that most people had strategies available to them for coping with small, phased step-ups in the interest rate, up to about four increases over a period of time. They had ways in which they would adjust their lifestyle so they continued to meet their mortgage obligations. We will be updating that research in some way over the coming months.

One comment I would make is that if these people had been regularly paying their mortgages on a repayment basis, as a lot of have, during the course of the years of low interest rates they will have been paying down their debt. So they will be in a better position when the interest rates do start picking up.

Q322 Mark Garnier: It is quite a dynamic picture this. You are absolutely right, there are a lot of people who have been paying this down. There are different ways you can skin this particular cat. The Bank of England also comes up with numbers that say if you see a two percentage point increase in the base rate we are going to see up to 28%, I think it is, of households having to make some significant changes to their standard of living in order to accommodate that. There is another set of numbers that say 42% of households currently cannot afford an unexpected £300 bill, which is also quite alarming.

The problem is there is a Venn diagram and, at the end of the day, what you are ultimately trying to find is where those households are getting hit by the most of them and what the value of the outstanding debt is. So what are the implications on the banking market but also what are the social implications? As legislators, what we have to look at most carefully is, by looking at this Venn diagram, how many households we think are going to be in serious trouble when the interest rates inevitably go up and when the tide comes in we see which households are holed below the waterline. Does anybody have any idea?

Paul Smee: I will pause for a second and say if you are talking about a 2% increase, you will probably then be in an economic situation where people's incomes are increasing and so their ability to cope will also be increasing. We do not have—

Mark Garnier: Assuming that distribution is even.

Paul Smee: Indeed, I accept that. I would have thought by the time you had a 2% increase, you would believe that that was fairly wide based.

Q323 Mark Garnier: The only reason I am very cautious about this—I am sorry to keep interrupting you—is that we talk about a 2% increase in interest rates as something pretty heinous and major. Actually it is not. It is just going back to a normal low level of interest rate. It is just going back to something vaguely normal. We have a super-loose monetary policy. We are just going back to a very loose monetary policy with a 2% increase in interest rates. The problem is, when you are right down at this level, a 2% increase in interest rates is a fivefold increase in funding costs. This is quite important when you are looking at the cost of forbearance for banks and then the knock-on effect on to households.

Chair: It is particular relevant with high loan-to-value ratios, which we are encouraging at the moment.

Mark Garnier: Yes, and an over-inflated value of property.

Chair: We will allow you to say something now.

Paul Smee: I am not sure whether I should just say, “Well, I agree”. You make very valid points. The issue for us is the way in which we, first of all, identify and, second, help manage those who are liable to get into this sort of difficulty. Since the last time there was a high level of arrears, I believe the sophistication and consideration with which lenders handle those in difficult situations has improved significantly, which I think is positive.

Q324 Mark Garnier: You do not think that that is as a result of the fact that they can be more generous because the funding costs are so low?

Paul Smee: I think there are other inhibitions from external authorities on them as well, but I think it is also a cultural change that has gone on within the lending community.

Q325 Mark Garnier: Just one last point on the mortgage rescue scheme, which is something that was to help people out. That is now due to end in March 2014. When that goes, what do you think the effect on that is going to be? There are a lot of things happening at the same time and this is disappearing. My twofold question is, do you think we are going to see an increase in defaults and the second point is do you think that might see a change in culture back to being a bit more hard-nosed on the part of the mortgage lenders?

Paul Smee: Relatively few people have accessed the mortgage rescue scheme, which is one of the reasons why it has been removed. I think it was a very useful catalyst for driving a change in culture, but I think the change in approach is now so embedded that I would not regard the removal of the scheme as indicative that the culture would necessarily change.

Q326 Mark Garnier: A final question with probably a yes or no answer. Do you think that when interest rates start going up we will see an increase in the number of defaults?

Paul Smee: Yes, mathematically that is probably the case. I do not over-exaggerate the rate at which the increase will happen or the speed with which it will happen either. There may be an uptick from the very low levels. As you say, we are at very low levels now. There may be an uptick, but do not think in terms of tens of thousands back to the 1990s.

Mark Garnier: You do not give me any sense that you are particularly worried about a floodgate of defaults coming through.

Paul Smee: I do not believe there is a floodgate that will open. I believe that it is better managed than that.

Mark Garnier: It could pick up but it will still be quite low?

Paul Smee: It may pick up, but it will still be relatively low because of the changes that have happened in the intervening years.

Chair: Thank you very much indeed for the evidence you have given us today. There is the odd thing that you might be sending us. We would like to move straight on, if we may, to the next session, which is on energy and infrastructure.

Examination of Witnesses

Witnesses: **Stephen Glaister**, Director, RAC Foundation, and **Peter Atherton**, Equity Research, Liberum Capital, gave evidence.

Q327 Chair: Thank you very much for coming to give evidence to us, both of you. Is it your first time before a select committee, Mr Atherton?

Peter Atherton: Yes.

Chair: You are no relation to the former opening batsman, I take it?

Peter Atherton: None, unfortunately.

Chair: Can I begin with you, Mr Glaister, and ask you if you think the focus on HS2 is blinding the Department's view on investments needed in other types of transport, for example roads?

Stephen Glaister: I don't think it is blinding the Department. I think it might be taking more attention than perhaps the economic evaluations would suggest is justified. We in the RAC Foundation would absolutely acknowledge there has been an important change in policy in the Department on roads over the last year, which was set out in the White Paper in the summer, that has at least two separate components. One is a recognition that roads are a lot more important than had been the view within the Department and, therefore, a reform of the way strategic roads are to be delivered; and, secondly, a substantial increase in the amount of money that would be made available for roads after 2015, which was announced in the spending review in the summer.

To that extent roads have not been completely ignored. What I do think, however, is that we have not had a decent discussion either inside the Department or more generally about the relative merits using the established scientific methods of appraisal of putting a very large amount of capital into HS2 as against conventional rail or national and local roads. It is HS2 being put on one side, assumed to be there and spoken for, and it has not entered the debate about whether you could spend that money more effectively and indeed spend it more effectively in some other area of public policy.

Q328 Chair: You are alleging that HS2 is being treated on the capital side in much the same way as aspects of health and education spending are being treated on the current side. That is they are ring-fenced and you are saying HS2 is being ring-fenced and is not subject to the same analytical rigour to which other projects are subject. Is that what you are suggesting?

Stephen Glaister: I think there is a sense in which HS2 has been ring-fenced, but it has been subject to rigorous analysis. I think the economic analysis appraisal that was done for HS2 is perfectly fine. It was done according to principles that the Treasury would recognise. It is just that when you do that sum it does not produce a particularly good rate of return compared with other ways of spending the money. That has been ignored in the way that the Government has processed it.

Chair: I am going to move straight on to questions from John Thurso on energy and I might come back later with some further questions.

Q329 John Thurso: Mr Atherton, could I come to you first? I seem to remember in around 2006 when DTI was in one of its iterations—I think it was called DBRR or something at the time, but I can't quite remember which name it had—there was a variety of reports that came out on energy, all of which made prediction about the supply needs and the consumption. That was in a series of reports and we are more or less in exactly the place that was predicted in that we still need roughly the same consumption and we still need roughly the same generation, but eight years or whatever it is have gone by since then. Do you think that the Government has a coherent energy policy?

Peter Atherton: It certainly has an energy policy and it has been very consistent. If you look at the UK and you look at energy policies—people accuse the Government of vacillating and policy changes—the policy has been very consistent. We agreed in 2003, as the EU, to go down the path of decarbonising our economies and the vanguard of that decarbonisation effort would be the power sector, because it was agreed way back in those days that the power sector would be the industry that could go first. That would be the cheapest option. Then other industries like transport and heating would follow on and a lot of that load would be moved on to a decarbonised power sector. What has chopped and changed a bit is how you deliver that.

Originally we had some market interventions like the European carbon trading scheme. When the Coalition came in they decided that those interventions that Labour had put into place were not sufficient to deliver the targets. They had a review and out of that has followed electricity market reform and now the current Energy Bill. What you have seen is the number of interventions and the scale of those interventions have increased over time, but the policy goal that was agreed in 2003 at the European level and put into UK law in 2008 in the Climate Change Act has not changed at all. In fact it is the only policy I can think of that has not changed for 10 years.

Q330 John Thurso: Let me rephrase the question then. We have an entirely consistent goal, which all parties have stuck to since the early 2000s. Does anybody have an implementation strategy?

Peter Atherton: Yes, and you have all just voted for it. It is called the Energy Bill. That is the tactic of the delivery. It is a set of new market interventions that the Government hope will unleash £100 billion-plus investment, particularly in renewables, over the next six or seven years. They have signed the agreement with EDF on Hinkley to deliver the nuclear components of that. Though there is a strategy, I think the big question is whether that strategy is plausible, desirable and deliverable.

John Thurso: Let me ask you: is it plausible, desirable and deliverable?

Peter Atherton: I have written several reports in recent years arguing that it is implausible and is extremely unlikely to be delivered. That was before recent political interventions that have made it considerable less plausible.

John Thurso: If I get you right, we have an entirely consistent policy that has remained unchanged for over a decade and it is not plausible or deliverable?

Peter Atherton: In my view, correct.

Q331 John Thurso: In your view, what is the key problem to delivering that strategy?

Peter Atherton: Starting in the early 2000s and then the mid-2000s and when Parliament voted for the Climate Change Act, I think you grossly underestimated the economic, financial and engineering challenges of decarbonising a sector like power as quickly as you are proposing to decarbonise it. Basically, within a period of 15 to 20 years you are attempting to take a sector that is a cornerstone of the economy—it is not just any sector, it is a sector upon which the rest of the economy hangs—and take it from one that is overwhelmingly fossil fuel with a bit of nuclear and a little bit of renewables to one that is overwhelmingly renewables and nuclear. That would have been gigantically challenging even if renewable technologies were cheap and easy to deploy, which they clearly are not, and even if the engineering was mature, which it clearly is not, and even if the public was willing to pay any price, which it would appear that they are not.

The inherent complexity and contradictions within the strategy to deliver the goal are coming out, I am afraid. We are seeing that now in the public debate around affordability. I am afraid the affordability crisis that we are seeing in energy policy at the moment in the UK was entirely predictable, and predicted by myself and others five years ago, and it is a thing that has played out in many European countries over the last four or five years.

Q332 John Thurso: I am going to stay away from renewables because something like 98% of renewables that are available at the moment need requirement for back-up capacity and the renewables that are more consistent are not yet developed sufficiently to be a player in the next few years, but let me ask you about one area of power and that is, of course, then to go back to the lowest carbon footprint of all power sources, which is nuclear. In 2006 that was 20% of our generating capacity and, according to the latest from the Treasury—we assume they have the numbers right—is 7% of our generating capacity. It takes a number of years to build a nuclear power station. Well, the Chinese are rolling them out at one every five years. Are you saying that we should have gripped this and got on with it more quickly? Is looking at that your backstop energy? You are critical, but where exactly do you see solutions?

Peter Atherton: On nuclear, I think there is this misnomer that we should have been cracking on with lots of things earlier. We have a perfectly good power fleet today. It is getting on a bit. It is a little bit old, although we have one of the younger power fleets in Europe, as it happens, because we had the large dash for gas in the 1990s and in the early 2000s we also built quite a few gas-fired power stations. So we have a relatively young fleet by international standards, but it is now reaching that bit in the cycle where a lot of replacement will be required, regardless of whether you had environmental goals.

In my opinion, not as an equity analyst but as an observer on energy markets, it seems to me very sensible to at least replace the existing nuclear fleet with new nuclear because it is good quality base load, highly reliable, and not vulnerable to movements in world energy prices. However, there has to be at a price at which you are willing to do it and certainly I am very critical of the Hinkley deal. I think it is the most extraordinarily expensive deal that I have ever seen as a market analyst at £8 billion per reactor and a nine-year built programme. It is going to generate power at the equivalent of a gas price of about \$25 per million Btu, which is compared with the gas price today of \$11 per million Btu. I wrote a note saying I thought it was a fantastic deal for EDF and their partners and a shocking deal for the UK and the consumer.

Q333 John Thurso: How much are these changes in the execution of policy, rather than the policy itself, and the evaluations thereof driven by short-term year-in-year decisions by the Treasury rather than a long-term analysis of what is the best investment as might be done in other enterprises?

Peter Atherton: I would say minimal in the latter. We have recently seen the political debate around affordability, in particular “catch fire”, and that is leading to short-term manoeuvrings. The reason we have this forthcoming generation crunch, as it is known, over the next two to three winters is very simple. The policy has two strands. One is a closure programme of the types of technology the Government has decided they do not like—coal and oil to begin with and then, later on, gas—and a new build programme to replace that. Simply put, the closure programme is running to time, the plants are closing, and the new build programme is running at least three years late.

The question is, why is the new build programme running at least three years late? Well, it is nothing to do with short-term noise coming out of the Treasury. It has to do with the technologies we are having to deploy, which are proving to be much more expensive than people anticipated five, six, seven or eight years ago and much more difficult to deploy in terms of the engineering skills associated with that. Therefore, the interventions in the market the Government needs to deploy to get those technologies built have to be bigger interventions.

When the Government came in and launched the review of the electricity system basically they said, “Okay, we have a series of interventions that are produced to encourage these technologies to be built”, but they are just not big enough. We need to take more control as the state because the fundamental uneconomic-ness—that is not the right word, I know, but you see what I mean—of these technologies is so great that the existing interventions like the renewable obligation scheme and the European carbon trading scheme, are not big enough to bridge the gap to make it worthwhile for investors to do the investment.

Q334 John Thurso: Would you accept that it is perfectly legitimate for any Government to take the view that simply the lowest cost option today may not be the best policy outcome over the longer term and, therefore, it is quite right for a Government to look at both carbon and security of supply in the matrix that allows them to come to a decision? Do you think it is ever possible, given those further issues, that the market and competition can deliver long-term policy outcomes or is it the case that the market has to be shaped such that the long-term policy of security or low carbon or whatever are built into the market? In other words, can the market operate to deliver the long-term without being shaped by Government or is it absolutely necessary that Government must shape the market in order to deliver the outcomes?

Peter Atherton: Personally, I think it is perfectly legitimate for the Government to take a view on what type of energy infrastructure is appropriate for the country going forward, but it is then beholden on the policy-makers to be honest with the public about the cost implications of that and the competitive implications of that for the economy. You guys have to weigh the issues but, in concluding to go down one particular route, I think it is then beholden on policy-makers to be honest and up front.

The traditional objectives of the power sector in the UK has been to deliver safe, reliable and affordable power. When it was state-owned from the second world war onwards, it was pretty successful at doing that and in the 20 years since privatisation it has been pretty successful at doing that. I think state and private have been able to deliver the three traditional goals. What happened in 2003 was we put a fourth goal on it, which is decarbonisation, and we made that the overwhelming priority of European energy policy.

We weighted policy overwhelmingly towards climate change and the market cannot deliver that because it is not priced. The original attempt was to price it with the European carbon trading scheme and it was then decided that that was going to be insufficient, not least because we signed up to the renewables directive. Instead of just having a broad objective on decarbonisation, in 2006 we decided to sign up to a particular type of technologies to deliver that target. That was a particularly bad decision because those technologies, which is onshore wind, that the rest of Europe has relied on to deliver that target are not available to us.

Q335 John Thurso: What you are saying is that the goal of decarbonisation is perfectly valid and even the total expressed in carbon terms is totally valid, but we fell into the usual politician traps of looking for the best soundbite to deliver it and, therefore, have not necessarily pursued the right technologies and avenues for the larger goal?

Peter Atherton: Correct, and if I may say also—

John Thurso: You can stop at “correct”. I like that.

Chair: You can carry on if you are going to add anything more.

Peter Atherton: I was just going to say, Chair, that the issue around affordability, which has obviously captured the political debate in the last three years, as I mentioned before, this is wholly if not highly predictable and has already played out in many European countries. There are only two ways around the affordability problem that you have in energy now. You either deal with the issues and the reasons why costs are rising, which means you have to deal with the policy, or you have to convince the British public that this is the price worth paying. Everything else is just kicking the can down the road.

Q336 Chair: I just want to explore those two questions very briefly. Let us take the “price worth paying”. We need to know what the price is and I think you have made an estimate of the price somewhere that I have seen. Is it £375 billion?

Peter Atherton: That is the total capital required of the power and gas sectors—not upstream gas but the utility bit of the power and gas sectors—to be spent between now and 2030 on everything. That is not only the cost of the policy because there is a lot of money you would need to spend anyway. I think the Government’s estimate of it is around £200 billion, but they exclude a lot of the things that I would include. For example, they would not include smart meters while I would include smart meters.

Q337 Chair: Do you know or have you made an estimate of what you think the full economic cost of the carbon reduction policy is, which is not the same number as the number we have just been discussing?

Peter Atherton: Probably the only way I can attempt to answer that question is: what would we likely spend anyway given the age of the networks and given the age of the fleet? If we just allowed the market to replace assets on a commercial basis—

Chair: You would have to take a business-as-usual case.

Peter Atherton: Business as usual—

Chair: Much as I think Stern did on—

Peter Atherton: Yes. You would do some renewables and some nuclear and so on. That would be about £150 billion. I would put the net cost of the decarbonisation at somewhere in the region of £200 billion to £230 billion.

Q338 Chair: Do you know how that would be broken down? The Chancellor has agreed that the Treasury is going to lead a piece of work to establish a Government estimate of that number. Are you one of the country’s leading experts in this field and would you be able to contribute to that discussion?

Peter Atherton: I would be delighted to, Chair. What I am looking at as a capital markets practitioner is what the capital markets are going to be asked to fund here, which is why I calculated the number. We published that number in our research, so we are very happy to share it with anybody.

Q339 Chair: Yes. I am asking a bit more than that. The Government is going to break this down line by line, policy by policy, subsidy by subsidy, regulation by regulation. Have you done that kind of analysis?

Peter Atherton: In terms of the capital required, yes. In terms of the impact that has on bills and the annual cost of that capital being deployed, we have done gross numbers. We have done some estimates around where we think electricity bills will be in 2020 and 2030 compared with where they are today, for example, but not then breaking that bill down between networks and policies.

Chair: Given that the Chancellor has decided to do this, it will be the job in this Committee to make sure it is done properly by the Treasury and we might want to come back to you to assist with that work.

Q340 Mark Garnier: Professor Glaister, this is slightly off the Autumn Statement but I am none the less interested in your comments on this morning's announcement from Sir Howard Davies about the airports. Do you have any thoughts about what he has come up with?

Stephen Glaister: No.

Q341 Mark Garnier: None at all? Do you have any thoughts at all about airport capacity and what we should be doing with it?

Stephen Glaister: It is not my subject, no.

Mark Garnier: All right, I will leave it at that. I don't suppose you have any for me?

Peter Atherton: I live in west London, so—

Q342 Mark Garnier: Do you think it is a serious issue? Presumably you are dead against a Heathrow Airport expansion if you live in west London.

Peter Atherton: To be honest, I would go for expansion of Heathrow, even as a west Londoner. As a West Londoner, I get more benefit of having Heathrow five miles away than I do from the noise.

Q343 Chair: I do not think we can rely entirely on that sort of advice, much though we like west Londoners. Mr Glaister, can I ask you to answer the initial question I posed to you in a little more detail?

Stephen Glaister: Yes.

Chair: The latest national infrastructure plan outlines that £120 billion will be invested in transport projects. Is that realistic?

Stephen Glaister: It is a worry. The realism of the Government's plans on their transport budgets generally is a worry over the long term and you have had your discussion earlier today about the state of the national debt and how other policies are affected by that. If I look at the announcements that were made in the summer for the three heads of expenditure in the spending review, for the six years starting 2015, the Government committed to spend £22.5 billion on Network Rail, £16 billion HS2 and £15 billion on the strategic road network. I think it is going to be very difficult to find all that money over the years to deliver that, especially since, on the road side, there is no charging mechanism. The Government has foresworn that and so it will all come directly from the Exchequer.

Against the background of a difficult national debt issue, there is a concern about whether the Government will be able to deliver it. I say that particularly because, on the road side, we have been here at least twice before. There was the Roads for Prosperity in 1989,

which was a big roads investment programme that essentially was not delivered because the Conservative Government of the day could not find the money as they came to the end of their term. There was quite a lot of roads money put into the Labour Government's plans towards the end of their term of office, which was pulled out in the spending review of 2010; including the cancellation of A14 famously, but a lot of roads were pulled out at that time.

For various reasons, historically we have had recognition of a roads problem, and a roads programme to deal with it which has not been delivered. I am a bit concerned that may happen again in the current regime.

Q344 Chair: In a nutshell on the roads issue, you think that the balance between roads and rail is not correct and you think more should be spent on roads. If I may summarise, you made two points. First of all, you think the overall envelope for the amount that is likely to be available is optimistic.

Stephen Glaister: Yes.

Chair: Secondly, even within that envelope, you would have a different distribution weighted more towards roads and less rail. Is that correct or have I summarised you incorrectly in any respect? If I have, please correct me.

Stephen Glaister: No, that is broadly my view, but the way I would fill out that point about the balance of expenditure is that I believe that the Treasury has very well-established ways of calculating value for money for different transport investments. Although they are now getting harder to find in the public domain, they still exist and for years they have pointed very clearly to the proposition that there are very high rates of return roads projects that are not being funded while much lower rates of return rail projects are being funded. That was a point made by Eddington in his review and I think it follows through.

Having said that, as I acknowledged earlier, after 2015 the Government is tripling the amount of capital they are putting into the strategic highways and so it is, to an extent, redressing that balance but, as a member of the public, I cannot find an argued case for why the balance of the expenditure in roads versus railway is the way it is. We get lots of shopping lists. We saw them in the *National Infrastructure Plan*. Schemes appear and disappear. There is no argumentation to say why those particular schemes are high priority on the Government's list and why other schemes are not being funded.

Q345 Chair: Can we touch on that in a bit more detail? The return on HS2 is logged by the Government at a ratio of 1:7; therefore, £1 generating £1.70 of income.

Stephen Glaister: This is for the full scheme?

Chair: For the full scheme. Just to give us a feel, what are these ratios then, first for the marginal road project and then the marginal alternative rail project?

Stephen Glaister: I am afraid I cannot answer that in the sense there is no well-established margin, but there are a number of road schemes, some of which have been funded and I think some of which have not, with benefit cost ratios of seven, eight, nine, 10 and 11; very much higher. On the rail side, I am not aware that the Government publishes cost benefit ratios for rail schemes apart from HS2. I am sure it does the work and I am sure that plays a part in the Government's negotiation with Network Rail and the rail regulator in setting the five-year plan.

Chair: Perhaps we had better ask them to supply that to us.

Stephen Glaister: I think that would be a good question to ask, yes.

Chair: I think you had better help us draft a question then.

Stephen Glaister: What I can say is that, if you look at the Department's published summary of the schemes that they have approved between 1 January 2012 and 30 December 2012, 58% of them were in the very high category. That means a benefit cost ratio above four.

The remaining 42% were in the high category. That is between two and four. They approved no schemes less than that. In other words, no schemes with a benefit cost ratio below two at all in that period. That is the only information we have about the return on the portfolio that the Department has.

Q346 Mr Mudie: Mr Atherton, the figure of £375 billion, £240 billion of that is going to come from the private sector in the Government's eyes. In view of the difficulty it has had in the past three years getting the pension funds interested and so on, do you think it is realistic to expect that capital to be forthcoming?

Peter Atherton: Of my list that adds up to £375 billion, all of that will come from the private sector. I think the public markets are very wary. By public market, I mean the equity market and the public debt markets. They are extremely wary not just of the UK energy policy but of European energy policy. The experience that investors have had in other European markets over the last four or five years who have hit the affordability crisis ahead of us shows that what happens in reality is that the Government of the day tends not to allow price increases to go through resulting from all this new asset build.

What they tend to do is renege on what they promise the investors they can earn as a rate of return and, therefore, take that money off the investors and use that to keep bills down, which is essentially what the Labour Party have just announced in terms of the price freeze. What Labour is saying there is that they expect the industry to suck the costs increases for two years, to absorb that in their profits. That is a theme that we have seen across Europe over the last five years and that has made equity investors and indeed debt investors very wary. The Government is aware of that to a degree. Hence the Energy Bill, which is designed to make the investment environment much more attractive, it would hope.

Secondly, the Government has been looking much more towards the private capital market; so directly to pension funds, sovereign wealth funds, infrastructure funds and so on. I don't think the Government publishes numbers, but if you look at what it seems to be expecting the big utilities to fund, and that is effectively the public market, and what it is expecting direct investors to fund—sovereign wealth funds, infrastructure funds, pension funds—probably five years ago it was 90/10 and today it may be 50/50. I am not a private markets person, so I am not that close to those guys. I can tell you public markets are extremely sceptical and are very unlikely to provide even if it was a 50% share.

Q347 Mr Mudie: Yes. What is the difference between the five pension funds who have said they will put £25 billion in over five years and just going to the market and picking some Chinese money up or something?

Peter Atherton: The biggest difference between direct investment from pension funds and the way the capital would normal be delivered by a company is the company. Normally the pension funds would provide the capital to, say, Scottish and Southern Energy or to Centrica or to Scottish Power and they rely on the management to choose the projects and determine whether those are—

Mr Mudie: No, I am thinking more from the Government's point of view. On the face of it, after the election, once again there is going to be a huge increase in capital expenditure. There is some doubt whether the market would deliver that. What is the importance of getting the pension funds? They are attracting a capital market has not contributed directly in the past, but the cost to the Government, I presume, will be marginally the same. They will still have to pay for it.

Peter Atherton: That is right. Consumers will be paying, because the principle is that the consumer will pay for all this investment.

Mr Mudie: If there is a direct consumer. The roads programme is an example. There is no direct consumer, so the Government will be meeting the costs of that capital, won't it?

Peter Atherton: On the roads side?

Mr Mudie: Yes.

Peter Atherton: Yes, absolutely. On the energy side it is all meant to be picked up in bills. In terms of getting the likes of the sovereign wealth funds interested, there is a need in the world for yield. There is a lot of capital out there. That capital is chasing yield. If you can put together a package that provides good yield through a very secure cash flow stream then there is interest out there from the private finance markets. The issue of UK pension funds is that they find it very difficult to invest in this stuff. They have been working on this now for many years. It is technically very difficult, with lots of rules and regulations around what they can invest in and so on, and they just do not have the expertise and they are not willing to take construction risk. That is one of the core things.

The problem for the Government overall in tapping into the private capital market is the private capital markets are very reluctant to take construction risk. They are very good at owning assets once they are built and if they are sitting there on a very secure income stream, but they are good at stepping in and taking construction risk, which is where you would normally expect the public market to—

Mr Mudie: Is that the pension funds you are talking about?

Peter Atherton: Yes. The pension funds, sovereign wealth funds, infrastructure funds; private money rather than money that has been raised on the public exchanges.

Q348 Mr Mudie: There is some suggestion that, with this deal done just before the Autumn Statement, they had actually arrived at having an agreed platform that eased the worries of the pension funds. Are you aware of that?

Peter Atherton: I saw the announcements around the £25 billion. While that would be a quite significant move forward, it is frankly a drop in the ocean relative to the amount of money that we expect to spend on infrastructure. How much of that will fund new build or will that money own existing assets once they are built, i.e. again, who is going to be able to bear the construction risk? Are the pension funds willing to fund from conception through to construction an offshore wind farm, say? I hear that they are still very reluctant to do that.

Q349 Chair: Mr Glaister, this £14 billion contingency fund for HS2, do you think it is a good idea to have a large contingency fund? Some say yes and some say no. What is your view and, in a nutshell, why and do these contingency funds normally get spent on big projects?

Stephen Glaister: The Treasury insists on putting them in because it feels it has had its fingers burnt in the past where an inadequate contingency has been included. Whether it is an appropriate amount or not is hard for me to say. What I would say is it is important that, if the Treasury is going to insist on there being a contingency and there is a case for a certain amount, it is done consistently across the piece because if you are going to put in £14 billion for HS2, you need to make sure you put in a proportionate amount in other schemes so they can compare across the piece.

Going back to our earlier conversation, I believe it is the case that, when we make these comparisons between roads and railways and HS2, a similar level of contingency has been included in all cases. That helps with the comparison. If you were to strip out the £14 billion for HS2 and say they are not going to spend it and, therefore, the benefits will be higher in relation to the costs, you would have to do the same thing for the other schemes; otherwise you would lose the comparability.

I think the professionals in this field are uncomfortable with the way the Treasury insists on these rather mechanistic levels of contingency in the schemes because they feel they produce perverse incentives. Obviously there is a tendency to think if you have a budget that includes a contingency then you are going to end up spending it. What you should be doing is good, effective costing and binding yourself to effective costs. Of course there will be uncertainties. You do need a little bit of contingency to allow for that. That is not the way the Treasury has done it and I am sure there could be improvements in the method. However, whatever it is the Treasury does, they do need to do it consistently across the different schemes if they are going to have good decision making, I believe.

Q350 Chair: Mr Atherton, am I right in thinking you are not much of an enthusiast for the carbon price floor?

Peter Atherton: Am I an enthusiast for the carbon price floor? It is what it is in the sense that it improves the profitability of many of the companies that I cover. It is a tax that falls on to the consumer through the power price and enhances the profitability of most generators on the system. I note that as an equity analyst. It is a fact that in the UK power price we now have a carbon price of around £20 per megawatt hour and European consumers are facing a carbon price of around €5 per megawatt hour. The UK price will escalate over the next decade up to £30 per megawatt hour in 2009 money; so by the time we get there about £43. Europe may or may not have sorted out the carbon trading scheme by that point and imposed on themselves an equivalent price. Certainly I am not aware of any other of our major trading competitors anywhere in the world that are anticipating a carbon price anything remotely of that scale either today or by 2020.

Chair: Whether or not we should have one, we are certainly overdoing it. That is your point.

Peter Atherton: It is large number. That does have quite a material impact on bills. For example, if you look at the current forward power price on the traded markets, we are currently around £53 per megawatt hour and it does add about £2.50 each year going forward, so you get to about £60 in three years' time. That is entirely down to the carbon price floor escalator.

Q351 Chair: Do you know how that translates into consumers' energy bills?

Peter Atherton: In electricity, the wholesale price is roughly half the bill. The carbon price floor escalator over the next three or four years will add about £10 from, say, a £50 base. So you go from low £50s to low £60s. That is about a 20% increase and that is half the bill, so 10% on the—

Chair: It sounds like you may be able to help the Chancellor with his number crunching, Mr Atherton.

Stephen Glaister: Chairman, may I comment on that topic of the carbon price? I think if you do not have a uniform carbon price there is a risk it causes terrible distortions in the market. If I buy a litre of petrol, I pay 60 pence duty plus VAT on that duty. If you use the Stern price for carbon, which is a place to start, the right value might be about 15 pence per litre; so you are paying very much more than the Stern price for your duty. If, instead of using a litre of petrol, I go and plug my electric car into my domestic supply, I am paying 5% VAT instead of the normal rate and I am paying a tiny carbon credit component in the price I pay for electricity. That is greatly distorting, in carbon terms, the choice of whether I burn petrol in my car or electricity in the car and that does not have any logical base to it, I don't think.

Peter Atherton: Absolutely. What I find interesting, Chairman, is that, if we go back to when we launched our decarbonisation policies in the mid-2000s, every discussion was on

the abatement costs of carbon, how much each measure was costing. It never gets discussed now. Is the absolute cost the impact on bills?

For example, the ECO scheme, which was at the heart of the discussions recently around affordability, and the movement from the bill into general taxation; word from the companies is that the cost under ECO is well above £100 a tonne in terms of carbon abatement, which compares to Stern of £20, which compares to the Government's own carbon price of £20. For some reason policy-makers have lost sight of what you are trying to do here. You are trying to reduce carbon in the most cost-effective way and pinning a price on the tonne of carbon that you save under each measure and tracking that through time seems to me an eminently sensible thing to do, and yet you very seldom see that done now in DECC documents, Treasury documents or anybody else's documents.

Q352 Chair: Could I end with a question to you, Mr Atherton, as well? If you look at energy policy over the long term—and Dieter Helm wrote an interesting book about all this going back decades—we had a highly-interventionist energy policy for most of the post-war period, which derives from war-time experience. It became even more interventionist under Tony Benn and then all that was put completely into reverse in the early 1980s, first with David Howell and then particularly Nigel Lawson. As a country, we had a very competition-based energy policy for the late 1980s and 1990s. That was then put into reverse by the last Labour Government and that reversal has been maintained, in some ways increased, by the Coalition Government. Do you think that we would do better with a more or less competitive energy policy? In other words, should we be intervening more to get what we want or should we be using market tools?

Peter Atherton: I certainly agree with the characterisation of where we are going to on energy policy. I recently attended a talk by Ian Marchant, the ex-CEO of Scottish and Southern Energy, who described the Energy Bill as soviet. If you step back and look at the central powers that DECC will have in terms of planning our energy system under the Energy Bill, they are quite amazing. They will literally choose not just what technologies get used but it will be down to the siting of the plant and that plant over that plant over that plant and that proposal over that proposal. These are central Government controls well in excess to what existed under the old Central Electricity Generating Board, which was an engineer-driven, arms-length organisation though it obviously followed general policy.

In terms of competition, I am afraid to deliver the 2020 renewables target and the 2030 greenhouse gas reduction target does require the scale of intervention that is being proposed, otherwise it would not happen. Something would happen and on my modelling of the system, if you just left the industry to replace coal with gas on a needs-must basis, you would probably go from 500 grams per kilowatt hour, as we are currently are in terms of carbon intensity for power, down to something like 200. The target that the Committee on Climate Change has set that you need to hit is between 50 and 100. It is that additional 100 to 150 gram reduction that is the difficult thing to do and the staggeringly expensive thing to do.

To do that, you basically need the state to do two things. The state has to take control of all the investment-making decision processes, which it is doing under the Energy Bill, and the state also has to accept the risks and the cost of that will also fall on to the state or the consumer effectively as an arm of the state. One of the problems with EMR and the Energy Bill is that the state does take on all the powers of decision but tries to leave quite a lot of the risk in the private sector, and that is one of the reasons why the Energy Bill is a very unpleasant halfway house. That is why people like Dieter Helm, for example, would argue that we should go straight to full regulation and generation; so people can just build assets and then regulate a return, in the same way as National Grid will build a transmission line and

then regulate a return on it. If you are going to do this then you have to go the whole hog, effectively.

Chair: Do you agree with that view or do you think we should—

Peter Atherton: Yes, I do, because where we are leaving it at the moment is proving to be possibly the most costly way anybody could envisage delivering it. Hinkley would be the classic example of that. Nobody in their right mind would sign an agreement with EDF to fund the economics of an £8 billion reactor that it is going to take them nine years to build. That is just economically insane, frankly, and the only reason you are doing it is to deliver the 2030 target. Without the 2030 target you wouldn't do that in any universe I can think of.

Chair: We sometimes have witnesses coming before us and we struggle in two hours to find out what they really think. Today we have had two witnesses, certainly ending the session, where we have only had three-quarters of an hour and we have found out pretty much exactly what you think on both these key issues. You have been extremely helpful. Thank you very much. I am sorry the session has taken a bit longer than had been planned.