



Treasury Committee

Oral evidence: Budget 2014, HC 1189

Tuesday 25 March 2014

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Members present: Mr Andrew Tyrie (Chair), Mark Garnier, Mr Andrew Love, Mr Pat McFadden, Mr Brooks Newmark, Jesse Norman, Teresa Pearce, John Thurso

Questions 1-97

Witness[es]: **Paul Mortimer-Lee**, Global Head, Market Economics, BNP Paribas, **Michael Saunders**, Head of West European Economics, Citi, and **Robert Wood**, Chief UK Economist, Berenberg Bank, gave evidence.

Q1 Chair: Welcome, and thank you very much for giving evidence this morning. Did any of you follow the evidence that we took from the Bank last week on the output gap?

Michael Saunders: I did.

Chair: Could you tell us, Mr Saunders, do you find the difference of understanding between the Bank and OBR on what constitutes spare capacity—one using that term to mean primarily employment, or unemployment, and the other using it as a wider measure of the output gap—a helpful distinction?

Michael Saunders: I think the Bank are right to say that output gap concepts are uncertain and people measure them in different ways. I do think it is quite a useful concept and to me it would be helpful if the Bank were to explain more clearly how their measures match up against others.

Q2 Chair: You heard that evidence and you were not convinced by it, or you were?

Michael Saunders: I am not sure I would say whether I was convinced or not convinced. I thought that what they have ended up with is a way of describing spare capacity that is less clear than the system that other people use. I don't find that very useful.

Q3 Chair: Does anybody want to add anything to that? Given the output gap, both for monetary policy and the overall conduct of financial policies, it is a big question and a very important one and I note your uncertainty about it. I also note that others don't seem to have noticed, or have you noticed?

Paul Mortimer-Lee: I think there is a distinction between what the Bank sees as spare capacity, which is basically the amount of capacity you can use up until you start seeing some inflationary impetus. The OBR has a longer-run concept, which I think, for example, Janet Yellen would share in the States, in the sense that there may be resources that through time are pulled back into the labour force, that are not immediately accessible to the economy at the moment but over the fullness of time will come into the labour force. For example, if you look at reports from the north-east on quantity surveyors, 26% of firms cite that there is a shortage of quantity surveyors, because we have not been training them for the last five years. Over time people will be trained and so what seems like a short-run bottleneck in the labour market will disappear over a period as they are trained.

To be boring, I think they are both right and they are looking at different things. The Bank is looking with respect to when there could be pressures on inflation and wages and the OBR at a longer-term concept about how much capacity could, over a longer period, be pulled into the economy. The Bank's inflation horizon would be a couple of years; the OBR is looking at five years. I think the different horizons give the two institutions a different perspective.

Q4 Chair: It certainly sounds as if everyone is picking up something slightly different from the same piece of evidence. Do any of you think that you are more or less certain about the future direction of monetary policy now that you have heard what the forward guidance phase 2 means?

Robert Wood: I wouldn't say I was more or less certain. For me what it did was return the Bank more or less to its pre-forward guidance policy.

Chair: So that is abandoning forward guidance?

Robert Wood: Yes. Forward guidance, as I understood it, was giving you considerably more information about how they were going to set monetary policy, so you had a target, for instance, or a threshold not a target.

Q5 Chair: Do you agree with David Miles' piece in the *Financial Times* yesterday saying, "Oh no, we know a lot more about it"?

Robert Wood: We know a little bit more, but I think the broad framework for policy is more or less identical to what it was back in 2005, which is over two or three years the Bank of England will try to close the output gap or spare capacity or slack, however they describe it, sufficiently fast to keep inflation on target to hit 2%.

Q6 Chair: You mentioned two years there. Of course, that time envelope was widened during the crisis by the former Governor to four or five at one point in evidence, as I recall. You are saying it is now back at two to three, which is what we used to hear from the MPC every month in the period of the great moderation.

Robert Wood: Of course they disagree, as we have heard in speeches between them, but in their inflation report they said, “We think there will be a small amount of slack remaining after three years”, which I think means they will aim to close the output gap in two to three years.

Q7 Chair: Does anybody want to disagree with that or add anything substantive to that point?

Michael Saunders: I would say that in terms of what the MPC are signalling about the future path of interest rates, where we are now is slightly different to both the pre-guidance period and the guidance period itself. Pre-guidance the MPC’s mantra was always that they would take each month as it comes and they would give no signal either way of where interest rates are likely to go. Then we had guidance that aimed to give a very strong steer and now I think they are somewhere in between. They are giving a vague steer that interest rates are likely to be going up and that is quite different to the previous phase for forward guidance with vague hints that it is not straight away and that the eventual peak in rates will be lower than before. That is all quite different to the pre-guidance world.

I think it is important to appreciate, though, that these are not commitments from the MPC. They are forecasts based on how they view the economy at the moment and the experience of their own forecasts, or indeed of other central banks, is that they can’t forecast the economy very well. From the other central banks that do give precise interest rate forecasts, like Sweden, New Zealand and Norway, you see that the forecast areas on their interest rate forecasts are very large. It is not because they are trying to mislead you but just because the forecasts on interest rates depends on the forecasts of growth and inflation, which often turn out to be wrong.

Q8 Mr Newmark: The OBR is now forecasting growth of 2.7% this year, which sits among independent forecasts ranging from 2.5% to 3.3%. Are you more or less optimistic than the OBR about the UK’s near-term prospects and why?

Michael Saunders: I am more optimistic.

Mr Newmark: So you are with the Bank of England?

Michael Saunders: Yes. Indeed, if anything, I think growth in coming quarters may be even stronger than the Bank of England.

Mr Newmark: More than 3.3%?

Michael Saunders: They have built in upward revisions for the last few quarters, so they take the economy’s starting point as being higher than the OBR or I do, and I think also higher than most other forecasters do. In terms of the quarterly path of growth, they have

about 0.9% near term and then slowing to about 0.6% in the second half, and I think it probably would stay more like 0.9% throughout the year.

Q9 Mr Newmark: If I think back just a year ago, we were talking about a triple dip recession. Everybody was pulling their hair out saying, "The end is nigh" and now it looks like everybody has swung from one extreme to the other. Do you think people may be being over optimistic or you really do think the growth is returning and will be even faster than the OBR is saying?

Paul Mortimer-Lee: This time last year we had the data from 2012 as very mixed, messed up by the Olympics, the weather, the Jubilee and so forth. People find it very difficult to forecast strong growth when growth is currently very weak and so they didn't. What we saw was a removal of headwinds, I think. Importantly, the crisis in Europe abated and that allowed optimism to come forward. There were measures to stimulate the housing market. We have to say that the pace of structural fiscal tightening was rather less than it had been in previous years and the economy picked up. That has seen a remarkable switch round in confidence. I did not expect that to happen and that confidence—

Q10 Mr Newmark: What was the tipping point? We have a long period of stagnation and suddenly it is as though, like a bunch of lemmings, all the economists suddenly think, "Actually, things are going to be much, much better than we anticipated" and it is like en masse everyone is now trying to outdo each other with how much better things are going to be.

Paul Mortimer-Lee: I don't think it is just the economists. I think it reflected a mood change in society, in firms and households, that had been looking down and then started looking up. There was a shift in psychology and that shift in psychology meant things like investment that had been held back, people's willingness to invest in housing because they thought house prices were going to fall, then they perceived they were going to rise. That is a huge shift in the expected real returns on housing and people's behaviour changed. We did see a pick-up globally, importantly in Europe. I think at the moment the momentum is very good.

Our own forecast is very similar to the OBR but I can see that in the short run the momentum looks good, the surveys are very good, firms are optimistic about the future. Investment and consumer spending could continue and it may be that in the short run the OBR is too pessimistic about consumer spending and the consumer savings ratio continues to decline. I can see that there are upside risks to the forecast in the near term and if I was the Chancellor I would love to see those materialise by this time next year. My worries about the forecast are more about the longer term, not the cyclical recovery, which is there and is real, but the structural underpinnings of the long-term growth.

Q11 Mr Newmark: Your concern is that it is not a sustainable recovery. Is that what you are saying?

Paul Mortimer-Lee: I think it will continue but will slow to 1.5% rather than 2.5%.

Q12 Mr Newmark: Robert, what do you feel about that? Do you think it is sustainable or not? Are we living in a fool's paradise, totally driven by the housing market and if that suddenly went things would go crashing down again, or is there more to it than just housing?

Robert Wood: I think there is more to it than just housing. I think what we are having is something closer to a normal cyclical rebound in the economy, which we have been waiting for for a number of years now and finally it is coming through, both because uncertainty about the eurozone has fallen dramatically over the past year but also as confidence in the UK has turned round. Maybe debt has been paid down enough for households to feel better about the future. They can see a more optimistic outlook for the economy. I think it is sustainable in the sense that it will continue for a number of years. I think the saving rate for households will continue to fall and house prices will continue to go up. We have a very supportive monetary policy.

Q13 Mr Newmark: Just listening to you then, it is going to be more driven by the psychology of asset prices and people feeling a little wealthier, which is what happened before, rather than maybe people's pay packages increasing. The evidence is again we are at a tipping point where for quite a long time now—and obviously this has been Labour's argument—prices have been exceeding wages but it now seems to be we are at tipping point where wage packages might start increasing more than prices. I don't want to tread on someone else's territory, but do you see that may be also driving confidence?

Robert Wood: Personally I am more optimistic than the OBR because I think we have both things. We will have optimism about asset prices and help from monetary policy but also an upturn in real wage growth and productivity. I think we will have both elements helping and that is one reason why I am more optimistic.

Q14 Mr Newmark: If I can turn to business confidence, I was at a Grant Thornton briefing on the budget; actually I was giving the briefing. I saw a confidence chart that was very interesting. The confidence index for business is extremely high. The consumer has been the principal driver of the recovery to date but, given there is this optimism among businesses in the near term regarding output and profitability, do you think that we have genuinely turned the corner because we not only have effectively confidence with the consumer but we also have confidence with business? Is that leading to this sort of J-curve effect where we are coming up and that curve is going to be quite steep as we see growth returning?

Robert Wood: I think absolutely of vital importance was that turnaround in firms—

Mr Newmark: I am just looking for you to agree with my analysis, that is all.

Robert Wood: Until the back end of last year that was lacking. We had falling household saving, a turnaround in the housing market, but firms were a little bit reluctant. Then in the

last three to six months of last year their confidence turned up so we also saw employment rising rapidly and we are now seeing business investment. That is why I describe it in a way as something closer to a normal cyclical recovery. In the past we would cut interest rates, consumers would cut their saving, consumption would go up; that would then lead businesses to be more confident and they would invest. That is more or less the sort of timeline we are now seeing with this recovery, I think.

Q15 Mr Newmark: There are two things that can drive us, as I see it. One is that both individuals and businesses have been destocking for quite a while and, having destocked, once that confidence comes back they then effectively restock their inventory or not putting off fixing a kitchen or whatever it might be. That is one thing that can be driving this recovery. The other one is the investment allowance. I am curious, on the balance of the two, what do you see happening in driving that confidence and investment that will help turbocharge growth? Michael, you haven't spoken for a while. Do you want to say something on that?

Michael Saunders: I think this broadening of recovery, driven by a lower savings rate and the housing markets, has already begun to come through. We have had strong business investment now for three quarters in a row and what lies behind that is corporate balance sheets and aggregates are in terrific shape with very strong liquidity. Investment is really low as a share of GDP. Capacity has picked up quite sharply.

Q16 Mr Newmark: Was the investment allowance necessary at all or would that have already happened?

Michael Saunders: The investment pickup is happening anyway, but given how low investment is in the UK, I think it is right to tilt policy towards encouraging that further. I am not sure that the ceiling on the investment allowance is yet high enough.

Mr Newmark: It is dealing with 99% of businesses though.

Michael Saunders: But a much lower share of aggregate investment spending. I think that is a route to go down, something that would help that rebalancing of the economy that is very useful.

Q17 Mark Garnier: Pitch in any of you who want to answer these questions. Can I carry on with this household debt question and the household leverage? What is pretty clear is that over the last 20 or so years households have become more and more leveraged. If you look back to the 1980s, during the Lawson boom, if you like, you saw household debt as a proportion of household income rise from 80% to 90%, that sort of level, peaking at around 100% by the late 1980s. It was fluctuating around but it was pretty steady, from 1987 up to 2002, between 100% and 120%. Then there was a massive spike taking it up to 170% by 2007 as households became more and more leveraged. Clearly that has come down, although the nominal number, as you know, has not

changed since 2008—£1.47 trillion. Obviously that has come down as household incomes have gone up. As more people go to work then wages go up. We are now beginning to see a pickup in that.

Is it the case that we have now got ourselves into a situation economically that we have to have increasing household debt as a percentage of income in order to maintain economic growth? Who would like to start on that? Why don't you, Michael Saunders?

Michael Saunders: I think that households in aggregate have deleveraged substantially. The debt to income ratio now is back to 2003 levels, and I take your point that it is not back to where it was.

Mark Garnier: Yes, but it is expected to go back up again.

Michael Saunders: Yes, although the OBR have been forecasting that for a while and in practice it has tended to undershoot their forecasts. Even now the debt to income ratio is still falling. Household debt in aggregate is growing at about 1.5% year to year in nominal terms whereas incomes are growing at probably about twice that pace. So we don't have credit-led growth at the moment. We are deleveraging more slowly and the shift from deleveraging rapidly to more slowly is part of the story of the rebound in growth. We may yet come to a point a few years down the road at which household debt has risen sharply and we are back to the credit excesses of 2006-07, but I don't think that is where we are now.

Q18 Mark Garnier: You sound a lot more optimistic than some other people. Does anybody disagree with that?

Paul Mortimer-Lee: I am quite worried about the picture the OBR paints of debt going back to 2% below the peak levels because people are making decisions on debt currently on the basis of interest rates that are extraordinarily low by historical comparison. What worries me is that this will not last. Eventually we will move back to levels of interest rates that are more 4%, so 2% inflation and 2% growth, and that the margin squeeze that the OBR assumes between mortgage rates and bank rate will not occur. Therefore, there will be an adverse shock to household income gearing, to household cash flow, as the debt built up at low interest rates has to be serviced at much higher interest rates. That is a real recession risk towards the end of this forecast period, I think. I would hope that the regulators would step in long before we get to those levels.

Mark Garnier: When you say the regulators, you mean—

Paul Mortimer-Lee: The prudential regulators would be having words to the banks to say, "This is going too far. This is a risk to the macroeconomy". We have more tools to deal with it this time than we had previously.

Q19 Mark Garnier: That is a challenge for the Governor of the Bank of England in order to be able to fend off inflation. We have just had the inflation figures at 1.7%, so down 20 basis points, which is a happy thing but nonetheless his challenge is to take the heat out of any sort of bubble while at the same time allowing households to adjust to a new interest rate paradigm.

Paul Mortimer-Lee: Absolutely. It is difficult to do that. We saw the previous Governor repeatedly deny that the previous run-up in house prices was a bubble. Having burst, it looked increasingly like it was a bubble.

Q20 Mark Garnier: What is interesting, and having been on this Committee now for four years, is that when we were first looking at the creation of the Financial Policy Committee one of the questions we were asking—I don't know how closely you followed this—was what constitutes a bubble and there were some quite woolly answers. What seems to be different this time round is when we have the new Governor and talking to the new FPC, when you ask them questions they seem to be much clearer about what a bubble is. Do you get that sense as well?

Paul Mortimer-Lee: Yes. We have been through one. We know what it feels like, we know what it looks like, and we will recognise it when we see it again.

Q21 Mark Garnier: Are you all satisfied in your analysis that you think the FPC have the intelligence and the understanding of what a bubble is to be able to head off a future bubble? I know it is a slightly hypothetical question but it is quite an important point, given the fragility of households and fragility of recovery.

Paul Mortimer-Lee: I am not certain. I think with all these things it is difficult to bring a decisive change in policy that could change the dynamics of the economy. You will only do it when you are really sure and by the time you are really sure it is often too late.

Robert Wood: I was going to add that I think the FPC have plenty of tools to do this if they want to. I would agree with Paul that you may well use them too late. I like to think that particularly the housing market is a bit like an oil tanker. Once you set it in one direction it takes an awful lot to shift it. People start to expect prices to rise and, of course, that is when you get into a bubble when you have these exponential price rises. They have plenty of tools. I think the key thing is that it does not seem to me, from what has been said, that they see controlling house prices per se as part of their remit. Their remit is to control financial stability, so if house prices crashed but banks had a lot of capital put aside to protect them from that crash then that is fine. Of course, for the whole economy a big house price crash, and certainly for households who are affected, is not fine. So I think in that sense we may well see action, if we see it, too late.

If I can add on your earlier question about are we having credit-led growth. Not now in the sense that credit is not rising, but I think what has been key for the recovery is an easing in credit conditions, the fact that people know they can borrow if they need to, the fact that the conditions on their mortgages have eased so they know if they need to remortgage they can, and I think that has allowed them to cut back their saving. So we are not seeing net borrowing rise now but that easing in credit conditions has led households to cut savings significantly. I think Michael's concerns about the OBR forecasts are right. Of course, this rise in debt has been projected for some time but I think, big picture, house prices are rising rapidly now and that normally translates into higher leverage over a period of time because people have to take on more debt to buy the house. So I do buy into that picture of rising debt to income.

Q22 Mark Garnier: Do you think that is a problem we are ever going to deal with? Is it a good thing that households end up being permanently in debt?

Robert Wood: No, I don't think it is a good thing. Turning back to the sustainability question, I don't think it means the recovery is going to end in the next two or three years because households are releveraging, but I think when we do get another downturn it does make us much more vulnerable to that downturn.

Mark Garnier: And indeed vulnerable to rising interest rates.

Robert Wood: Yes. The higher debt the more vulnerable you are. It is worth remembering that debt to income is now where it was in 2003, and interest rates were considerably higher then than they are now. There is some room to have interest rates rising, but of course if you go back to 5%, which the Bank of England do not expect, then there would be a big shock.

Q23 Mark Garnier: Can I turn to the productivity puzzle? We have a lot of commentators coming out with views about the productivity puzzle. We do not really know what the puzzle is and why productivity is still 4.4% below the previous peak. We had a comment from the Governor of the Bank of England when he came in a week or two back where he suggested that this productivity conundrum is largely due to the fact that we have seen relatively few business failures during the course of this recession and we could have a hoarding of labour and a hoarding of capital within those businesses that are enjoying bad forbearance at the moment. Is that the answer or do you have a better answer than that?

Robert Wood: For me it is part of the answer. I do agree that very poor availability of finance over the past few years has almost certainly prevented some rapidly growing firms from expanding and forbearance has almost certainly kept in business some poor productivity firms, but I don't think it is the only thing. We also saw before the crisis what I think was an unsustainable rate of increase of GDP, of the economy. Some of what we have seen is a return to normal. We were overestimating the rate at which the economy could grow. Similarly to the way history recently meant I had been slow to pick up the recovery, I think equally before the crisis it was hard to see a downturn. I would add other things like the rising supply of workers, from here as older age workers stay in the labour market longer and also from abroad, has probably been significant too.

Paul Mortimer-Lee: If there had been a shortage of demand and labour hoarding, then we should have seen a substantial acceleration of productivity right from the beginning of last year and we did not. Productivity continued to be quite poor, although it did increase in the fourth quarter. When you think about what has happened, what we have seen is lower productivity and real wages and higher employment than expected. This is something that you don't associate with a downward shift in demand but an increase in supply. I think there has been a big increase in labour supply, partly older workers, partly the release of workers from the public sector into the private sector, partly the welfare reform and partly immigration from new EU states but also from existing EU states where unemployment is

significantly higher than we have at the moment. I think the explanation is more that a shift in labour supply has driven down real wages.

Q24 Mark Garnier: What is absorbing that supply? I don't disagree with a word you are saying, but ultimately somebody has to be making money in order to pay for this supply. If you take on a member of staff, you can't just go to the magic money tree at the bottom garden and pay their salary.

Paul Mortimer-Lee: The fact that you are getting lower-wage workers enables the economy to shift towards lower productivity private sector jobs, particularly in the service industries. If you look at transport, food and communications, productivity has been quite low, although it also has been very low in financial services. If this is the right explanation then the pickup in productivity that the OBR and the Bank of England assume won't happen, I think, until we see significant labour shortages and wages start to move up. That will encourage firms to raise productivity to keep unit labour costs under control. A low productivity growth is why I think that growth in 2016-2017 will be only 1.5% rather than the 2.5% the OBR supposes. Further welfare reform will continue to increase the supply of relatively low productivity workers to the labour force and that will tend to reduce average productivity and subdue real wages and therefore consumption.

Q25 Jesse Norman: Mr Saunders, in your note you have said that it is a feature of the budget that progressively more of the fiscal tightening has been pushed into this Parliament and later on into the next Parliament. Can you expand about that for a second?

Michael Saunders: I don't have the numbers in front of me, but in broad terms if you go back to the 2010 budget, about 90% of the total fiscal tightening in terms of the structural primary balance would have been completed by the end of the fiscal year that is about to begin, the 2014-15 year, before the next election. Ever since then that proportion has fallen steadily and under the current plans it is about 50:50. The total fiscal tightening is just above 10% of GDP and roughly 5% of GDP of that happens in this Parliament, most of it in the first two years, and roughly 5% of GDP is pencilled in for the next Parliament. That is a major part of the story of the economy's weakness in the first couple of years and then the rebound since 2012. There has been a shift from very heavy fiscal restraint to almost no fiscal restraint in 2012, 2013, and 2014. We have lifted a headwind, if you like.

Q26 Jesse Norman: The effect of this is that a lot more of the tightening will come in the next Parliament, no matter who the Government is, if they are to hit the target of moving back to surplus on anything like the schedule that has been described.

Michael Saunders: Correct. The condition there is if they are going to follow those paths. My understanding is that there is not agreement among all of the parties as to what the target for fiscal policy would be, whether it is going for a current surplus or a complete public sector surplus. In that sense the required fiscal tightening would be different, depending on what your fiscal target is.

Q27 Jesse Norman: The phrase you use in your report is “major political risks”. What does that mean?

Michael Saunders: At the moment in the plans we have got this target of about 5% of GDP pencilled in for the next Parliament. Only the first year of that is covered by the current spending plans in detail and so the means by which the current coalition would seek to achieve that further tightening is largely unclear. I don’t know where they would cut. Conversely, under a different Government that may have a different fiscal target, again I don’t know how it would be achieved. My uncertainty, as someone who watches this, is: what are the measures you would need to take in order to achieve that fiscal target and do you have plans to take them?

Q28 Jesse Norman: If there is a change of Government, the risk that the target may not be hit goes up significantly?

Michael Saunders: I think there is uncertainty as to how the current coalition would achieve that target because they have not spelt out their plans either.

Q29 Jesse Norman: Thanks. Mr Mortimer-Lee, do you think that the Bank would be more inclined to tighten monetary policy if it adopted an OBR-type output gap estimate alongside its current thinking about slack in the labour market?

Paul Mortimer-Lee: The Bank of England seems to think that we can have unemployment at around 6% before we start seeing some inflationary pressures. The OBR thinks the sustainable rate of unemployment is about 5.25%. I would say that if the Bank took the OBR’s forecast it might be less inclined to move rates earlier and more inclined to wait.

Jesse Norman: If it adopted the OBR’s forecast?

Paul Mortimer-Lee: Yes, if it adopted the OBR’s forecast because, first, there is lower growth in the OBR’s forecast and, secondly, the view of the sustainable level of unemployment seems to be rather lower under the OBR, so you go by later on both counts, or by less.

Q30 Jesse Norman: Do you share the OBR’s view that although there has been an increase in demand, there has not been an increase in supply capacity?

Paul Mortimer-Lee: Yes. I think there is clearly a big difference between capital goods, where there is clearly a shortage of capital goods, and the labour market. We have a much tighter position in the capital goods market than we have in the labour market and so there has not been a corresponding increase in supply in capital goods and that is why investment is quite strong. People have postponed investment plans. There is currently a big catch-up.

Jesse Norman: Yes, and they have been hoarding money in the corporate sector and now they are starting to spend some of it.

Paul Mortimer-Lee: They were not going to invest while they thought there was a big risk that capacity would be unemployed for a long time and now they are much more certain about the amount and there is a big pick-up in supply in terms of extra investment goals. The problem I have with the OBR's forecast is that this pick-up in investment goods demand seems to last for ever at almost double digit rates, and it is scarcely ever like that. There tend to be surges and spirits change, people catch up. You get a peak and then it comes off again, and I think that is much more likely than the OBR's forecast.

Q31 Jesse Norman: The current projection is that the result of the crash in 2008 and the subsequent events has been that output is something like 20% to 22% below what the trend would have been. Do you think that is somewhat more recoverable on a surge view of the economy of the kind that you are describing than it is on the very rules-based approach that the OBR seem to be adopting?

Paul Mortimer-Lee: Unfortunately, I think a lot of this loss is permanent.

Q32 Jesse Norman: How much of that loss do you think is permanent?

Paul Mortimer-Lee: We have lost at least 10% but maybe more. We don't know but there has clearly been a permanent loss of output.

Q33 Jesse Norman: So it has been a catastrophic blow to the economy.

Paul Mortimer-Lee: Absolutely, which is one of the reasons why much stronger regulation of the financial sector is so important. It is not just that you lose output for a small period of time; you lose it permanently.

Jesse Norman: Presumably it is a long-term matter.

Paul Mortimer-Lee: Yes, absolutely.

Q34 Jesse Norman: This is a question we can open up to others. Do you not also think, though, that there is some doubt about how effective economic theory is at the moment on this? I notice the number of disagreements there are just about how you define the output gap. Even the OBR itself is having to give an elaborate justification of why its judgments are differing from the factor analysis that it gives of various components of the output gap. We are operating at the outer limits of our conceptual understanding of what is going on.

Paul Mortimer-Lee: We are operating in a very different world and I think there are a number of things that make it difficult. One is the fact that we have almost zero interest rates so the economy knows that if there is an adverse shock there is very little monetary policy can do about it. We know that fiscal policy is very constrained and so there is very little fiscal policy can do about it. This can make for quite big shifts in psychology because if you fear you are going to go back into the pit and there is nothing the Government or the

central bank can do, you are ultra cautious. Once you decide you are not going into the pit then, “Let’s go to the races”. Mr Newmark’s question was why have things changed such a lot and it is this perception about the future has massive gearing when you are at the zero band. The economy does operate quite differently in this environment than in normal times.

Q35 Jesse Norman: So the psychology becomes much more of a toggle rather than any kind of graduated response to changes.

Paul Mortimer-Lee: The switch is on or it is off.

Q36 Jesse Norman: By the same token, presumably Government policy or economic policy becomes that much more nervous about external shocks because it only has a toggle kind of response. Those shocks may be US shock or they might be Ukraine or something like that.

Paul Mortimer-Lee: We should be very careful about adverse shocks, which is one of the reasons why, although I think the Bank of England is too optimistic about inflation, it is absolutely right to be very patient. The last thing you want to do in this circumstance is give an adverse shock to the economy and find you have fallen back into the pit. You must avoid that.

Jesse Norman: With the furniture all burnt. Thank you very much indeed. That is helpful.

Q37 John Thurso: Can I come to you, Mr Saunders, first, please and ask about the Government’s cap on welfare spending? It has now been outlined in the budget; we have somewhat more detail. What impact do you think that is going to have on policymaking in the future?

Michael Saunders: That is an interesting question. I would guess quite large if it is bought into by all parties because it would mean that you would have a trade-off. If you propose new welfare measures then you would have to squeeze elsewhere. I agree with Paul that welfare reform is part of the story of rising labour supply. I think that has been quite important in pushing people back into the workforce and you can see that those changes have quite powerful effects on the economy in many ways.

Q38 John Thurso: Do you think it will hinder policymaking or be a benefit, on balance?

Michael Saunders: I am not sure.

Q39 John Thurso: How realistic do you think it is to legislate for a cap where there is no sanction for breaching it and where a sensible policy in a position five years in the future might well be to breach it?

Michael Saunders: You have had a number of areas in which Government has sought to constrain itself, ringfencing and so forth. By and large, I think they have stuck to those so far. That is not to say that they would not always, but I take your point that a constraint

like that could be undone if a future Government wished to. It would just have to advertise the fact that it is doing so.

Q40 John Thurso: The total welfare budget is about £222 billion, of which about 45% is pensions and pension spending, and that is to be excluded, along with Jobseeker's Allowance, from the cap. How sensible is it to kick off with a cap that excludes broadly 50% of expenditure in that area?

Michael Saunders: I am not sure. I don't know. I am not enough of a pensions or welfare expert to give you a good answer on that.

John Thurso: Perhaps I can move to you, Mr Mortimer-Lee.

Paul Mortimer-Lee: If you are going to have a cap you should try to cap those things that you can control and don't cap those things that you can't control. In terms of Jobseeker's Allowance, you can't control precisely how many unemployed people there are going to be, so you should not try to control that. To some extent, people's decisions about retirement are also out of it. It may be sensible to start small and then think about where you are going to go over the longer term. For some of the longer-term choices, in a way by focusing on a number I think you are going to bring into sharp relief a choice between welfare spending and spending on current goods and services by Government as we come to future consolidation because people are going to say, "Some of the departmental spending is going to be cut by 30%-odd. Shouldn't we cut the welfare budget?" In a way, I can see that this is going to lead to much more political consideration or consideration in society more broadly about how much we spend on these items of welfare, and clearly these items of welfare may be more touchable, more politically dealable with than pensions and Jobseeker's Allowance. It may well be that it is not what it does today but the debates it leads to in the future that influences the dynamic of total Government outlays.

Q41 John Thurso: Can I take you to one aspect, which is tax credits and take you back to some of the comments you were giving in answer to Mark? Tax credits, of course, are designed as a feed-in benefit to enable people in work and to encourage people, brought in in 2001-02 or thereabouts, from memory. It is now the single largest benefit within the cap area. It is the single biggest lung. Going back to that conundrum on labour market and supply, to what extent is tax credits creating anomalies in labour supply by basically subsidising cheap labour that ought to be being paid in a proper economy via the actual labour cost rather than through a redistribution?

Paul Mortimer-Lee: If these individuals have low productivity and therefore would be able to access only a very low wage or no job at all, is it better to subsidise those people to be in a job or should we allow them to be unemployed? My own view is that it would be better for low productivity individuals that we subsidise them and encourage them into employment when otherwise they might not be employed. I think that has lots of desirable

social consequences and there is also a strong argument for encouraging that to build up experience and human capital over a period.

Q42 John Thurso: I think the point you are making is that by helping people in this way you lead to them becoming more productive more quickly than if you were to take a much more puritan view of it.

Paul Mortimer-Lee: If you take a much more puritan point of view, they might be unemployed for a very long time and therefore end up with no skills whatsoever. I think that would be a poor outcome for them and for society.

Q43 John Thurso: Given that I think we are all agreeing that it is a better way to do it, what is the sense, as the economy rises and more people come into the lower level of unemployment and therefore potentially earn those credits, of having a cap the largest element of which—I am trying to get my head round it.

Paul Mortimer-Lee: At the end of the day, the state has finite resources and if you put in a cap then you force the choice. If you want to do more tax credits, which is fine, what do you want to do less of, or if you want to do more of something else, do you want to do less tax credit? In a way you are forcing policymakers to make the choice that is real. That is the choice the state has. It cannot do everything it wants. It has to prioritise and putting them in a cap says, “Prioritise your welfare spending, please”.

John Thurso: On all accounts, let the voting pensioners off the hook.

Paul Mortimer-Lee: I think I will stop there. I couldn’t possibly comment.

Q44 Mr McFadden: I would like to ask you a question about the macro position and then one about the pension situation. Let’s start with you, Paul. The UK’s public sector net debt is projected to be around 74% of GDP in 2018-19, towards the end of the forecast period. If you look at the long run on this, debt has gone up and down, and we are talking about decades back. Do people in your position take a view of there being an ideal number here? Is it correct for the Government to pick a target that is presumably below that level?

Paul Mortimer-Lee: Any number is essentially arbitrary, but we do see in the past when gross debt in many countries has exceeded 90%, 100%, there tended to be adverse impacts on productivity and potentially adverse impacts on financial stability as well. Clearly there is also a limit on how much the Government can then respond to any future cyclical downturn. At the moment, I don’t think we have very much room to respond to a big cyclical downturn because debt to GDP is already very high. My view would be that a slow reduction would be quite desirable. I do think that the kind of figures that we had before the great recession seem sustainable and is something we should aspire to. I would not pick an arbitrary number at all.

Q45 Mr McFadden: The Chancellor says that Britain needs to run an absolute surplus in the good years. An absolute surplus has been relatively rare in any given year if you go back. Is that a good policy aim for UK politicians to unite around or is that something that bears a little bit more debate?

Paul Mortimer-Lee: I would want to see the debt to GDP ratio going down, so in a sense if we have got 2% growth, 2% inflation, 4% nominal GDP growth, if we get much below 4% we will be going down. Then the question is how quickly do you want to go down? Do you want to ensure that the momentum is maintained even in the bad years? If you want to maintain a downward momentum even in the bad years, a high debt to GDP level would be desirable. You don't want it to blow up from here. That means in the good years you have to run a much better fiscal position. If I said, "On average in a bad year I still want to go down, I want to have a deficit to GDP ratio of 3%, so what do I need to run in a good year?" I think a margin of 3% broad balance or a surplus is reasonable on that basis. You have to start off with an expectation: what do you want to do even when things are quite adverse, not mega adverse but quite adverse? Is it reasonable to want to still be going in the right direction? I would say yes and, if that is the case, somewhere close to balance or even a surplus I think is fairly reasonable.

Q46 Mr McFadden: Thanks. Mr Saunders, is there a magic number on total country debt and is this surplus a good thing to be aiming for?

Michael Saunders: No, there is no magic number. I think lower than where we are is desirable. You can see that the UK was able to absorb a massive recession and a massive rise in public debt without long yields rising significantly. I think that is partly because we started at a lowish debt level. I agree with Paul totally.

Mr McFadden: We went into the crisis with the lowest debt level in the G7, according to the budget.

Michael Saunders: Correct, but then I think we probably had the biggest rise of any of the G7 countries. I agree with Paul that aiming for something like a cyclically-adjusted balance in the next period from what is currently a high debt level probably is a sensible aim, because then we will at least have the prospect that we will get our debt level down to a position where we could hope to absorb a further shock if one were to happen.

Q47 Mr McFadden: Mr Wood, do you have the same view as your colleagues?

Robert Wood: More or less. No magic number. Yes, you need to run a better deficit position than in the past, given where debt starts now. The two things I would highlight are that I am not so fixated on a particular surplus or deficit number. The key thing to think about is how long is it reasonable to take to get debt to GDP down to 60%, 50%, 40%, whatever the better number is? Do you want to do it over 10 years or 15 years, in which case you need to run a surplus, or do you want to take 25 or 30 years? If you take much longer, the key thing with the public finances is that you start to hit the problems of an ageing population, health spending rising, pension spending rising, and that is in the

OBR's longer-term outlook. I think that is part of the reason why it might be an urgent pressure now to prepare for the future increase in pressures on the Government finances from about 2030 to 2035 when that really starts to pick up.

Q48 Mr McFadden: Let me ask you a slightly different question than the one you just posed about a rising pension population. For the pension changes in the budget, from where you guys are sitting—and I will start with you, Mr Wood, this time and go the other way—what are the sort of economic impacts of the changes that the Chancellor announced on allowing people to find contribution schemes to draw down their whole pot if they want to? What might the impact be on consumption, different financial products or on markets? What are people in your world thinking about these changes?

Robert Wood: On growth, on how it affects the economy, I would say on balance I would expect pensioners to spend a bit more because they are now freer to access the money and I would expect that to mean faster drawdowns of the pensions or earlier spending of the money. I would also expect it to increase saving of current working age people, because you now know you have more choice over where to shift your funds when you are retired and what you can do with them rather than being forced into an annuity. On balance, I think it would be a small positive for consumption. Frankly, I don't know how big the number would be but I think directionally it would be positive for consumption.

Mr McFadden: At the moment, £11 billion of annuities are bought every year.

Robert Wood: So a little under 1% of GDP. In terms of financial markets, I guess one key question is how much money flows into the housing market in one way or another now these funds can be allocated to different investments other than just annuities, and of course the gilt market. The final thing I would point out is that infrastructure spending is one thing that exercises a lot of people, given that part of the plans for the next few years was to have the providers of these annuities, these pension providers, allocating funds to help infrastructure. This money won't just disappear—people currently have a lot of money invested in annuities—but it does mean that over the next 20 or 30 years, presumably as flows into annuities fall, that pot of money available will also become less significant.

Q49 Mr McFadden: Are you saying that there might be an issue here with Government saying to pension funds, "We want you to invest in long-term infrastructure" while at the same time instituting a change that takes away the funds for that to happen?

Robert Wood: Yes, that is exactly what I am saying, but what I would also add is that it does not take away the funds right now. It cuts off the extra flow into these funds. There is still a lot of money invested in annuities right now but obviously the flow into it will fall over time.

Q50 Mr McFadden: Okay. I have got you. Mr Saunders, what is your view of these changes?

Michael Saunders: I agree with most of that. I think the effects near term on the economy are small but they build over time because most of the DC schemes are not yet at the point where people are retiring off them. You can see that the flows out of them would be much larger if you go forward 10 or 20 years. One of the interesting questions is going to be the extent to which people seek to migrate from defined benefit to defined contribution, and if that happens then the effects could be larger.

Q51 Mr McFadden: The Government is being cautious about that. We talked about the £11 billion a year. There is over £1 trillion invested in DB schemes. If there is a rush to the exit from that, what might the effect be?

Michael Saunders: Then it would be basically the same effects on flows by fewer annuity purchases, potentially more spending, but on a much greater scale, because in aggregate the DB pension schemes are closer to maturity and obviously much larger than the DC schemes.

Paul Mortimer-Lee: I agree with most of what has been said. There may be an incentive for people to save more eventually. I agree that there will be a short-term boost to demand and to tax revenues. Longer term, people may actually save more. One of the questions I have about this is in the past you got a tax break and the quid pro quo was you had to invest it in a pension in the form of an annuity. Now that you don't have to invest in an annuity, what is the rationale for the tax break? What makes this form of saving tax privileged? I think there are a number of questions that are raised. One is DB versus DC schemes and the other is why are we tax subsidising this form of saving and not all other forms of saving?

Mr McFadden: I think that was a question raised by the IFS and they are up next so maybe we can pursue it with them.

Paul Mortimer-Lee: The other thing I worry about is whether there will be financial innovation where people try to get people to take their cash out even earlier, so borrow on the back of you are going to get a great big lump sum when you are 55 but take it when you are 50 or 48. That is a worry, I think.

Chair: We are going to be looking in more detail at this. If you have further thoughts on any of the questions that have been raised or you feel we have not asked the questions you wish you had been asked, do drop us a line. We are very receptive to further written evidence, but we are on a tight schedule today. Thank you very much, all three of you, for coming in.

Examination of Witnesses

Witness[es]: **Paul Johnson**, Director, Institute for Fiscal Studies, and **Gemma Tetlow**, Programme Director, Pensions, Savings and Public Finance, Institute for Fiscal Studies, gave evidence.

Q52 Chair: Thank you very much for coming in. You have provided a great deal of very interesting information, as the IFS has historically over many years, prior to and since the budget. In your presentation on the budget you noted that the long-term fiscal position of the UK has been weakened by what you described as permanent tax giveaways funded by what you called “unspecified spending cuts and temporary increases in tax revenues”. What did you mean by that? It does not sound very good news for your view of the robustness of the Chancellor’s arithmetic.

Paul Johnson: I think it is important to put it in context in the sense that the changes in the budget were pretty small in the total scale of the planned consolidation, but there were some tax reductions, particularly the increase in the personal allowance, which are permanent, and a restatement of some increases in spending, for example on child care. In the scorecard you see increasing revenue from, for example, the pension changes that you were just discussing and one or two other tax changes, including the short-run voluntary NICs payments. These things balance out in the scorecard but the increased revenue runs out pretty soon after the end of the scorecard, and indeed goes negative, while the reduced taxes or increased spending are permanent. Obviously they can be changed but it is more difficult to change these things once they are there. But as I said, these are a few billions out of the still £100 billion-odd of borrowing we are doing.

Q53 Chair: They are not serious enough concerns for you to want to challenge the Chancellor’s statement in his budget that he had not been tempted to squander the gains from a recovering economy and improve borrowing forecasts. Is the Chancellor being as prudent as he claims?

Paul Johnson: Again, I think the differences are small but I think he is not being quite as prudent as that might suggest. I do not think this is an entirely neutral budget. One reason for stressing that a little more than we might otherwise is that rather similar things have been done over the last budget and autumn statement where we have seen, for example, one of the biggest, contracting out for employer national insurance contributions, will cost the public sector around £3 billion a year. That was scored as additional revenue and the assumption is that they will just be additional spending cuts. It is something that has happened two or three times. You begin to add those up and it begins to make a noticeable difference.

Q54 Chair: A crucial way of looking at the extent to which the Chancellor is being prudent is to assess his performance against his own fiscal mandate. The fiscal mandate in turn is derived from an OBR estimate of, among other things, a rather arbitrary judgment—certainly it is a very difficult one—about the size of the current deficit or surplus. Given how difficult that is and that the Government is now reviewing the fiscal mandate, do you think the cyclically-adjusted current budget target should remain part of the mandate?

Paul Johnson: It is a difficult one. I think it is appropriate to think about your fiscal position in the context of where you think you are relative to the cycle or relative to the output gap. Clearly, if you are simply outbalanced, if you think you have a massive negative output gap, you are well above trend, then that is not a long-term sustainable position. So you do need to take a view on that. In one sense you need to do it, in another you need to be very aware of the considerable uncertainty that exists around it. I think it is quite interesting that while the fiscal mandate still exists, and the Chancellor refers to it, he is referring more and more to his aim of getting to actual simple budget surplus by 2018-19, which is not directly related to the level of the output gap. We will be doing some additional work and thinking about what the fiscal rules might be going forward, but there are balances between uncertainty on the one hand and the need to have an output gap measure on the other.

Gemma Tetlow: The only thing I would add to that is, as Paul said, there are good reasons for not worrying about the bits of borrowing that are purely cyclical and temporary. In more normal times, this distinction becomes less important. If you are in a small recession or you are in a small boom, then well within the five-year forecasting horizon you would expect the economy to be back at its trend level again and, therefore, the cyclically-adjusted measure is exactly the same as the headline measure. The reason that the cyclically-adjusted measure was an important part of the fiscal mandate four years ago now is that we were forecasting a very long period of below potential economic activity. Therefore, there was a difference for all five years of the forecast horizon between a cyclically-adjusted measure and a headline measure. As we get back to a more normal operating position, I think the distinction between the two becomes a lot less important and it is a lot easier simply to think about the headline measure.

Q55 Chair: There is going to be a lot of focus on this over the next few years, not to mention in the general election, given that the two parties have a different view about what they want to achieve, a point that you also flagged up in your pre-budget presentations. The OBR, from what I can tell—and I am looking now at page 156 of the *Fiscal Outlook*, table 4.39—seems to be suggesting that the surplus of the current budget, on the basis of their own forecasting, is going to be £30 billion. The Shadow Chancellor's stated position, as you put it in your presentations at any rate, is that he does not want a surplus. He wants a balance over the same period. Is that correct?

Paul Johnson: My understanding of what the Shadow Chancellor said back in January, that he was looking for a balance or surplus on the current budget at some point through the next Parliament, does, on these numbers, suggest that he has left himself with £30 billion of additional room for manoeuvre relative to where the current Chancellor is. The Shadow Chancellor has made it clear that he has not set out a specific target and he may want to over-achieve on that, but that is the constraint that he has publicly announced.

Q56 Chair: You said a moment ago, on the relevance and importance of this current measure, that you are doing some extra work on what the Government has put out in this field anyway.

Paul Johnson: Given that the Chancellor has said that he is looking at the fiscal framework, we will do some work over the next two or three months to look at some of the options that might be open to him.

Q57 Chair: One more question, which goes back to the point about how credible the forecast is over the longer term. In your own *Green Budget* publication on page 40, table 2.4—you might know all this so well that you do not need to look it up—you have a set of numbers showing how difficult it is to maintain strict discipline on public expenditure while at the same time ringfencing nearly half resource DELs or departmental expenditure limits. A key question has to be: is it realistic to believe that a Government can deliver these numbers, given that the denominator is shrinking every year from which you have to take further cuts?

Paul Johnson: That is a difficult question. What we have done there is take the numbers from the autumn statement. We have assumed that all of the tightening that needs to occur will happen through departmental spending. For example, we have not factored in the £12 billion of additional welfare cuts the Chancellor has suggested and we have not factored in potential tax increases. There are options open to Governments that want to meet that same target.

In terms of the scale of the cuts, if you make those assumptions then the cuts are more than a third between 2010 and 2018 in non-ringfenced departments. The difficulty, of course, is that the biggest ringfence is around the Department of Health and our other calculations suggest that, once you look at health spending on an age-adjusted per capita basis, that is falling by around 9% over this period.

The two bits of unringfenced spending that are genuinely more significantly protected are obviously the overseas development spending and school spending, which is not constrained in quite the same way that health spending is because we do not have quite the same demographic change that schools are having to deal with at the moment that the health service is having to deal with at the moment.

Q58 Jesse Norman: Obviously you will have heard the discussion we had on the outward cap earlier. Do you share the view that the volatility of policy is somewhat increased because we are at the zero band on the monetary side? We are in more of a toggle where there is a tremendous incentive to keep everything slow and gentle economically, because of the worry that a shock would cause people to suddenly change expectations, and that the reason why you might get a sudden change is because we have burnt the furniture and we are at the zero band of monetary policy.

Paul Johnson: That is clearly a constraint on the kinds of policy that people can pursue. There are clearly concerns about what would happen if interest rates were suddenly raised,

given the condition of the economy, and it clearly puts a lot of additional pressure on the fiscal side. I am not sure whether it makes the policy any more volatile.

Q59 Jesse Norman: Very quickly on the same related issue, do you also share Michael Saunders' analysis that the delay in the fiscal tightening until later in the next Parliament creates political risk?

Paul Johnson: Gemma might say something about exactly what that delay is. It is clear that there is a large amount of consolidation still required in the next Parliament. Beyond 2015-16 we have not heard from this Government what exact spending cuts they would introduce. We do not know what the Opposition would do. That is kind of the position we were at in 2009-10 before the election, but clearly that there are three years of very big spending cuts pencilled in and we know next to nothing about what they will look like.

Gemma Tetlow: The only thing I would rephrase slightly about how Michael Saunders described that pace of the tightening is he was talking about the changes in the structural primary balance, which is one way of looking at it. If you think instead about what active policies have been introduced and are planned, the current Coalition Government has stuck to its plan for the tax increases and the spending cuts it was going to do in this Parliament but, in a sense, the size of the problem that they have been faced with has been revised over time. They have tacked on to the end of it additional cuts to come in the next Parliament.

The pace of policy change has been as planned over this Parliament. It is just that there is more needed and further to go in the next Parliament and perhaps that makes sense if you think there was a trade-off between the amount of policy action you can do versus the effect on the macro-economy in the shorter term. It makes sense if the problem is bigger to take longer to deal with it, but it does mean that there is more left somewhat unspecified in the next Parliament.

Q60 Jesse Norman: Also, just to pick up the Chairman's point, it puts a further squeeze given the amount of ringfencing already apparently being planned.

Gemma Tetlow: Certainly the default currently in the plans is that that further spending cut that is planned in the next Parliament comes from departmental spending because we have not yet heard any explicit further welfare cuts or tax increases but, as Paul said, a new Government after the next election could choose to shift that mix a bit and take some of the pressure off departmental spending.

Q61 Mr McFadden: Can I pick up on where we left off with our previous witnesses, which was on the budget and pension changes? I will start with you, Paul. First of all, what are the fiscal implications of what the Chancellor announced?

Paul Johnson: I think relatively small. The scorecard suggests an extra £1 billion or £1.5 billion of revenues in the short run. The OBR document makes it very clear there is a huge amount of uncertainty about that and that depends on fairly unknown assumptions about how pensioners will behave: how much they will draw down early or the extent to which

they will, nevertheless, buy annuities or not. If you take those forecasts, in the long run—and I think this is after about 2030-something—you get a reduction in revenues as the income is used up a bit quicker. I think the answer is the fiscal implications are probably small; probably positive in the short run and negative in the long run.

Q62 Mr McFadden: Let me just get this straight. You are saying in the short term, as people probably draw down more than they would have and spend more than they would have, there is a short-term boost to Government revenues, but in the longer term there may be less for exactly the same reason, namely that the money is no longer there in the future?

Paul Johnson: Yes, that is what the OBR numbers suggest. As I said, they are very clear there is a lot of uncertainty around that. Something of that kind one would expect. How big it is, that is uncertain.

Q63 Mr McFadden: Can I then ask about the tax implications, as distinct from the fiscal implications? Our previous set of witnesses raised a question, which I think you did in the immediate post-budget presentation that you did, of whether these changes raise the question of how the taxation of pensions should be treated. I will start with you Gemma. Could you expand a little bit on that and explain to us why you think this raises this question of how pensions should be treated tax-wise?

Gemma Tetlow: Pensions are, in a number of ways, more tax-favoured than many other types of saving. One of the justifications for that might be that people are giving up some freedom by saving into a pension because they were required to take an annuity. Clearly, the set of changes reduces the restrictions on people's behaviour, although it will still be the case that they cannot access this money until they get to 55 at least.

The thing to be clear about is exactly what we mean by the more tax-favoured bit of pension saving. You do not pay any tax on your contributions to a pension. You do not pay any tax on the investment returns in your fund, but then you pay tax on the way out. Most of that we would not think of as over-generous tax-favouring of pension saving. There are strong reasons, as outlined in the *Mirrlees Review*, for not taxing the normal return on savings and ISAs have a similar feature, although they are taxed and then exempt in the two other places.

It is not that bit of tax treatment of pensions that we were focusing on as being more generous than other forms of saving. It is other elements, such as the fact that employer contributions to pension schemes avoid all national insurance contributions as well, which obviously never get charged on the way out either, and the fact that you can take 25% of your pension fund completely tax free. That is 25% that never gets taxed at any point. It is those elements that seem much more generous relative to any other form of savings vehicle that you could think of.

Q64 Mr McFadden: Is a simple way to put this that these changes will make the savings that you get in a defined contribution scheme much more similar to other types of saving and therefore they should be treated, tax-wise, like other types of saving? Is that a reasonably way to sum that up?

Paul Johnson: Sort of. Not in the sense that we think they should be treated like money I stick in a bank account or if I just go out and buy shares, because they are taxed very heavily. We would not suggest that—

Mr McFadden: What about the money I stick in an ISA?

Paul Johnson: —pensions should be taxed very heavily. They should not be taxed twice. It is just that they should be taxed once and, as Gemma said, the case for taking a quarter of it up to £300,000 or something, completely tax free—never been taxed on the way in, not taxed when it is there, not taxed on the way out—has always looked a little difficult but, given that you can now take this as a lump sum anyway and pay normal tax, the case for that is probably reduced. I think it is important to be terribly clear that we are not suggesting with any of this that we want to move away from or that the Government should want to move away from exempting from tax contributions on the way in because that is just part of a—

Mr McFadden: Exempting pensions from tax contributions.

Paul Johnson: Exactly, because I think that is just part of sensible system for taxing savings; you are only taxed once and you are taxed on the way out. That seems like an appropriate way of taxing savings.

Q65 Mr McFadden: In your submissions and evidence you said there are two good public policy reasons to incentivise pension saving, which is to prevent people unintentionally under-saving or to prevent people from falling back on to means-tested benefits because they have not made sufficient provision during their working lives. Do the new reforms to the state pension make a difference to those reasons? Do they reduce the worry about means testing in the future and, if so, in what way?

Gemma Tetlow: The reforms to the state pension are intended that, once it is fully in place, virtually everyone will qualify for a single-tier pension that will be slightly above the level of pension credit. That does mean it slightly reduces the number of people who would be expected to end up on means-tested benefits in retirement relative to the current system. However, it does not mean that no one is likely to end up on means-tested benefits.

Importantly, pension credit is not the only means-tested benefit that many pensioners qualify for. A lot also qualify for housing benefit and council tax benefit, which continue much further up the income distribution than pension credit does. The Department for Work and Pensions, for example, in their impact assessment for the single tier reforms, estimated that by 2060 under the single tier system about 15% of pensioners would still be eligible for some form of means-tested benefit and that excludes council tax support.

Q66 Mr McFadden: So there is still a taxpayer interest in the behavioural consequences of this change?

Gemma Tetlow: Certainly, yes.

Q67 Mr McFadden: The Government has been cautious about the switch from defined benefit schemes into defined contribution schemes as a result of this. If the argument here is “trust people with their own pot of money”, which is how the Government has advanced this in the last week, why does the same logic not apply to the money that has been saved in defined benefit schemes?

Paul Johnson: I think part of the issue there is that, from the beginning of the defined benefit system, you have risk sharing. For example, if I hit 60 and I am pretty ill and I think I am not going to live terribly long, I have a very big incentive to take my money out of the DB scheme and make use of this ability not to have to buy an annuity. If I do that and my DB scheme is funded on the assumption that a proportion of people will die early, which they are, then that requires additional contributions from everyone else or reduced benefits; probably additional contributions.

There is a danger of undermining the funding structure of DB schemes if you allow those who will benefit most from not having an annuity or a pension to move out early. I can understand the caution here because I think you do risk the schemes being selected against by those who do less well from the schemes. I think that is a fundamental part of the risk sharing that defined benefit schemes provide.

Q68 Mr McFadden: That is an interesting reply. The final question is, if the argument is to trust people with their own money, what is the logic of auto-enrolling people in a pension scheme in the first place, which is almost a form of enforced saving?

Paul Johnson: I think it is an interesting question. There is a move towards a little bit more paternalism on putting the money inside and a little bit less paternalism on taking the money outside. It is not compulsory. As you say, it is soft compulsion.

Mr McFadden: It is not compulsory, but it is a pretty heavy nudge.

Paul Johnson: There is clearly a judgment to be made there. I think the judgment that the Government is making is that you need that automaticity of saving—and you can pull yourself out if you want—just to ensure that people do what is easiest and then they are forced to make a choice at the point of retirement.

Q69 Mr McFadden: I do not understand why there should be a different approach. If you are trusted with your money, why are you not trusted with your money when you are young?

Gemma Tetlow: There are perhaps two potential reasons for auto-enrolment. One would be that people are very short-sighted. Therefore, even if it is quite easy for them to make

the choice to opt into a pension, they do not see the benefit of it because they discount the future.

Mr McFadden: Exactly the argument why it was brought in.

Gemma Tetlow: The second perhaps would be that it is quite a lot of hassle to get yourself organised with a pension. If the default is that you are making those contributions, it removes that hassle factor from you. To get rid of the requirement to buy an annuity later on, I think you would have to believe that people are somewhat less short-sighted at the age of 55 or certainly less short-sighted about the end of their lives at that point.

Chair: Which they may well be.

Gemma Tetlow: Which they might be.

Q70 Mr Love: We said earlier on in our previous witness session that having done away with the requirement to have an annuity would call into question the tax advantage. If that happens in the longer term will we have a complete review of tax-preferred savings? In other words, will pensions and ISAs and other vehicles for tax-efficient savings merge? Will we move away from having pensions as a favoured treatment and move towards something much more comprehensive in terms of choices that you may have and ways that you can save that are not particularly related to retirement but hopefully will provide an income in retirement?

Paul Johnson: I do not know whether we will. I think it is an interesting question, though. We saw quite a big overhaul of savings taxation in the budget. We have been talking about the pension changes. We also saw an increase in the ISA limits and an increase in the amount of cash you can save through that. You can think of those systems being brought a little bit closer together because you can put more into the ISAs. You no longer have to annuitize the defined contribution pension. There is still a significant difference, which is that one, the ISA, is taxed upfront and not taxed on the way out and the other is not taxed on the way in but is taxed on the way out. To unravel those would be a big change and not one I think you would want to achieve.

If you wanted to do what you are suggesting then the obvious thing to do would be to bring down the point, from 55 down to 50 or below, at which you can access your pension. I think what the Government has said is they are going to consult on increasing that in line with the state pension age. That would suggest to me that that is not what you have suggested, which is, as I say, very interesting. It is not what they have in mind because they have said very clearly they are going to consult on increasing the age at which you can do it rather than reduce the age at which you can do it.

Q71 Mr Love: Let me just follow this for a second, because one of the other things that was said in the previous witness session that I found interesting is the innovative nature of drawdown vehicles. In other words, people in the City would invent a vehicle, on the basis that you had this pot for your pension, that allowed you to drawdown even earlier than 55,

perhaps 50 or 45. Will the innovation in the marketplace force Governments to consider how they tax advantage savings and move them into line in a way that you are saying is not conducive at the present time but may well work out as being a pressure on them to equalise the different savings products?

Paul Johnson: I do not know the extent to which that is likely to happen, to be honest. I am not expert enough on how these products are designed. I was not clear about what I heard from the previous witnesses. I presume the sort of thing they have in mind is using that asset as collateral against some kind of borrowing or as collateral against a mortgage or something. That happens to some extent anyway. I guess that may become more common, but I do not know.

Chair: That was a very interesting set of exchanges there.

Q72 Mr Newmark: There seems to be some sort of consensus developing, if I can use that word, between the various political parties on the need for a welfare cap or somehow getting welfare under control and the Government has now provided more detail on what they view as the overall envelope of a welfare cap. Do you think that will improve policymaking in the future?

Paul Johnson: There are a number of points here. One is that it is interesting looking at the cap and the amount of forecasting room around it, which does not grow as you go out. It is about 2% or 2%-and-a-bit each year into the future. You would expect the uncertainty to grow over time. Potentially at least, the tightness of this cap will be bigger over time or it may turn out to be very loose, because there is quite a lot of uncertainty about where we will be in 2018, for example. I suspect setting it five years ahead with a fixed 2% to 2%-and-a-bit forecasting margin around it will not last.

For example, in 2016, if it turns out that the forecasts are much lower than they are now, I would expect a future Government to tighten the caps. There is a set of uncertainties about exactly how it will work in practice. I think the positive aspect of it is that in times past we have seen unplanned, very substantial growth in some bits of social security. Think about housing benefits at some points or you think about disability benefits at other points.

Q73 Mr Newmark: All right. Do you think there is a lack of flexibility in the system in itself? Do you think there should be caps on individual areas within welfare?

Paul Johnson: This is the question that the cap raises. You can imagine a world in which one benefit, say personal independence payments, starts rising much quicker than expected but that is offset, for some reason, by some reduction in housing benefit or tax credit. If that happened, the cap would not bite and that would not force any policy change, but you might think that you want to be thinking about each individual benefit and what the appropriate structure and spending on those is. Having the cap here will force more active decision-making than perhaps the current structure has force, but within this slightly strange systems where caps are—

Q74 Mr Newmark: Just to understand, are you saying that the welfare cap itself is not structured in a granular enough way to give it flexibility, or do you think it is too broad and, therefore, it does not matter if you get a little rise in one particular benefit as long as there is an adjustment on the other, or would you like to see a cap in housing or a cap in some sort of child benefits or whatever it might be?

Paul Johnson: As ever, there is a trade-off here. The current cap is potentially very flexible if different things are going on with different bits of the system, but very inflexible if everything is moving in the same direction or if the forecasting error turns out to be significantly more than 2% four years out. There is clearly just a trade-off between where you put that flexibility.

Q75 Mr Newmark: The welfare cap excludes the state pension. Do you agree with this exclusion?

Paul Johnson: It is not clear what the benefit of putting the state pension in would be. The state pension is completely uncontrollable unless you think you are going to renege on previous promises or you are going to adjust, year by year, the rate at which you increase the state pension. If you put the state pension in you are, I think, suggesting that you would consider adjusting the state pension and that is just a policy decision for Government, whether they think that is an appropriate thing to do.

Q76 Mr Newmark: In the *Green Budget* you note, "A mechanism forcing the Government to assess its policy on state pension spending might be beneficial". Can you explain your rationale for that?

Paul Johnson: For example, if you are thinking about the way in which you are indexing the state pension, clearly the triple lock is a more generous indexation structure than one that is not a triple lock. You certainly will want to think about what the cost of that is going forward.

Mr Newmark: I would ask how much more time I have, Chairman, before I ask—

Chair: One more, Brooks.

Mr Newmark: Is that it? Okay, fine, because I have three. Thank you, Chairman; generous, as always.

Chair: Have a couple, Brooks. Have a couple.

Mr McFadden: Keep going, Brooks.

Q77 Mr Newmark: Let us deal with this thing. In the US when they had their debt ceiling and they broke it and everything else, we saw the way the market reacted and so on. The consequences of breaking the welfare cap: there does not seem to be a deterrent unless you look at political stigma. Does the Government have a credible plan on how to

reduce welfare spending should it reach a cap, for example if a disaster happens, we have another crisis in Europe, Russia invades Ukraine and moves on to the Baltic States and the gas dries up and everything? What happens then?

Paul Johnson: I think there are two questions in what you were saying.

Mr Newmark: The second bit was facetious, by the way.

Paul Johnson: Well, not entirely. In normal times all you do have, I think, is political stigma and sometimes that works and sometimes it does not. We have a child poverty target that nobody is taking terribly seriously, quite honestly.

Mr Newmark: That is an example of an aspiration as opposed to real cap.

Paul Johnson: It is supposedly to be legislated. Similarly, there was a debt target, which is going to be missed. These things do not appear to have had an enormous amount of bite. This may have more bit but I think there are two issues. One is it would be nice to know what sort of response a Government might have if you are moving in that direction.

The second one is, if we did fall into some significant additional recession—and we know that, while the Job Seeker's Allowance and particular bits of housing benefit are clearly driven by the cycle, other bits of the benefit system are not invariable to the cycle and might rise in the circumstances that you are describing. The question is—and I do not know the answer to this question—suppose that were to happen, would this cap bite or is this a cap only for normal times? I presume that the Chancellor will say this is a cap for whatever times, but it would clearly bite much harder if we were to move into a substantial recession than under normal circumstances.

Q78 Mr Newmark: Gemma, you are nodding. Do you have any thoughts? It is not a vote. It is just prayers. Your time is up. My time is up. Sorry, Gemma, you were just saying.

Chair: Carry on, Gemma.

Gemma Tetlow: We did try to look a little bit at how binding this 2% forecasting margin is and the one time that it would have been breached in the last few years is, between the 2011 budget and the 2012 budget, there was a reasonably significant downgrade in the economic forecast from the OBR. That led to the forecast for welfare in scope spending in 2015 being more than 2% higher in budget 2012 than it was in budget 2011. That was a reasonably significant revision to the economic forecast, but not a large recession. That sort of scale of change could cause a breach in this.

Mr Newmark: Thank you, Chairman. I will call it a day.

Q79 Teresa Pearce: On the welfare cap, to just have a cap on welfare without other corresponding policies that would pick up consequences—what I am thinking of is within the welfare cap there are things that cannot be controlled without other policies coming in. For instance, there

is housing benefit. Unless you can control rents, how can you control the housing benefit budget?

The other thing that concerns me is that within the welfare cap there are things that it might be very sensible to spend on such as carer's allowance. It would be much more sensible to spend the welfare budget on carer's allowance than for people to go into care homes, which would cost the taxpayer so much more. Do you have concerns about the cap alone being quite damaging to people's welfare rather than it being part of a holistic group of policies?

Paul Johnson: You are right that, as there are boundaries between the health and social care budgets, I think there are boundaries between things like the carer's allowance and social care budgets and, as ever, considering these things entirely in isolation can result in unintended consequences. It will be important within that cap to think very carefully about the consequences. In terms of things like the housing benefit budget, I am not suggesting it will be the appropriate thing to do but it clearly is possible within that, as this current Government has done, to change the rules to reduce the amount that you are spending.

Whether you would want to change the rules just because higher levels of low income had resulted in more people coming on to housing benefit; you might want to respond to that differently to where something was going up because rents were rising much more quickly than you expected. This is a very top-level cap. It would be very nice to see more detail underneath that about some of the ways in which you might respond.

There is a lot of flexibility within the budget. Some of that, as you say, could have unintended consequences elsewhere. The choices over all of the other benefits could range from, as the Government is doing at the moment, just not increasing things in line with inflation—that saves you a lot of money over a few years but hits absolutely everybody on those benefits—through to changing the structure of the housing benefit system, which this Government has done, through to responding differently to the way that rents rise.

This is a huge budget and so there are huge numbers of choices that could be made and I do not think we learn very much about what those choices would be from the simple fact of a cap.

Q80 Teresa Pearce: Do you think a cap is just a blunt instrument?

Gemma Tetlow: I will add to what Paul was saying. To the extent that this causes you, on an ongoing basis, to assess where welfare spending is going, and the OBR is, in fact, going to publish a report each autumn assessing changes to the welfare forecast and what is going on. To the extent that it causes you to have an ongoing review of benefit spending and to think about, "What is the level of this and how is it distributed and why has it changed since we last looked at it", I think that is a positive thing. Hopefully, it might cause you to make better policies because you look at this every year rather than suddenly realising that your budget has exploded in a way you did not intend and then trying to address the issue.

Q81 Teresa Pearce: I agree with what you are saying, that it makes you look at what is being spent and why and the reasons why and, therefore, you adjust the causes of the reasons. That is good. You are

talking about forecasts, but there are so many things in the welfare cap that you cannot forecast. There are bereavement allowances, for instance. You can't forecast how many people are going to die. You can't forecast how many people are going to need carer's allowance. Pensions are exempted and that is the one thing you can forecast. It just seems to me that it is the start of a conversation. It is not the end of a conversation and it is attracting a lot of attention without any of the detail underneath being properly understood.

Paul Johnson: I would entirely agree with you. It is the start of the conversation and it gives, as Gemma was saying, the push to that conversation. I think there are lots of actuaries who would disagree with you about the ability to forecast bereavement allowance, but anyway.

Teresa Pearce: Well, yes, maybe. Thank you.

Q82 Mr Love: I wanted to ask you whether there are obvious ways in which we can improve the debate that is likely to occur when they breach the limits, whether the forecast margin is set at an appropriate level. You mentioned 2012 as being a year where we would have breached that. Is that an appropriate margin at 2% and are there other changes that could make it a more effective weapon than having the debate about welfare?

Paul Johnson: As Gemma said, 2% is clearly a margin that will bite in not terribly dramatic times. I presume there is no point having a margin that is so big that is not usually going to bite and not have one so small that it bites every year. It is like the question about what is the right level of debt; I do not know what the right level of margin is.

In terms of the discussion we had earlier, I think what might make this more effective would probably be thinking about what sort of response you would have to what sort of change in the budget. I would like to get a sense from the Government of whether the intention is or is not that if one benefit is rising very fast it is the whole budget that will be looked at or whether it will be the single element that will first be part of that cap.

As I say, it is the start of that conversation and a conversation that at least has the potential to be helped by doing this. It has the potential to be hindered if then the whole debate comes back, "We have to get within that 2% margin even if something dramatic has happened that is going to make that incredibly difficult". Hopefully, with the OBR publications and so on we will have more openness about some of that.

Q83 Mr Love: It seems to me that the traditional view has been that when there is a recession the financials will change completely in terms of welfare. You indicated that if there was a recession it would almost certainly breach the 2%. Normally they allow the automatic stabilisers to work in those circumstances. This would probably suggest that they are not going to allow that to continue. As well as gaining a

debate about what we should do about welfare in those circumstances, do we lose something in terms of the economic impact of automatic stabilisers?

Paul Johnson: Possibly and maybe it is worth reflecting on the fact that fiscal rules tend to go straight out the window as soon as there is a recession. I would not be surprised if this kind of thing did, too.

Gemma Tetlow: Without the welfare cap you are supposing that the current structure of the benefit system is the appropriate automatic stabiliser to operate. It might well be that, depending on the type of recession you are experiencing, you might want to do more or less than that. The current benefit system may not provide enough of an automatic stabiliser or it might provide a bit too much. I do not think our benefit system is designed in such a way as to provide the optimal stimulus during a recession.

Q84 Mark Garnier: The zero rate personal allowance level has gone up to £10,500. Is this progressive or regressive?

Paul Johnson: It is the most progressive thing you can do with the income tax system.

Mark Garnier: The most progressive?

Paul Johnson: The most progressive thing you can do with the income tax system. It is clearly not the most progressive thing you can do with the tax system. As we have said, doing something with the national insurance floor would be more progressive from that point of view. You could do more progressive things overall with the benefit system. In terms of the overall effect, I think it probably regressive over the first half of it and then progressive over the second half of it. It helps people in the middle more than it helps people at the bottom or the top.

Q85 Mark Garnier: This is the problem, isn't it, with the people at the bottom end? If you are paid below £10,000 a year, it is going to make absolutely no difference to you whatsoever. Why do you think the Government is not tackling the national insurance contribution conundrum?

Paul Johnson: I am inclined to say you should ask them.

Q86 Mark Garnier: We did a few years ago because, of course, there was a review set up of some sort to look at doing exactly this and trying to work out if we could get rid of national insurance contributions altogether. I think the eventual conclusion was—and I think over many Governments, not just this one—that it is just too difficult to get rid of it. It is too complicated. Is this a genuine reason or do you think it is just people are not bothering over many years of talking about it?

Paul Johnson: There are two issues there. Under the last Government the point at which you started paying income tax and the point at which you started paying national insurance came very close together and so it was an active decision of this Government to pull them

apart again. Obviously part of the reason for that is to move both national insurance floor and the tax allowance up is even more expensive than just moving the tax allowance up.

There are clearly some people who gain from the increase in the income tax allowance who would not gain from the national insurance floor, those with unearned income who are not paying national insurance, and that would be true for pensioners after it passes through £10,500 where the pensioner allowance is at the moment. You are affecting slightly different groups and you may have a slightly different distributional focus, but I suspect it also has something to do with the salience of the income tax system relative to the national insurance system.

Q87 Mark Garnier: There are a lot of political parties talking about increasing this tax free allowance to £12,500 and some talking about it introducing a 10p tax rate, presumably as a starting rate as opposed to whatever. What would be far more progressive would be to raise that starting point of national insurance and forget, for the time being, doing anything with the base allowance. Would you agree?

Paul Johnson: That is right. Yes, I agree.

Q88 Mark Garnier: Could I turn to the higher-rate tax threshold, which is now £42,285 by 2015-16. That is going up, isn't it? It has gone up by 1%, but more people are being dragged into it. I think you estimate that 400,000 are being dragged into it but that is because these people are getting paid more and are catching up with it, rather than it coming down, isn't it?

Paul Johnson: It has come down significantly since 2010, but not in a way that has made anybody worse off, no. It has made people worse off if they are earning more than £120,000, and significantly worse off, but for other higher-rate taxpayers essentially what the Government has done is to ensure that they are either not gaining or not gaining more than basic rate taxpayers when the personal allowance has gone up. I think it is important to be clear. A lot more people are paying higher-rate tax. The point at which you start to pay higher-rate tax has come down, but that has not resulted in most higher-rate taxpayers being any worse off. It has just prevented them from gaining from the increase in the personal allowance.

Q89 Mark Garnier: The corner we are all in together is absolutely the case up to £120,000 and if you earn £120,000 to £150,000 you are more into it together than anybody else and after that you are less in it together.

Paul Johnson: Well, it depends what your baseline is. Certainly those earning over £120,000 have lost something like £1,100 a year, if my recollection is correct, from the tax and national insurance changes. Those between about £40,000 and £120,000 are essentially unaffected from the main income tax changes and those who are base rate taxpayers have gained about £500 a year from just the income tax changes. There is a

series of other things going on as well, of course, but from just the things we are talking about that is the pattern.

Q90 Mark Garnier: Do you think this is going to cause any problems? Do you think it is going to stifle ambitious or stifle people's enthusiasm to work harder, put more hours in and to go across the tax threshold or do you think it will make no difference?

Paul Johnson: It is important to be clear that you are moving essentially from 32% tax and national insurance to 42% tax and national insurance. I don't think there is a huge amount of evidence that that change will make a great deal of difference, but these are pretty uncertain estimates.

Q91 John Thurso: Can I ask you about tax avoidance and HMRC and the changes that the Government are planning there? First of all, is the announcement of a new requirement for taxpayers to pay upfront in big disputes, which presumably only affects people who have quite a lot of tax to pay and who are engaged in spending a lot of money in trying to avoid it, but the critical point is that the new policy is estimated to bring in about £4 billion over the next five years. Do you think that is a realistic estimate?

Paul Johnson: We have no data on which to assess that. The only information we have is the published information that is in front of you. That scheme is a bit different from some of the other avoidance schemes because it is about bringing in money upfront, which, in a sense—

John Thurso: It is cash flow rather than end result.

Paul Johnson: Yes. On the positive side, I think HMRC is much more certain about that number than it would be for a lot of tax avoidance numbers because these are things happening at the moment. On the minus side, again you can see—and Treasury and OBR have been quite open about this and in all of these things—they have been quite open about the fact there is extra money upfront but there is less money later on.

Q92 John Thurso: In a way, one could take that £4 billion figure as a proxy for HMRC's estimate of what they think they can contest and possibly win back.

Paul Johnson: Possibly. We have not gone through the numbers. Given the numbers going forward, and the numbers going forward look negative, you can probably back out of that, I think, how much of this they would expect to take upfront and then have to pay back. It might be worth asking them because they must have that number.

Q93 John Thurso: It seems to me there is not a lot of data and neither the OBR or the Government seem to put a lot of data out. It might be worth pushing for a little more clarity.

Paul Johnson: Given the numbers you have there, there are some very specific question I think you could ask of HMRC to provide you with information about their expectations.

Q94 John Thurso: A spinoff from that is, if all that money got taken in advance and HMRC had its judgment slightly wrong and the HMRC then lost those cases and it had then to pay all the money back with interest, that would be quite a large contingent liability, would it not, to be placing on the Government's accounts going forward?

Paul Johnson: There is some assumption with these numbers about how much will have to be paid back and I do not know what that assumption is. It would be very good to get that.

Q95 John Thurso: So there is some work to be done there. The last one to ask you is the question around the idea that HMRC should be given the powers to seize money directly from people's bank accounts. Do you agree with that?

Paul Johnson: That is a little outside my expertise to be able to comment on it, to be honest.

Q96 John Thurso: That is an interesting answer because one might say that this is more a matter of justice and civil liberties than it is to do with the Treasury. It is quite a big step to say, "We are going to allow the Government tax-takers to raid your personal account directly". That is quite a big step, isn't it?

Paul Johnson: Yes, I think it is a significant step but, as I say, it is not necessarily one that we are in the best position to comment on.

Q97 John Thurso: The Government has said that a minimum aggregate allowance of £5,000 will be left in place across all accounts. I remember, when tax credits first came in, regularly winning cases against HMRC where they were claiming sums of £12,000, £10,000, £7,000 and them then writing off those debts. Under this policy they would have snaffled the cash first and you would be fighting to try to get it back. Given their record of competence in that area, this does not fill me with any great confidence.

Paul Johnson: I think it is certainly worthy of pursuing further.

John Thurso: Well, we will pursue that further. Thank you.

Chair: Thank you very much indeed for coming in to give evidence this morning. You have produced a wealth of very interesting information in the run-up to this budget, as you so often do, and this evidence was also useful. There may be some further things we would like to follow up with you afterwards, not least the point that we were just having an exchange on there on what should be extracted from HMRC.