



Treasury Committee

Oral evidence: [Autumn Statement](#), HC 870

Tuesday 9 December 2014

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Members present: Mr Andrew Tyrie (Chair); Rushanara Ali, Steve Baker, Mark Garnier, Mike Kane, Mr Andrew Love, John Mann, Jesse Norman, Alok Sharma, John Thurso

Questions 1-117

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

Q1 Chair: Thank you very much for coming in to give evidence this morning on the autumn statement, which had very much the feel of a budget about it, if you ask me. It looked like a budget, quacked like a budget. Could I begin by asking each of you whether you think the inflation target really is symmetrical, whether the MPC is and should be indifferent to whether inflation is 1% or 3% , for that matter 0% or 4%? Why don't I move from left to right as I am looking? Mr Daly?

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

Q2 Chair: So on the one side we have a manageable path, well known and well worn, and on the other side we have this terrible precipice?

Kevin Daly: Trapped by the 0% interest rates and the difficulties, as I think the Japanese experience has shown, of trying to deal with that. As I say, the target itself is symmetric but the way one has to deal with the dangers presented by falling either side of that target are different.

Q3 Chair: If you were walking along a path where just to one side of you there is a sheer drop and to the other side is a slight incline, do you think most people would move a fraction further away from precipice?

Kevin Daly: I am not sure I would go as far as to characterise it as a sheer drop.

Chair: But you have said the risk is—

Kevin Daly: The risk is, but there is a difference between a sheer drop and a sharper incline. I think it is the case that once inflation begins to fall below 1% then they will have to respond to that more aggressively.

Jamie Murray: I would agree with that sort of assessment. I don't think the discontinuity is quite that stark. I don't think the difference between prices rising slightly and prices falling slightly would make an enormous difference to developments in the economy. But there is a secondary point about uncertainty over the level of potential output. If you do not know where the level of potential output is you might be inclined to be a bit more cautious on the downside than you would on the up, since unemployment is a very unpleasant experience for most. So I think there are reasons to be cautious in setting policy and you might wish to be a bit looser on the downside than on the up.

Alan Clarke: The short answer is, yes, I think we are more sensitive to low inflation than high inflation but we should pay attention to core inflation, stripping out volatile items that we can't control—petrol and food. Different economies behave differently to lower energy and food. In the eurozone, for example, lower energy and food typically is positively correlated with underlying inflation, so those lower upstream costs get passed on to consumers. Over here it is seen as a windfall; lower petrol, lower food, consumers have more spare cash in their pockets and typically spend it. A good example of that is the PPI pay-outs over the last year or so. Those cheques for thousands of pounds have come home to people. They have not saved it; they have spent it on holidays and cars. I think consideration of core inflation is pretty key.

Q4 Mr Love: The IMF has recently warned of the dangers of stagnation in the world economy, describing it as the “new mediocre”. Are there dangers for the British economy in stagnation?

Alan Clarke: I think we are in a different era to where we were pre-crisis. Even if we have been growing pretty well, as we have been, once we grow to the point where the Bank of England starts to raise interest rates, that is going to stop growth from going back to the 3%, 4%, 5% growth rates that we dream of. That is going to hold back growth and austerity will continue for some time even once the deficit has come down. It is not a normal state of affairs to have a net debt to GDP ratio of 80%. There is many years to come before we get that back down to a more normal level. The new mediocre is probably an accurate description of what we should expect for the next decade or so.

Mr Love: Mr Daly, would you disagree with that?

Kevin Daly: I would to a degree. We are relatively optimistic on growth. When the IMF published its world economic outlook, it talked about the risk of oil prices rising significantly, painted a scenario where that would be quite damaging for growth. In the period since then you have had oil prices fall by \$40 per barrel, which on the IMF's own estimates should be sufficient to lift the level of GDP growth over the period of a year by around 2%. So there really is a significant stimulus for both UK and global growth from

the decline in oil prices we have seen since the IMF first made these warnings about mediocre growth. We would tend to be on the relatively optimistic side for both global growth and the UK.

Q5 Mr Love: We have heard the pessimist, we have heard the optimist. Mr Murray, I am looking at focusing on the UK economy. The IMF were talking about the world economy and there are views about that. What do you think the dangers of stagnation are for the UK economy?

Jamie Murray: The OBR has a scenario where this sort of stagnation continues, and you can see that just leaves the public finances in tatters really. It would extend the period of austerity for perhaps another decade. If the sort of performance we have had in productivity over the past five years was repeated or became the new normal it would be a serious challenge to everyone. We would have to seriously adjust our plans for what we are going to spend over the next decade or going forward.

Q6 Mr Love: Is there a danger we can talk ourselves into stagnation?

Alan Clarke: I think that is probably true. If you look at the structural deficit, austerity does not narrow at all this year. There is no austerity this year. You could look back at previous years when austerity was there but it was not massive by historical standards, and I think the media coverage of it probably did scare people into saving more or spending less. So I would accept that that is a danger.

Q7 Mr Love: The impact on investment and consumption of the thought that we are going to go into a period of stagnation will cause stagnation itself. What are the dangers of that?

Kevin Daly: My own view is that people respond more to the pounds and pence in their pockets than they do to warnings by politicians of dangers lurking abroad. Most people, the men and women of Britain, will notice the impact of things such as the sharp decline in oil prices. We have already seen petrol prices decline significantly but if they remain at these levels we calculate we are likely to see unleaded petrol fall to around £1.05 to £1.10 per litre. That is a significant decline and people will really notice that. I suspect they will notice that more than they will the concerns over global growth.

Q8 Mr Love: Let me ask one final question of Mr Murray. There is already concern being expressed about whether or not consumption can remain at the levels it is. People are reducing their savings, going into debt. Is there the nightmare scenario that we will all wake up one day and people have stopped spending?

Jamie Murray: It certainly would not be a good scenario, but the policy settings are such that the most likely outcome is that households will have to keep spending and the saving ratio probably will slide a bit further. That is because monetary policy is loose and there is a very large adjustment happening in the economy and there is going to be some

displacement of Government spending to other consumers. So really it is the policy stance that is driving that behaviour.

Q9 Mike Kane: My questions are around the eurozone and its performance. I was with the Chamber in Warsaw on Wednesday and, first of all, they were saying we should be more careful about what we say about our closest allies in Europe, particularly the Prime Minister. Secondly, they were saying it is our tenth biggest market, the UK is their second biggest market and they are performing at 3.3% growth. So some people outside the eurozone are doing well. What do you see as the structural problems within the eurozone and why it is performing so badly?

Kevin Daly: I think the structural problems are reasonably well understood. If you are trying to deal with the twin deficits of a significant budgetary deficit and also a significant trade deficit, so a loss of competitiveness, trying to make that adjustment within the confines of a currency area, a currency union, without the freedom of the exchange rate, is very painful. You can see even within the currency union of the UK how long it has taken the north of England to make an adjustment to the structural problems that befell it in the 1980s. Making those adjustments is painful within a currency union and they take a long time. That problem is exacerbated by the fact that if you have low inflation, which you need to improve competitiveness, that tends to hurt fiscal dynamics. It is very difficult to adjust both the deficits simultaneously within a currency union.

As it relates to the implications for the UK, I think there is a distinction to be drawn between the negative impact that will come from sluggish growth, which we clearly have in the eurozone, and the negative impact that comes from a full blown sovereign/banking crisis, as we had in 2010, 2011 and 2012. The sovereign crisis had the effect of significantly raising the funding costs of the UK banks and I think that was very significantly negative for the UK, but my view would be that the UK could continue to deal with a period of sluggish growth. There is a distinction to be drawn between those two scenarios.

Q10 Mike Kane: Thank you for pivoting to my self-interest as the only northern MP in the room today. That is a good answer. I could talk about 100,000 jobs being sucked out of the east Manchester economy between 1980 and 1985, but we won't go there today.

I just want to push you a little further on the eurozone. Two weeks ago we asked Mark Carney whether he thought it will go back into recession. Considering the length of your last answer, I had better just nip in with another one: which countries are you most concerned about?

Kevin Daly: To answer your question very shortly, I do not think the eurozone in aggregate will go into recession. In the medium term I am most concerned about Italy and the political developments there.

Q11 Mike Kane: How far do you think the European Central Bank can help?

Kevin Daly: Our view is that they will engage in sovereign QE, and there are a number of measures. The so-called TLTRO was designed specifically to copy the UK's funding for lending scheme, which I would argue was very successful in the UK. I would be relatively hopeful that from very low expectations for the success of these measures, they may bring more success than is commonly perceived.

Q12 Steve Baker: Could I take you back to some of the questions the Chairman was asking you about inflation? When I look at the food poverty inquiry report that has just come out—if I can persuade my iPad to show it to me—they looked at the period between 2003 and 2013 inflation and they are blaming food poverty on inflation in food, general inflation, fuel and housing, saying wages have not kept up and manufacturing job losses and so on. Mr Clarke, when you talked about excluding food and fuel, could you put that exclusion of food and fuel in the context of food and fuel inflation driving people into food banks?

Alan Clarke: Yes, absolutely. Food and energy have been the naughty children of the consumer price index basket for many years. Part of that is bad luck, the weather. You go back five years when we had El Niño and La Niña weather effects, global agricultural commodity prices surged by well into double digits and that pushed up food over here. When the Bank of England was engaging in quantitative easing in 2011, inflation on a headline measure was 5% but if you stripped out food—energy at the time was also spiking because of oil—and if you stripped out the VAT increase, that core measure that I referred to or underlying stripping out core and university tuition fee hikes, it was a much more muted level of inflation. It was still above target but nowhere near the 5% level; I can't recall the actual level right now.

Q13 Steve Baker: I can see why you would be interested in that from an academic point of view or to disaggregate and look at particular sectors, but if we adopted a measure as a matter of policy that excluded food and fuel, wouldn't we be turning our backs on some of the poorest in our society?

Alan Clarke: Yes, you are absolutely right. The average person certainly eats and drinks and fills up their car with petrol so you should not ignore it altogether, but the Bank of England was dead right when it was arguing that we need to do quantitative easing despite 5% inflation because these things are outside of our control. We shouldn't not deliver loosening to the economy because of high inflation. That is exactly what the hawks on the MPC are arguing now, that lower petrol is pushing headline inflation down but that is a boost. We should not be easing monetary policy because petrol is low. That is a windfall to the average family. I think a common-sense approach is don't ignore headline inflation but certainly don't ignore core inflation either.

Q14 Steve Baker: There is much more I could ask you about this but I will just move on. Thank you very much.

The MPC's Kristin Forbes said to us that consumers drawing down their savings is a sign of confidence in the recovery. Would you agree with her that drawing down of savings is a sign of confidence in the recovery?

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

Q15 Steve Baker: Moments ago you were talking about policy driving people's behaviour, but surely people's propensity to hold cash could also be affected by their expectations of returns on that cash. Could it also be the case that people are now looking at long periods of very low returns on cash so they do not see a reason to hold it?

Jamie Murray: That is what monetary policy is intending to do, to drag consumption forward from the future. So, yes, there is something there as well.

Q16 Steve Baker: How much longer do you think we can go on dragging forward consumption from the future through the drawdown of savings and the extension of credit without restarting another boom-bust cycle?

Jamie Murray: There is a slightly fine line to be walked there. You have a lot of uncertainty about what the sustainable level of consumption is. There have been a lot of revisions to the way we measure the saving ratio that takes better account of pensions, for example. There might be a bit more room than people previously thought for consumption to fall and remain in vaguely sustainable levels.

Q17 Steve Baker: Perhaps if I rephrase it and bring in Mr Daly as well. If we draw forward consumption in order to get more demand now, wouldn't you expect less demand later?

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

Q18 Steve Baker: Just turning to housing for a moment, I think Scotiabank said that help to buy was a sugar rush injected into the housing market, that the stamp duty reforms were injecting adrenaline into it. Is this not part of the same story, that what we are trying to do is get this credit expansion going into houses in order to get the economy going now? Is that what you are suggesting?

Alan Clarke: I think it is a temporary quick fix, temporary as in a couple of years, but what we really need is wage inflation to pick up. Household disposable income growth is pretty muted; it is improving. There are some early signs in the last few months that wage

inflation is starting to pick up. We are vulnerable to external shocks and the growth we have been enjoying over the last year or so could go away. I think it is a worthwhile insurance policy to keep the consumer going for at least the next six months or so, or maybe a year, until wages do get up to more normal levels and we can have a more self-sustaining recovery.

Q19 Steve Baker: Haven't the United Kingdom and the United States, for a decade or more, followed this policy of expanding credit into housing in order to give us a sugar rush? You are nodding.

Alan Clarke: I think that is true. When you compare the eurozone with the UK and the US, the UK and the US did a lot of QE, the housing market has boomed and we are both the fastest growing developed economies on the planet. The eurozone is struggling and we are still scratching our heads about how to get it going. So it is not desirable, there are people who have missed out on the housing boom and that is regrettable, but I would rather be in the position of the UK and the US than the eurozone.

Q20 Steve Baker: It feels to me that you are confirming something that I have long thought, which is that we have had a decade-long sugar rush of housing expansion and now we are saying it is only a short-term fix. If we have been doing it for a decade, when is it ever going to end?

Alan Clarke: I think the short answer is once we get wages going. The housing market has been the jump leads to get a self-sustaining recovery as soon as we get wages going.

Q21 Steve Baker: This is a fascinating conversation. The reason that real wages would rise would be because of an increase in productivity, wouldn't it, and that would mean an increase in the accumulation of capital? If we are expanding credit into housing to get a sugar rush, we are not going to be accumulating capital, are we?

Alan Clarke: Yes, that is true. On the productivity side, typically fast productivity does tend to be the thing that sees wages pick up, so that is true. You are right, it is not productive to put cash into housing, which is not a productive asset. It is better to put it in factories and assets that will produce a return. It is not something you would want to rely on long term.

Q22 Chair: When you talked about wanting to get some wage inflation going, what you really meant was something very different, which is you want to improve productivity?

Alan Clarke: That is true. I think wages have been lower—

Chair: Just to be clear, is that what you are saying? It is something very different, isn't it? When people think about wage inflation they are really thinking about getting more money for doing the same thing. What you are talking about is people getting more money, having earned it because they are producing more goods and services.

Alan Clarke: I think wages have been low not just because of the housing market. It is because of the supply of labour. There are more migrant workers coming in—200,000 in the last year—and more older workers staying in the labour market. That is a bigger reason for wages to have been low rather than the housing market attracting capital away from productive assets. So it is more than just the housing market in that regard.

Q23 Steve Baker: I am still reeling from the notion of having a mainstream economist agree with my Austrian school perspective, but there we are. Mr Daly?

Kevin Daly: I disagree with the characterisation. I was just being politely quiet. I disagree with the characterisation of the turnaround in the economy in the past couple of years. Improving credit provision was a critical part of that turnaround, so the funding for lending scheme together with the reduction in the euro-area uncertainty, both of which took place in mid-2012, led to an opening up of credit availability at the start of 2013 that sowed the seeds for the recovery that we have seen since then. But a lot of positive things have come from that, not just in the housing market. You have seen better sectoral allocation. One of the problems post the crisis and post any recession is the sectors and firms that tend to drive growth are not the same sectors and firms that drove growth prior to the crisis. You need a reallocation of capital and resources and labour from the old sectors and firms to the new sectors and firms. Without a functioning banking system to intermediate that reallocation, resources will get stuck in the wrong places. I think largely speaking that is what happened prior to this opening up of credit availability and explains why growth has improved so significantly in the last two years but also why it is such well balanced growth.

Chair: You are going to have to be very quick. It is quite a long explanation of why you are not an Austrian but we will give Steve one last go.

Q24 Steve Baker: Are you seeing that substantial reallocation of capital through the credit system into real productive businesses that will give us a return in future? What I am concerned about is that we are expanding credit into things that are essentially consumer durables, housing, or into consumption but not into real productive assets that will give us a return in future. Are you saying that you see credit going into those productive assets rather than things that are essential?

Kevin Daly: I think we are at the start of that process. I would also emphasise that most of the growth in the last two years has been driven more by investment spending than by consumer spending.

Q25 Mark Garnier: I would like to carry on with wages. The OBR is forecasting 2% wage growth until 2019. Do you agree with that?

Kevin Daly: My own forecast is we expect wage growth to pick up to around 2.5% by the end of 2015, heading into 3%, 3.5% in 2016.

Mark Garnier: So you are much more optimistic.

Kevin Daly: Yes. If you will indulge me for a second—

Chair: Only for a second or two, please.

Mark Garnier: Chairman, I would say if it is good news indulge as long as you like.

Kevin Daly: I think in general the OBR's forecasts are too pessimistic. They have revised up growth for 2014 from 2.7% to 3%, in 2015 from 2.3% to 2.4%. That is the third consecutive upward revision to growth that they have made. Nevertheless, their forecasts are significantly more pessimistic than ours but even more so pessimistic than the Bank of England's. In the near term they expect growth already in Q4 to have slowed to a pace of around 2% to 2.5%. There is no evidence of that having taken place in the data.

Mark Garnier: Just to be clear, is this wage growth or GDP growth?

Kevin Daly: Sorry, GDP. In the near term they are relatively pessimistic beyond any evidence that you can find of such a slowdown in the data, but also in the medium to long term, by the end of 2017, they expect the level of GDP to be a full 2% lower than the Bank of England expects. If you factored the Bank of England's forecasts into the OBR's fiscal projections, the deficit would be eliminated a full year earlier than the OBR expects. My personal view is that the Bank of England's forecasts are more likely to be correct than the OBR's forecasts.

Q26 Mark Garnier: That is really interesting. Do either of the other economists disagree with that?

Alan Clarke: I agree with the OBR's forecasts for wages, but I think there are significant risks in both directions. In the latest single month the wage data was 2%. We have seen this spurt in the last three or four months. It would not take an awful lot to be on the headline measure in the low 2% by early next year. However, reports from the wider labour market are quite downbeat. For example, on the settlements data from Incomes Data Services, because of the national minimum wage hike in October, settlements had been 2.5% for well over a year. The 3% minimum wage hike comes in and settlements dive to 2%. That sounds illogical but the reason that has happened is that firms, particularly in the retail sector, have honoured the national minimum wage increase for their lower paid workers but they have compensated for that by paying higher income workers much smaller wage rises. For me, that is a sign that there is not a lot of pricing pressure in the labour market. There is a lot of supply of workers.

Q27 Mark Garnier: I am very curious as to why there is not. We see an economy that has grown very strongly over the last few years and each month we see the ONS figures being revised upwards. Not only are the first estimates coming out better than expected but then the revisions are better than expected as well. We have seen a huge increase in employment. There is a debate about where that employment is driven, whether it is full-time jobs or part-time jobs, but it seems that the majority of those jobs now are full-time jobs. We have seen a lot of very good news coming out and yet we are not seeing the wage inflation that you would have expected to with that. One of the reasons that has been suggested to me is that if you take out the people who have jobs of less than a year you are looking at more like 4% wage inflation for those people. The success in getting youth unemployment into

work and of the apprenticeship scheme has actually been a drag on wage inflation because those people with longer-term jobs have done much better than has been suggested. Is that a fair analysis? Jamie Murray, you were nodding most vigorously.

Jamie Murray: It is also true that that 4% of existing workers who have been in their jobs for longer is well below the pre-crisis level as well, because that level was close to 6%. That is reflective of the fact that productivity is not growing and the difference there relative to the trend is about 2% in the growth rate as well. I do not think there is anything out of the ordinary in the sense that weak productivity is driving weak wage growth.

There is an additional effect on top of that, as you say the compositional effect, and there is a real question there about how long that continues and whether any of it unwinds. If you look at the share of income that is going to labour in the OBR's forecast, you see it has fallen quite a lot recently, so they are taking home less of the pie, and that is expected to continue. There has been a structural loss of relative income share for labour and there is a question about whether that might reverse a bit, in which case you get stronger wage growth in years to come than they are forecasting.

Q28 Mark Garnier: Can I ask about the role that immigration is playing on wage growth? Mr Clarke, is inward migration into the UK a depressing factor on wage inflation, wage growth? If so, can you quantify it?

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

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

Q29 Mark Garnier: That is really interesting. Just one last question, if I may, on immigration, which is to do with the pull factor of immigration that is clearly a very big political thing out in the wider country and we are trying to understand what is going on with immigration. If the British economy continues to do well, is it not the case that we will

continue to have that pull factor with potentially a large group of people coming from diverse economies such as the eastern European economies where GDP per capita and wages are that much lower than they are here? Is there the risk that in this country our success will not be met with wage inflation because we will continue to see that pull factor acting very well, notwithstanding your point about the older workers? As we continue to do well, until such time as the economies and wages equalise more, we are just going to be a victim of our own success? Does anybody want to discuss that point?

Kevin Daly: My own view as an immigrant is that immigration is a very good thing, but I understand the transitional difficulties it can present.

Chair: Are you one of those low-wage workers, Mr Daly, that we have just been hearing about? It is all right, that was very unfair.

Kevin Daly: No, I think it is fair enough to say that I am not. But there are stresses that are presented by immigration. Although economists in general are favourable towards immigration, they need to recognise the social strains it presents. I think it is a measure of the UK's relative success, absolute success, that it remains an attractive destination for workers across the world.

Alan Clarke: I don't have concrete data to back this up, but the topic of migrant workers has surfaced while the UK economy has been doing well. During the crisis there were stories of migrant workers going back home again because the economy was not growing too well. Again, pre-crisis when we were doing well migration had a lot more headlines. I do not have the data to back it up but my sense is that you are right. If we continue to grow faster than our closest neighbours, migrants will be attracted here, but it will address skill shortages.

Q30 John Thurso: Mr Murray, can I come to you first? Net bank lending remains negative. Is that a comment on the availability of credit or on the prudence of firms?

Jamie Murray: It is probably a bit of both. What we have seen following the recession is quite a big displacement away from borrowing from banks towards other sources of finance, so capital markets, essentially. Things look a bit better there, a bit freer, for the corporate side at least, for large corporates in capital markets than they do from banks. For households net lending is much slower than it was in the past. You need a much larger deposit now for a house and, despite the fact that house prices have gone up so much, that is why their lending has not.

Q31 John Thurso: Coming back and focusing on business lending, which is what is interesting me, you make the point that the large companies, and particularly listed companies, have access to finance through all sorts of routes other than bank lending. As we know, balance sheets are fairly awash with cash anyway so they probably do not have too much of a problem. One of the things that everybody hopes will drive future prosperity is the growth of SMEs, the sort of middle culture, and therefore it is availability there that I am really concerned about. Do you think credit conditions are improving for SMEs and that they are able to access the credit they need when they want it?

Jamie Murray: In shorthand, yes. The problem with the 2011 period was that the SMEs could not avoid the increase in bank funding costs; it was passed through to them. Since 2012 credit conditions have eased so much for the banking sector and that has also been passed on to SMEs. You would rather think that there might be more on the demand side than the supply side there. But it is worth remembering that SMEs account for a very small share of overall investment and the type of lending they might be engaged with might be more short-term working capital type of borrowing, that sort of stuff, so they would be more interested in maybe short-term overdrafts or extensions to boost their capacity than large investment projects.

Q32 Chair: They are absolutely crucial in employment terms and at the early stages of economic recovery, are they not?

Jamie Murray: I am not sure about the early stages of economic recovery but, yes, they are.

Q33 Chair: They disproportionately represent reallocation of resources in the economy after a shock, do they not?

Jamie Murray: They may. It depends how much you think the investment has a role to play.

Q34 John Thurso: Can I go on from that to look at business investment generally? First, do you think that the data that we get from the Bank of England is sufficiently reliable for us to make judgments on who is getting credit where they need it and who is therefore able to make investment where it is needed? It is just the data question. Do you think we have good enough data from the Bank of England?

Jamie Murray: Yes, broadly speaking. There has been quite a lot of improvements made.

Q35 John Thurso: If we then look at business investment overall, it has been revised up and looks much healthier and much more of a driver of the economy than previously thought. Is that getting to the right places, and to what extent as between large corporates and the other half, which is the SME market?

Jamie Murray: I think since large corporates do most of the investment that suggests that they are getting the capital they require. On business investment more generally, the OBR's forecast is for it to rise substantially as a share of GDP to a share that has not been seen for at least 20 or 30 years. They are obviously quite confident that the capital will get there if required, or they will at least spend some of the cash they have hoarded over the past decade. Whether that is a realistic forecast is another question.

Q36 John Thurso: Can I come to you, Mr Daly, on the same thing, to comment on availability of credit and on business investment and what it is meaning at the moment?

Kevin Daly: The availability of credit to SMEs is improving. I think it has an awful long way to improve. It is coming from a very low base. The SMEs were really starved of credit availability. As I say, the good news is that it is getting better but I think there is a long way to go and in many cases the problems are that the UK banking industry lost the technology, if I can put it that way, to evaluate the business cases of—

John Thurso: Might that technology involve human beings actually making a good decision?

Kevin Daly: When you talk about technology people think that can only mean computers, but I mean literally the technology of people being able to evaluate a business plan and approve a loan or not approve a loan. One of the difficulties, one of the logjams in getting that SME credit availability going again is the need to rehire such people, the old-fashioned bank managers.

Alan Clarke: Net investment has been going down, but one thing the Bank of England stressed in their bank lending survey has been lots of firms repaying loans, so that has adversely affected those data. It looks like there is less new lending. There has been new lending; it is just a lot of the old lending has been repaid. That might be telling you something about credit conditions because if firms have the spare cash to repay those loans they must be confident that if they need credit further down the road they will be able to get it.

Q37 John Thurso: Well, I am not sure. Can I just test you on that? People do not necessarily repay loans because they are confident they will get credit. They repay loans because they don't want to be beholden to a bank they don't trust. There are two answers to that, are there not, particularly for SMEs?

Alan Clarke: Yes, that is probably true and I think they have said in their anecdotal responses that they do not want to be reliant on the banks.

In terms of is the data reliable, in that bank lending survey they have a backward looking survey: how much new lending has there been for mortgages, for corporates? There is also a forward looking element. It does rely on trusting the banks who say they do expect looser conditions in the next quarter or tighter conditions or to lend more, and that is more a leap of faith. It is not a concrete number; it is an expectation.

Q38 John Thurso: I think you all broadly agree, from what you are saying, that the availability of credit does not appear to be an issue in business investment at the moment. We are past that point. Is that broadly right?

Kevin Daly: I think the situation is getting better. That journey is not yet complete.

Q39 Chair: There is a difference of view between Mr Murray and Mr Daly on this, isn't there?

Jamie Murray: No, not entirely. You could always hope that credit conditions could get even more accommodating but I think the process is largely there.

Q40 Chair: You were saying a moment ago that SME lending was recovering from an extremely low base. I think the phrase you used was there is an awful long way to go.

Kevin Daly: Yes, in terms of improving the availability of credit.

Q41 Chair: Rather than extending this exchange now, it would be helpful if you could set out what you think that is in numerical terms on the basis of the Goldman Sachs estimate. Would that be possible?

Kevin Daly: Unfortunately not precisely, the reason being that the interpretation of credit lending data is complicated by the fact that the net data will often shrink even when credit is becoming more available because you have companies repaying loans.

Chair: That is why we are asking you. If it were straightforward, we would do it ourselves.

Kevin Daly: It will depend on the assumptions you need to make on when companies are repaying the loans and why.

Chair: Have a look if you can. That would be wonderful.

Q42 John Thurso: The last very quick point in relation to investment is: what impact is business investment having on the productivity gap if any? Perhaps we could start with you, Mr Clarke.

Alan Clarke: On the revised data, we are seeing about 10% year over year business investment growth. That may be investing in assets for future production and that would be good for productivity. However, having had such a long period of a real lack of business investment growth, I suspect part of that is making up for depreciation that was not made good during the crisis. I am sure there is a boost to the productivity outlook as a result of it but I think part of it is making up for lost time during the crisis.

Q43 John Thurso: This is just actually investment to replace the depreciated kit or stock that was not done during the recession. Does everybody agree with that?

Jamie Murray: The bank said that the reduced investment in physical and tangible capital reduced the level of productivity by 3 to 4 percentage points relative to pre-crisis trends. That is how much of the gap it explains. That was before the investment revisions were available. Now the investment is stronger and productivity is maybe a little bit higher, I suspect there probably would not be an enormous change to that estimate but that is probably the magnitude of what we are talking about, what the weak investment did to the economy.

Q44 Rushanara Ali: I have some questions around public finances. Looking at the forecast for June 2010, public sector net borrowing was supposed to have fallen to £20 billion by 2015-16 but it is now forecast to be £76 billion. Looking back over the past few years,

could different economic policies have led to an improved outcome? Can I start with Mr Murray?

Jamie Murray: I think that is a good question. The way I see it is that the bad fiscal performance relates to the bad wage performance, so these two crises, the fiscal crisis and the cost of living crisis, are related and they both have their root cause in the failure of productivity to grow. The question that you need to answer really is: had Government policy been different would productivity have performed differently? My own view is that it probably would not have had an enormous effect. I think Martin Weale did a speech last night or yesterday saying that the best explainer of why productivity has been weak following the recession is how deep the productivity loss was during the recession. It would be a bit of a coincidence if the bad performance afterwards did not have something to do with the bad performance during the recession. The question is would Government policy have changed that, and my guess is not a great deal possibly.

Rushanara Ali: Are there any other views on that question?

Kevin Daly: My view is that fiscal tightening or fiscal austerity is painful, it is damaging for growth. I think that most mainstream economists agree with that. But I also believe that by starting from a position where the deficit was more than 10% of GDP it was largely unavoidable. The adjustment that has taken place since then, contrary to what I might describe as the pro-austerity rhetoric of the current Government, the pace of fiscal consolidation has been slower than the OECD average. If you are asking would it have been better to tighten at an even slower pace what I would already characterise as a relatively gradual pace of fiscal consolidation, ironically the toughest year of fiscal consolidation was in fiscal year 2010-11 under fiscal policies set out by the previous administration.

Q45 Rushanara Ali: Turning to public spending cuts, the IFS described the implied level of cuts to public spending outlined for the next Parliament as colossal and Rob Wood, Chief Economist of Berenberg, has described them as implausible. Do you agree with either of those, given what you have already said, Mr Daly?

Kevin Daly: My view is that because the OBR's forecasts are likely to prove too pessimistic, cuts of this order will ultimately prove unnecessary. In the event that I am wrong and it is necessary to implement them, yes, I do believe they would be painful.

Q46 Rushanara Ali: Why do you think they would be unnecessary?

Kevin Daly: I believe the tax revenues will be stronger than the OBR currently expects, because its forecasts are too low and ultimately the task of reducing the deficit will be more manageable than it currently seems.

Q47 Chair: Would you describe the tax revenue forecasts of the OBR as forecasts about structural performance in the tax system?

Kevin Daly: One of the issues that I would draw with the OBR's forecasts comes back to wages and to what extent is that wage growth structural or cyclical, in answering your

question. The big surprise on tax revenues has been that for a given level of employment wage growth has been weaker than the OBR expected, but if for a given level of employment wage growth has been weaker than the OBR expected then surely that means that the availability of labour is more abundant than the OBR expected. Labour supply is greater, therefore the output gap is larger than they expected. The OBR has factored in the bad news of weaker than expected wages without factoring in the corresponding good news of better than expected labour supply.

Chair: We are very short of time. That is a very important point but if either of your wingmen here disagree with it they must speak up now.

Jamie Murray: I think it is a question of whether it is a temporary compositional phase or a permanent one. You can either read it as a greater labour supply or you can read it as weaker trend productivity growth because the characteristics of the people entering the workforce are less productive than you expected. There are two ways you can read it: you can read it as extra supply or you can read it as a bad underlying structural performance.

Alan Clarke: If I could make a point on the previous question, which is that the Government deflator that gauges inflation on Government spending got off to a really good start in the Parliament because it was negative. The prices that the Government was paying for goods and services was about minus 1%, but that has been shooting up. It is about 2.5% inflation while the rest of us seeing inflation of 1% or lower at the moment. It may be a case that the Government picked all the low-hanging fruit early on, but that has turned around now and that may be a way of making what looks like implausible cuts more plausible over the next year or so.

Q48 Rushanara Ali: If there are likely to be significant public sector cuts, how realistic do you think that is and is it sustainable to provide the kind of public services we currently do if significant cuts were made in the next Parliament in order to reduce borrowing?

Kevin Daly: If it proves necessary to implement the cuts as they are currently set out—as I say, I do not expect that to be the case—then that would be significantly painful, but it is my view, and I think the view of most mainstream economists, that fiscal austerity is painful.

Jamie Murray: I agree with that. I think the thing to remember is that no political party is particularly wed to that plan as it is set out in the Budget. That is a compromise or an assumption. It is not a specific plan by any of the parties.

Alan Clarke: In 2016-17 the forecasts imply the structural deficit narrows by almost 2%. That is massive compared to nothing this year and 0.5% next year and there is virtually no impact on the GDP growth. I think they have an offset in their forecast for higher exports, but that looks challenging to me. I would not say it is impossible but it is challenging.

Chair: That is extremely helpful. Thank you very much indeed for giving evidence this morning. I am sorry that as usual we are trying to squeeze a quart into a pint pot, but we have made some progress with some very interesting points and one of you is going to

think about whether there is anything you can send us. We will move straight on to the next session.

Examination of Witnesses

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

Q49 Chair: Welcome again. You are very familiar with our cross-examination of these issues. Could I begin by asking you, Mr Johnson, how important you think marginal rates are to incentives and therefore presumably productivity? We have just been discussing that. Then give us a brief rundown on the shape of marginal rates in the personal tax system at the moment.

Paul Johnson: Marginal rates are clearly pretty important in people's behaviour and work incentives, both at the bottom end of the scale where marginal rates are highest because of the withdrawal of tax credits and housing benefit particularly, and at the top end of the scale where people can be very responsive in terms of not so much probably how much they work but how they declare their income or where they work. It is important not just to focus on marginal rates though because at the bottom end of the scale the average rate, the effective tax rate that determines how much you get in work relative to out of work, is probably even more important. So if you don't get much more or less in work than you get out of work that is potentially going to have a big impact on your behaviour.

Chair: That is a rather special kind of marginal rate.

Paul Johnson: Indeed. It is an important one and for a lot of people it may be more important than the marginal rate that impacts what happens if you work an extra hour. So I think there is quite a lot of evidence that both these things matter. They matter differently for different people actually. For people over the age of 60, say, these things matter a lot because they have potentially more choice about how they behave. For example, for married women with children or lone parents with children, these things tend to matter more than they do for your average 40 year-old man who will tend to work pretty much whatever you do to him. It does matter who these things apply to.

In terms of the structure of the marginal rates, if you just look at the income tax and national insurance system, you have something that looks complicated enough. You move from 12% to 32% to 42% to 62% to 42% to 47%. I may have missed one there. If you include the tax credits and housing benefit, you obviously have marginal rates in the 90% and 70% before you just get back into the income tax rate, and then between £50,000 and £60,000, as child benefit gets withdrawn, you have very high tax rates for those groups. It is worth saying there is one other thing that was introduced in the autumn statement, which is the postgraduate loans. Postgraduates repaying both a postgraduate loan and an undergraduate loan, even if they are just a basic rate taxpayer, will face marginal rates of 50% relative to the standard 32%. There is a whole series of different things in here. For some people these marginal rates are really quite high.

Q50 Chair: Has the IFS done any studies of the extent to which people are sufficiently aware of the huge steps or cliffs they encounter in marginal rates and therefore the extent to which it is changing behaviour, or are you aware of research of that type?

Paul Johnson: We don't have work looking specifically at people's awareness but we do have work looking at ex-post the extent to which people respond to these things. You can see responses for some of those groups that I described, for people between 55 and 65, for mothers with children and so on.

Chair: They are evident ex-post for previous introductions.

Paul Johnson: They are evident, yes.

Q51 Chair: How do you mark out of 10 the Government's performance on dealing with some of the complexity in the tax system that is evident with these?

Paul Johnson: In the individual bits of the tax and national insurance system, this Government has not made any desperately big changes. You have moved a lot of people out of income tax through increasing the personal allowance but you have not moved anyone out, any earners of direct tax.

Q52 Chair: So any mark you give is really a mark on the previous Government. That is what you are saying, isn't it? So mark the previous Government and then tell us about how the current one is doing.

Paul Johnson: The previous Government introduced the 62% rate on over £100,000 and then a higher rate over £150,000. The current Government has taken national insurance and income tax away from each other and has introduced this new band on people with child benefit in there between £50,000 and £60,000. Once universal credit comes in, if it does finally come in, that will simplify and reduce some of the rates for other groups. I would not give either terribly high marks.

Chair: Out of 10?

Paul Johnson: I don't know—six.

Q53 Chair: Do you have anything you want to add, Mr Emmerson?

Carl Emmerson: In terms of how has this Government done, I would say there are some reforms that have improved how the tax system works but actually perhaps it was just a missed opportunity.

Chair: We are looking here at the personal tax system for the time being.

Carl Emmerson: Indeed. So there has been a huge deficit. There are things you could have done that would have raised money that would have tidied things up, so in that sense a missed opportunity. The child benefit withdrawal is implementing something that has a marginal rate that depends on the number of children you have. From next April, some

married couples will also get a transferrable allowance, but if you move from having £1 of income below the threshold to £1 above you lose all of that. That is perhaps not such a huge deal in the short run but if a future Chancellor wants to make that thing more generous and decides to go further and reward marriage using that instrument, then it will become worse and worse, this great big cliff edge where it says, “Ask your employer for a pay cut and you will be better off”, which is not a good feature of a tax system.

Q54 Chair: Do both of you agree with the Mirrlees Review conclusions, which are that the withdrawal of the personal allowance above £100,000 is patently absurd?

Paul Johnson: Yes. It just introduces an additional tax rate of 62%, so the tax rate goes 42%, 62%, 42%. That does not look like a terribly sensible system.

Q55 Chair: Here is an area that is right for reform in the next Parliament—

Paul Johnson: You would think so. It is also worth say that because—

Chair: —when whichever Government is in power has a bit of money to lubricate the system. As Mr Emmerson has just said, some of this has been caused by the deep financial stringency that has been required after the crash.

Paul Johnson: You are also affecting more and more people with this because the point at it comes in has not been indexed even with inflation for five years now, so the real impact of it is growing all the time. I think this is an additional issue with the tax system. We have a series of bits of the tax system that are just not growing with inflation, the £100,000 mark, the £150,000 mark, and inconsistencies about others, and indeed a lot of the things in the pension tax system.

Q56 Chair: You seem to making the case for another Rooker-Wise-Lawson amendment.

Paul Johnson: We do seem to have lost that in many of the new elements of the tax system and that is quite dangerous in terms of moving the tax system unintentionally or at least non-transparently towards a new place. The annual limits have come down for the way in which we tax pension contributions. There is no sign that they are ever going to be raised in line with inflation. The point at which child benefits is withdrawn, the point at which the 62% rate comes in and so on, all of these seem to be fixed in nominal terms and that will, over time, transform the way the tax system works and not in a positive way.

Q57 Steve Baker: Can we turn to ring-fencing? When this Committee reported on the 2014 Budget we said, “Ring-fencing distorts spending decisions. It also weakens rigorous scrutiny of spending in ring-fenced departments”. Does the IFS agree?

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

just an arithmetic outcome of the fact that a very large chunk of public spending is being ring-fenced.

Q58 Steve Baker: If I put that in very plain language, ring-fencing some departments amplifies the effect on other departments?

Paul Johnson: Yes.

Q59 Steve Baker: Thank you. The IFS has noted that, according to Government policy, total departmental spending would need to fall by a further 14% of GDP over the next Parliament. You also noted that that implied unprotected departmental spending would need to fall by 26%. Would removing the protection of ring-fenced budgets lead to more efficient cuts in expenditure?

Paul Johnson: Let us be clear, that is not percentage of GDP. That is just the percent in real terms that it would need to fall.

Q60 Steve Baker: Okay, but it is the same question. Would removing the ring-fencing lead to more efficient spending decisions?

Paul Johnson: Let us put the pensions to one side, because that is not a formal ring-fence within the DEL. There are two big ring-fences there. One is health and one is schools. My sense is that even if one were not to formally ring-fence the NHS, there is not a lot of appetite to cut it, and indeed we are seeing an increase in spending on the NHS next year. There is strong lobbying from NHS England and others to increase going forward. Whether the formal ring-fence is making a difference to those decisions I do not know. The schools ring-fence, interestingly, which is not quite as big as the NHS ring-fence but it is still very big, appears to have come under considerably less scrutiny and there may be scope for scrutinising both those things.

Q61 Steve Baker: Does the IFS form a view on departments' ability to cope with particular cuts or reduced rates of increase?

Paul Johnson: We do not have a particular view of what would happen if the schools budget or the transport budget was increased or reduced by 5%. We do know, for example, that within the transport system there are very high value projects that are not happening because spending is not happening. We have a view about public sector pay, which is a particularly important part of this whole story. One of the reasons that public sector spending has been able to be kept under control over the last five years is that it has been possible to keep public sector pay down, because it is only just about now catching up with the very sharp cuts in private sector pay. That has been more possible over this five years than perhaps it will be over the next five years.

Q62 Steve Baker: But you would not form a view, for example, on whether the NHS could cope if the ring-fence was removed and spending was cut or an extra £2 billion or £2.5

billion or whatever this Government promises? You would not form a view on the consequences of those kinds of political pressures?

Paul Johnson: We do not have a model of the whole NHS in order to say that the effect would be this or that. We can look over long periods and see what has happened over long periods.

Carl Emmerson: We tend to say, “What has happened to the NHS budget? How does it compare historically? How does it compare internationally? How does it compare to the ageing pressures you have?” For example, if one were to freeze the NHS budget from 2010 through to 2018, you then see what is happening to that budget per head and per age-adjusted head, given that the older population is growing much faster. We would point out that that is a 9% drop. It does not mean it cannot be done, but it shows that perhaps a freeze would be quite a challenge for the NHS.

Q63 Steve Baker: Yes. You might be able to say that 9% drop would imply such and such for productivity but, of course, you would not try to explain how that productivity would be realised.

Carl Emmerson: No. We would also say that we have not had a period where the NHS budget has not risen.

Q64 Steve Baker: Just finally from me, do you think that the proposed cuts are possible without a reimagining of the state?

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

Q65 Steve Baker: You are not challenging the underlying assumptions about, for example, whether the NHS is free at the point of use, I do not think. You are talking about how they are delivered. Is that right?

Paul Johnson: Clearly that is an option that is open. We have a health service that is freer at the point of use than most health services internationally. Something that is a little bit different would not be impossible from an economic point of view, although it would obviously be challenging from a political point of view.

Q66 Jesse Norman: Just picking up that point, Mr Johnson, you seem to be in a position of saying that the squeeze on the public finances is going to be caused in part by the ring-fencing of the NHS budget but, at the same time, saying the NHS budget is under enormous pressure because of international comparisons and ageing population and the rest of it. Am I right about that?

Paul Johnson: I think both those things are right. For a set amount of spending, clearly if you are going to protect big chunks of it like the NHS you need bigger cuts elsewhere.

Q67 Jesse Norman: The reason you are protecting it is because you have these escalating pressures on the NHS. That is the reason it is being protected.

Paul Johnson: Absolutely, of course.

Q68 Jesse Norman: I want to turn to the question of tax revenues, which are absolutely the foundation, it seems to me, of economic forecast. Do you think the OBR is too pessimistic about tax revenues? That was the view that was expressed in the previous session.

Paul Johnson: That largely depends on forecasts, as Kevin Daly was saying, about earnings, where he is more optimistic than the OBR. We do not make our own forecasts about earnings. I think, given their forecast of economic growth and earnings and the composition of growth, their forecasts for tax revenues look reasonable. Clearly, if things turn out better than they are suggesting—and, as your previous witnesses suggested, the Bank of England and a number of other commentators think they will turn out better—then there is happily some risk on the upside here.

Q69 Jesse Norman: Potentially quite a geared return. If earnings start to move that could have quite a significant effect on tax revenues, could it not?

Carl Emmerson: Potentially we have seen the same in reverse since the Budget. One of the big things in the OBR's numbers is that in three years' time they are expecting to get about £20 billion less from income tax and national insurance contributions, partly because earnings growth is now expected to be weaker but partly because they now think you get less tax per pound of earnings in the UK economy. Clearly there is a risk on one side that recent trends could continue and the OBR may be proved to be too optimistic again, but these things could unwind and one lesson learned is that it is very difficult to do these forecasts. These numbers can move in a very large amount.

Q70 Jesse Norman: Right but for the avoidance of doubt, you do not have any private views as to whether or not you think the OBR is too pessimistic?

Paul Johnson: No.

Carl Emmerson: No.

Q71 Jesse Norman: Can you talk a bit about the composition of tax revenues and shortfall? We know one of the reasons is a lower effective tax rate. There were various one-offs in the way in which tax revenues have been below. To what extent do you think is this a structural problem, a permanent reduction or a long-term reduction in the tax revenue-generating base, and to what extent is it not structural but a function of a particular set of economic circumstances?

Paul Johnson: It is difficult to know what is a set of circumstances that will continue or not. If it remains the case that a larger proportion of the working population is self-employed, that will result in less tax revenue than the similar world in which those people

were in employment, partly perhaps because they are declaring less income but particularly because the tax system structurally takes less tax from people who are self-employed because they pay very different amounts in the way of national insurance contributions, for example. If that economic change is structural then the tax change will be structural. When it comes to many of the other elements that is to do with what is happening to earnings growth. If we are in a structural world of very low earnings growth, then we are in a structural world of very low tax revenue, but if we are not then the tax revenues ought to take off again.

Carl Emmerson: We are saying there are some other risks too. We are taking a large amount of tax revenue from a relatively small number of people. That makes it harder to forecast as well. The rich are paying a relatively large share of revenue. The OBR is forecasting very strong growth in stamp duty revenue. That may materialise, but again it is harder to forecast how many housing transactions there are going to be in five years' time compared to today. It is very difficult thing and it is not just about earnings growth in the economy.

Q72 Jesse Norman: That is interesting, but the point you seem to making is that there is no evidence, as matters presently stand, that we are looking at, necessarily, a long-term reduction in the capacity of a Government to raise tax revenues.

Paul Johnson: If we get back to productivity growth and earnings growth then clearly we will get back to some degree of tax revenue growth. If we continue what we have over this period, which is employment growth with very little in the way of earnings growth, then that is going to create problems for Chancellors in the future.

Q73 Jesse Norman: The multi-billion pound question is the one that was raised earlier, which is the question as to whether or not the current situation we are in is a function of labour market conditions or whether there is a permanent reduction or long-term reduction in productivity growth. Do you have a view on that? The average worker generally seems to be better educated now and more productively using equipment than in the past. The idea that that person has somehow permanently become less productive is a bit of a hard stretch, is it not? Where do you come out on that argument?

Paul Johnson: You are right. The average level of education is still rising quite fast and so the productivity puzzle is an even bigger puzzle than it looks, because you would have expected things to have—

Jesse Norman: It points towards the labour market argument rather than a productivity argument.

Paul Johnson: Yes, exactly. You would have expected things to have got better. That said, we have been drawing new groups into the labour market. For example, if people in their 60s are happy to work 10 to 20 hours a week in relatively low-productivity jobs, it may be that there is some sort of structural shift in which there is an additional group who are willing to work those less productive jobs and that may have a statistical effect in the long run. This is not on the basis of much evidence, unless we believe the world has

changed fundamentally into the future. My guess is that we will get back to something that looks more like it was pre-recession, but when that will happen is anybody's guess.

Q74 Jesse Norman: But the effect could be quite powerful economically because, as you say, we have these self-employed people. You have more people in the workforce than before, broadly speaking. If productivity starts to reassert itself then the actual amount of money in the economy doing productive, generative work could be quite significant. Just to pick up on the point about self-employment, that is not necessarily a bad thing from an economic standpoint, is it? These people may be contributing less in tax, but the actual amount of economic activity may well be high and productive, benefiting the economy generally.

Paul Johnson: Particularly if the alternative was they would not be in work at all.

Q75 Chair: Just to clarify the answer you gave to the key question, which is whether these falls in tax revenues are structural or not, what I think you said was if incomes go up then we will find that tax revenues are more buoyant. What we need to know is, for any given unit of income, whether the permanent yield in income tax is going to be lower than we used to think. That is what structural means. Is this structural or not? The OBR seem to be saying it is. What does the IFS say?

Carl Emmerson: There is a fantastic chart in the fiscal evaluation report the OBR produces where they are saying, "In the current year, what is the average tax rate on coming from income tax and NICs?" It is much lower than what they thought back in June 2010 and only a small amount of that change is explained, they think, by policy changes such as the increase in the personal allowance. A lot of it looks like other changes that are going on in the economy. That does not mean it is going to keep falling going forward. Clearly there is a risk it does, but there is also a risk that it bounces back up to what we were expecting back in June 2010.

Q76 Chair: I am asking the same question, which I think is the key question that Jesse asked. I am asking it again and I am still looking for the IFS answer. Do you or do you not agree with the OBR? The OBR have made a big call here and what I am asking the IFS is: do you agree?

Paul Johnson: The OBR is making a call much more on its view about the structure of the economy than it is about the interaction between the tax system and the economy. We agree with its view about the interaction of the tax system and the economy. We do not have a view about the structure of the economy.

Chair: Well, we will take a look at that in the transcript but I cannot help feeling that that was a—

Mark Garnier: A thin gruel.

Chair: Yes, whether that was soup or water it is difficult to tell, but do you want to have a go, Mr Emmerson? "No thank you", he says. We have great witnesses here, Mark. Have a go yourself; see how far you get.

Q77 Mark Garnier: Can I turn back again specifically to the shape of Government and what we are trying to get out of it? The OBR says, “Between 2009-10 and 2019-20, spending on public services, administration and grants by central government is projected to fall from 21.2 per cent to 12.6 per cent of GDP”. The idea is that 40% of these cuts are going to be delivered during this Parliament with 60% more still to come, as you know. Genuinely, how realistic is it that public services are going to be maintained to any kind of familiar standards while trying to deliver such significant cuts in future expenditure?

Paul Johnson: If you are cutting spending on something by 40%, it would be pretty impressive performance if it was continuing to perform at the same level that it was before you imposed 40% of cuts.

Q78 Mark Garnier: You expect it to be unrealistic to be able to cut this without an effect on services?

Paul Johnson: Without an effect on services would be pretty difficult, yes.

Q79 Mark Garnier: Just out of interest, if you go back to the mid-1990s as a long-term period, what was the Government spending as a percentage of GDP? Do you know those numbers off the top of your head on this specific point, on these services, administration and grants?

Paul Johnson: It was certainly high. Our calculation is that, if you look at DEL spending excluding the NHS, it was about the same in real pounds terms in 1997 as it will be in 2020 on these forecasts. That is over 20 years of economic growth with the same real pounds spending on non-NHS DEL spending. That suggests a much lower proportion of GDP in 2020 than in 1997.

Q80 Mark Garnier: What about going back further than that? This comes to the fundamental question of: what do you expect out of Government? What I am trying to get to is: is this a recent phenomenon, where we have seen quite a high percentage of GDP being spent on Government, or is this something that is going back 100 years, where we are now seeing a fundamental change?

Carl Emmerson: The OBR’s figures show that Government spending on public services in 2020 would be at its lowest level since 1938 and we know the NHS is much bigger than what it was in 1938, so clearly the spend on other—

Paul Johnson: It did not exist in 1938.

Carl Emmerson: Exactly. The spend on the rest is squeezed quite significantly as a share of GDP. As Paul just said, in real terms you are talking about departmental spending outside the NHS back in real terms to what it was in about 1997 or 1998.

Q81 Mark Garnier: Nonetheless, it still comes to this great quandary that if you look back to 1930 you see, in the very broadest sense, tax receipts between 30% and 40% of GDP and the cost to the state between 40% and mid-50% of GDP. At what point does this ever work, Paul Johnson?

Paul Johnson: I am not sure I follow the question.

Mark Garnier: If you just go back over this long-term period, without being able to pay back debt without selling national assets, given what we know about tax receipts in terms of percentage of GDP over a long period, is it ever possible for a Government of this size to be able to pay sustainably into the future?

Paul Johnson: Other countries clearly have tax as a proportion of GDP at higher levels than those that we have at the moment and some countries have them lower. If you look at the US and Australia and a lot of non-European OECD countries, they have smaller levels of taxation. A lot of European Union countries would have higher levels of taxation.

Q82 Mark Garnier: But they are quite different economies. They are much smaller economies, are they not?

Paul Johnson: Well, Germany and France are not. I do not think it is economically implausible to suggest that you could have 1% or 2% or even 3% of GDP more in tax than we have at the moment, but that could be a big choice.

Q83 Mark Garnier: That can come from sorting out the productivity puzzle, getting higher wages up and that kind of stuff.

Paul Johnson: If the economy starts growing then fiscal drag is always the easiest way of increasing the tax to GDP ratio. I think your point is an important one because what we are not looking forward to in these figures is tax as a proportion of national income any lower than it has been for 30 years. Indeed, I think it still hits something close to its 30-year peak. We are not looking at tax as a proportion of national income at a particularly low level going forward. Therefore, to be looking at spending significantly higher than in these numbers you would need to have a state and a tax take that is a bit bigger than we have seen in the past. I think there lies the dilemma because we are going to have a world in the next 10, 20 or 30 years in which the demands on the state are going to be bigger.

We have a bigger, older population and the demands on pensions and health and so on are going to be greater. One way of dealing with that is to squeeze everything else to ensure that we keep spending on pensions and the NHS and the squeeze on that, as we have discussed, is quite substantial. Another way of dealing with it is to say, "Well, the demands on the state are bigger. We just will have a bigger state". That is a big political and economic choice.

Mark Garnier: If you cannot finance it—

Paul Johnson: Well, the question is: can you finance it? Could you get an extra percentage point or two or three from taxation? It is not economically impossible. It is politically very difficult, clearly.

Q84 Mr Love: The Chancellor has claimed so far that he has been able to “control public spending, improve public services, reduce the deficit and still cut income taxes”, all at the same time. Would you agree with this assessment?

Paul Johnson: The deficit is smaller. Public spending, at least on public services, has gone down although it has not gone down very much at all overall because of pressures on things like pensions. I cannot remember what the numbers are, but the overall level of TME has come down very little over the last five years. Income taxes have come down a bit, but other taxes clearly have gone up. Taxes in toto have gone up over this period, not least because of the very big increase in VAT at the beginning of the Parliament.

Q85 Mr Love: Would you like to add to that, Mr Emmerson?

Carl Emmerson: No, I think he is right. The Chancellor has delivered the spending cuts on public services that he intended at the start of the Parliament. He has delivered a net increase in taxes from things that he has chosen to implement. However, despite being a Chancellor who has put taxes up, on average he has been able to find money for some big giveaways on the tax side. You have seen some big tax cuts and some big tax takeaways. Overall it is a takeaway. He has clearly cut the deficit but he has not cut it as much as he hoped.

Q86 Mr Love: Let me look at some of these issues in greater detail. The Chancellor said in January that to reduce the deficit without even faster cuts to government departments will require £12 billion of further welfare savings. Is that still the case?

Paul Johnson: We think that if you are to look over the whole period of the forecast horizon, now out to 2019-20, to keep the rate of cuts for departments at the same level as they were over this Parliament you would need rather more than £12 billion of welfare cuts or tax increases.

Q87 Mr Love: What sort of figure are we talking about?

Paul Johnson: We reckon something more like £20 billion or £21 billion.

Carl Emmerson: One of the reasons for the difference is the Chancellor is referring to a £12 billion welfare cut to keep the pace of cuts up to 2017-18 and, of course, the forecast horizon now goes to 2019-20. We are including all four of those years, so it is not a surprise that we get a number that is roughly twice as big. It is not quite twice as big but it is that kind of ballpark.

Mr Love: So the Chancellor needs to update his figures from £12 billion to £21 billion?

Carl Emmerson: If he wants—

Q88 Mr Love: How successful has he been at restraining welfare expenditure? There have been a number of changes, particularly in housing benefit. Has that meant that expenditure has been constrained or is welfare expenditure continuing to rise?

Carl Emmerson: The measures he announced at the start of the Parliament to cut the welfare budget have delivered cuts, but they have not been as big as what was expected at the time. The biggest change is a move from RPI indexation for most benefits to CPI indexation and a move to 1% in many benefits. Those changes did not deliver the savings he hoped because the gap between RPI and CPI and the level of inflation has turned out to be lower more recently, so that did not achieve as much of a saving as hoped.

The other changes such as the shift from incapacity benefit to employment support allowance, which the last Government had started, and the shift from disability living allowance to PIP, both look like they are going to save less than what was hoped for because of operational reasons. As you start to do these reassessments of health, you find savings but not as big as was hoped for. The welfare cuts have delivered cuts but not as big as what were intended at the start of the Parliament.

Q89 Mr Love: Your analysis suggests that by 2019-20 88% of deficit reduction will come from spending cuts while only 12% from tax increases. Is that sensible?

Paul Johnson: There is a choice here and, referring to the conversation we were just having, what that choice implies is no increase in the long run or at least the medium run share of tax revenues and, therefore, in the long run of the state in the economy. If you were to say, "What would be a good explanation for that choice?" it would be to say, "Well, we do not want to take the recession and use that as a reason for ratcheting up the size of the state". That would be the defence you would make of that. I think the argument against it would be that this is what we were discussing earlier also, which is the scale of the cuts that it implies and the fact that potentially an economy is capable of coping with a slightly higher take from Government. That is exactly the balance you need to weigh there, again in the context of a world in which the demands on the state probably are growing because of demographic change.

Q90 Mr Love: Originally the Government's intention was that it should be an 80:20 split. You have suggested it is 88:12. Are we moving in the wrong direction? Should there be more consideration given to tax increases?

Carl Emmerson: The reason the ratio is changing is because originally the plan was for 80:20 but since then the deficit has proved more stubborn. More action is needed to get it down and what the Chancellor has done is, instead of responding by saying, "Hey, I am going to do some more tax rises", he has said, "Hey, what I am going to do is do some more squeeze on spending in the next Parliament". At the margin, all of the additional action he is doing to get the deficit down is coming on the spending side. That brings that ratio up from what was 80:20 to something like 88:12 and, as Paul just said, that is a choice that we have as a country. It is not right or wrong.

Q91 Mr Love: It is a choice, but you have used some flowery language describing the impact on other government departments than those that are ring-fenced as being colossal cuts. You are indicating now, in terms of welfare expenditure, the structural changes they have made to try to budget have been disappointing. Does that not mean that, realistically, going forward any Government will need to look to tax increases to make up the difference and keep the deficit reducing?

Paul Johnson: I suspect that will be easier and that is why, if you look at the tax increases over the period of the consolidation, most of them happen straight away and the spending cuts have been over a much longer period. It is not going to be impossible to make those cuts, if that is what the Government wants to do. It just needs to be clear what the impact of those would be.

Q92 Mr Love: Let me ask you one final question. The Government is saying that in the future they will look to tax reductions; £7.2 billion is the IFS estimate. In the context of deficit reduction, is that sensible?

Paul Johnson: It makes everything else much more difficult. It has been very striking over this Parliament how £12 billion or so is being spent on increasing the personal allowance and something like £7 billion or £8 billion on reducing corporate tax. Those are remarkable choices in the context of the deficit reduction you have and, therefore, the spending cuts you have. Clearly, cutting taxes makes the arithmetic elsewhere more difficult.

Q93 John Mann: Mr Johnson, if you were an employer who would you choose to employ, a 40 year-old with virtually no work history and severe mental health problems, who is perhaps an alcoholic, or a young graduate from the European Union?

Paul Johnson: If I was looking for a graduate-level job, I would employ a graduate. At the IFS we are always looking for graduate-level jobs.

Q94 John Mann: One of the problems in shrinking the welfare budget is, of course, that some people are not attractive to employers and those people remain in society and do not hold down jobs. There is a lot of evidence in relation to that. For example those with drug and alcohol problems may be forced to take a job by the state but they often get out of that job very quickly, not least because—they may or may not want to—the employer is not very keen to keep them on. There is an ongoing problem with today's policies in shrinking the welfare budget. You have identified that it would be a big political shift to start cutting pensions in real terms and you have identified other ring-fenced departments. There is a set of current policy fixtures that could change, but you are doing your assumptions, as I understand it, presumed on them not changing.

Paul Johnson: We have illustrated the impact of essentially the whole series of options that you would have. You could do what the numbers in the *Green Book* suggest, which is make all the cuts through DELs going forward and you could do anything all the way up to a world in which it is all done through increasing taxes and reducing welfare. If I recall, that requires something like £45 billion of tax increases or welfare cuts to keep DEL cuts

to zero over that period. What we try to do is illustrate the whole series of trade-offs that are available.

Q95 John Mann: With current policy projections you are suggesting cuts in some government departments. Let us take Defence as an example. How much are you predicting, with current policy decisions, the Defence budget will need to be cut by 2020?

Paul Johnson: The average cuts for non-protected departments over that period, given the policy assumptions you are describing from 2015 that protections continue, would be 14%. If Defence gets its share of that then it is 14% but, of course, you could decide to cut Defence more and other things less or Defence less and other things more.

Q96 John Mann: That is predicated on no change in the current status within the European Union and migration.

Paul Johnson: Yes. I do not think the OBR's numbers or any of the numbers we have put together are based on us being outside the EU.

Q97 John Mann: Has anything significant changed in the economic methodologies that you have used over the last five years?

Paul Johnson: To be honest, what we are discussing here is very straightforward. It is a straightforward spreadsheet looking at the trade-offs, given a certain amount of money, in terms of where that money goes. If you have an assumption about what total spending is and you know the size of the population and pension spending and so on and the total amount that is going to go on protected departments and the number of protected departments, there is not much methodology to change.

Q98 John Mann: Why then did you fail to identify five years and four ago in your projections, including when you came to this Committee, about the Chancellor missing so significantly his promises on deficit reduction and on the huge increase in national debt? You missed that five years ago. You did not project that what the Chancellor was saying in his first Budget was going to be so out. What I am interested in is why.

Paul Johnson: The reason he was out is that the economy in the first half of this Parliament performed much less well than he and the OBR projected and, as we have described on a number of occasions, we do not make our own projects of what is going to happen to the economy. We take economic projections and apply fiscal models to them. Given what has happened to the economy, the deficit has not come down. It has not been very much to do with changing fiscal projections, given economic projections.

Carl Emmerson: If you look at the history of official forecasts in the UK for the deficit, looking four years out, average error of projected borrowing, it is about 4% of GDP. So that is getting on for £80 billion. That is the average error. Clearly, whoever sits here and tells you the deficit in four years' time is going to be X could well be out by a magnitude of £80 billion up or down and still be making an average type mistake. You could get bigger errors and you would expect bigger errors in times when the world is much more

uncertain. You have plan not only on the basis of the central forecast, your best guess of how the world might evolve, but you also have to think a lot about the uncertainty around it and what you would do if things turn out to be a lot better than you expect and what you would do if things turn out to be a lot worse than you expect. One thing you can be pretty sure of is that it will not turn out exactly how you do expect.

Q99 John Mann: I want to ask you about the OBR's projections on the so-called Google tax. Do you think it is realistic to bring in the amounts of money that have been specified, particularly in the ensuing years after next year? Do you think that is an underestimate or an overestimate?

Paul Johnson: First, the numbers are not terribly big. From recollection, they are a small number of hundreds of millions. Secondly, given that we have no details whatever of what this tax is going to look like, I do not know.

Q100 Alok Sharma: Just picking on the diverted profits tax, this is a unilateral measure and clearly the Chancellor and the Government have been leading the OECD on these issues relating to tax avoidance. How effective do you think this is going to be as a measure in raising taxes?

Paul Johnson: We are expecting the details of this tax hopefully this week. We have almost no details of it, so it is very hard to know. My understanding of it is that it will be looking to identify those bits of profit that are in some sense undertaxed because of fairly aggressive avoidance behaviour. I think one should think of it more as an anti-avoidance measure than anything else. My understanding again is that the revenue projections are based on HMRC's bottom-up estimates of where they think those aggressive measures are happening and where they think they can get it from. To be honest, we are not in possession of any of that data or analysis to be able to make an independent assessment.

Q101 Alok Sharma: You are absolutely right. We need to see the full details of this, but do you think this will set a precedent for other jurisdictions to follow as well, given that it is predicated on the fact that if you have economic substance in a particular jurisdiction that is where you ought to be paying your taxes rather than diverting them to somewhere where you can get a more effective tax arrangement, shall we say?

Paul Johnson: That is an interesting question. In one sense, my understanding of where the BEPS process is heading is it does want to get to a world in which there is more relationship between economic substance and where the tax happens. One of the issues about the BEPS process is that there may be a zero sum game here and this may result in a different set of arguments internationally about where this revenue can be raised. Exactly how it was going to fit into that I do not know, but I would not be surprised to see other countries trying to do very much the same kind of thing.

Q102 Alok Sharma: I appreciate that you want to see the full details of this, but how compatible do you think such a tax would be with the double tax treaties that the UK has with other jurisdictions?

Chair: That is a tough question.

Paul Johnson: I think you may need to ask a lawyer about that, if I am honest. I do not know.

Q103 Alok Sharma: Could I just ask one more question very briefly, which is to do with the taxing of banks and offsetting prior losses only at 50%: how optimistic are you that this is going to raise £3.5 billion over the next five years?

Paul Johnson: The first thing to say is, whether it raises £3.5 billion in the next five years or not, that is not, on the basis of the way the legislation is currently drafted, going to be £3.5 billion in total additional. That is just money brought forward because of the way the tax is designed. Whether it would lead to additional efforts by those banks to avoid that tax or find other ways of not paying it, I do not know. It looks a bit like a windfall tax on a particularly greedy bank.

Q104 Alok Sharma: Do you consider this a retrospective tax?

Paul Johnson: Is it a retrospective tax? It is effectively retrospectively changing the rules around the treatment of losses.

Q105 Mike Kane: My question is around the air passenger duty and the changes that were made. They are abolishing it for under-12s in May and under-16s in May 2016. Any quick views on what you think of that?

Paul Johnson: I do not think it is going to have a big economic effect. My youngest children are turning 12 next week, unfortunately.

Q106 Mike Kane: Paul and Carl, you are very well-educated men, University College London and Birkbeck College London. It does not have a big economic effect. I want you to now project yourselves so that you are northern regional economists and you are looking out for the interests of regional airports outside the south-east of England. Let me ask you the question: do you think it will have any effect?

Chair: I do not think they have thought about that one.

Paul Johnson: I do not think either of us are experts on air passenger duty and the impact of how children are treated in that. In terms of if this is devolved to Scotland and they charge a different amount to airports in England then clearly tax competition issues will come into play.

Q107 Mike Kane: That is well read, because my next question was the Smith commission will give this as a devolved power. Therefore, the SNP are already saying they

will scrap air passenger duty north of the border. At £194 per flight over 6,000 miles, how do you think that will impact in terms of Scottish airports and, say, Durham Tees, Newcastle, Manchester, Leeds, Bradford, Liverpool?

Paul Johnson: That will clearly provide a competitive advantage to flights going out of Scottish airports and will distort choices about where those things happen.

Q108 Mike Kane: Should we have differential airport passenger duty in the UK? This is still a blanket policy. It is a classic capital-centric to get tax from Heathrow while bashing regional economies and drivers of growth in the regional airports elsewhere in the country.

Carl Emmerson: To turn the question around, if we are going to devolve taxes within the UK we should think carefully about devolving those that are particularly easy to measure where they are and will not distort location decisions. Property taxes are a good tax to devolve. That is why we have council tax devolved. Things like air passenger duty are going to be more problematic. It does not mean it is impossible and it does not mean you should not do it, but it is not going to be as good as property taxes and things that are less mobile. You asked whether we should have it uniform. If I was going to have an APD I would have it uniform on all people, not just those aged over 12 or 16.

Q109 Mike Kane: Yesterday I was with the chief executive of Cathay Pacific, the chief executive of Manchester Airport Group and the Chinese Consul General. They have had to fight for years to get to point-to-point, the first flight to China from a regional airport in the UK and they say it is down to APD. If we had differential APD, APD holidays or no APD at all we would reboot our northern and regional hubs with point-to-point to growing economies. Any thoughts?

Paul Johnson: I am afraid I have no idea about the responsiveness of where flights go from according to the tax rate.

Chair: It is always good to find out what the IFS do know and what they do not know. We have found a couple of little corners they do not know this morning.

John Thurso: I predict Wick International will be booming within a decade. Moving rapidly on—

Chair: It is just down the road from your constituency, is it not?

John Thurso: It is in my constituency, as you should remember having driven through it.

Chair: Of course, once you get north of Inverness—

Q110 John Thurso: Can we come back to the OBR's new welfare trends report and ask if you find that useful and if there are any changes you would like to see in it?

Carl Emmerson: I think it is a very useful report. When you think about what the welfare cap has done, maybe the annual welfare trends report is the bit you can definitely say is an improvement and perhaps it is a surprise we did not have this before. In terms of what

could be done better, for a first year I can see why they have tried to do the whole of the welfare system in one report but I think, going forward, it would be quite good if you had a particular focus on particular parts of the benefit system. Maybe the OBR should think about support for housing costs in one year's report and look carefully at the drivers of that and maybe in the next year's report look at the drivers of disability benefits and the health of the population, rather than try to do every single part of the welfare system in 150 pages.

Q111 John Thurso: That is a very interesting observation and begs the question: which one would you like to see them do first?

Carl Emmerson: I mentioned those two because they would be high on my list.

John Thurso: If it was your choice, which would you—

Carl Emmerson: Which would I do next? I think I would probably go for the disability because that is where a lot of the Government's reforms are. On housing benefit, because we have now CPI indexed the maximum amount you can get, the public finances are a bit less sensitive to what happens to private rents. Probably the health of the population, the level of disabilities and how that is feeding into disability benefit spending, would be pretty high on my list.

Q112 John Thurso: Paul, can I come to you? You had an article in *The Times* recently that caught my eye, which I cut out and kept. It has a statement in it that you wrote, which I suspect was deliberately meant to be provocative but it says, "Pensioners as a group have stopped being poor". Is it your thought that the state needs to start rethinking where pensions sit in the welfare system or how they sit in the amount spent?

Paul Johnson: What that statement was supposed to say was that 30 years ago pensioners were much more likely to be poor than people of working age and there has been a fantastic change over that 30 years that now pensioners are less likely to be poor than people of working age and, indeed, for the first time about three years ago, on an after-housing-cost basis, average pensioner incomes are higher than non-pensioner incomes. The world has changed is what that was trying to say and it has changed dramatically. That is not to say there are not poor pensioners. It is just that it is no longer the case that a very large proportion or a much higher proportion of pensioners are poor.

My sense is that the policy thinking has not necessarily caught up with that new reality and, therefore, you might want to think about whether we are taxing pensioners appropriately, whether we are taxing pensions appropriately and whether we are thinking about the universal benefits that are available appropriately, with one note of caution that the generation of pensioners 20 or 30 years hence may look very different from this generation. We have seen a big change in 30 years. We may see another big change over the next 30 years, so we do need to be aware of that change.

Q113 John Thurso: There are two elements in looking at pensioners and pensioner poverty or affluence. One is, of course, what any given set of pensioners have managed to

save for themselves or contributed to arrive at having a pension, and you draw attention obviously to all the public sector pensions. The other, and I think the one that most of us are perhaps more concerned about, are the pensioners who are pretty much completely or very largely reliant on the state pension. The triple lock was designed specifically to ratchet that up, whatever the circumstances, in that whichever one of the various measures happens to be doing best they will get the best measure. Since over time each measure will have moments of being best, the net effect is always an above-average increase. That then begs the question: at what point do you say, "Right, we have achieved the rebalancing. Now is the time to change that"? That was the bit you did not get into in your article. What are your thoughts in that direction?

Paul Johnson: My thoughts are very much consonant with what you said. If it goes on forever then the pension does not become infinite but it just grows forever. You do need to take a view about at what point you revert to either price or earnings indexation rather than the better of both. The judgment on that will depend on a range of things. To the extent that you have a very unequal distribution of income among pensioners with a large number on relatively high incomes, paying increasingly large amounts to them becomes a less effective use of money. To the extent that we move to a world in which more pensioners have less income then spending more money is a better use of money. You have to contextualise it in terms of the distribution of incomes that you have among pensioners.

There is no right answer to how big this number should be. It would be good to know what Government and Opposition think that number should be because at the moment we do not know. What we sense is it is just continuing until that point at which someone decides to stop, but it would be quite nice to know what that point would be.

Q114 John Thurso: Do you suspect that the decision point is beyond the time horizon of the current forecast and, therefore, Governments and Oppositions will worry about it when they get there?

Paul Johnson: Most likely.

Carl Emmerson: I think Governments also need to be aware, when they are making other changes to the tax system, how it affects pensioners differentially. Over this Parliament we have increased the personal allowance a lot. That has not benefited pensioners. If we continue to increase the personal allowance, however, as we will do next April, it will benefit pensioners. If we continue to run policy as we have done over the last 30 years or so where we tend to cut income tax rates and put up national insurance rates that will reward pensioners relative to the working age population, because pensioners do not pay national insurance whereas the working age population do. That may be intended, and it is fine if it intended, but if it was not intended then perhaps we should be a bit more aware about what we are doing and what redistribution is going on.

Q115 John Thurso: The state pension was supposed to be contributory. Do you regard it as contributory?

Paul Johnson: Not in any serious sense, no.

Q116 John Thurso: No. Is that something we should be looking at again? In a way, if you say, “Right, here is a pension; you have paid tax but there is absolutely no relationship between it”, you are inevitably into having more requirement from taxation to pay that. To what extent would a return to a contributory basis help in that or would it be irrelevant?

Paul Johnson: My view is that the move to the single-tier pension is the logical conclusion of what is now 36 years of trying to move away—SERPS was introduced in 1978. I think the history of pensions since 1978 has been moving away from SERPS. The single-tier pension takes us to the logical conclusion of that, plus a series of other changes that have weakened the contributory contributions necessary to get a full basic state pension, such that the very large majority of people were in any case building up rights to the full basic pension. With the single-tier pension we will have something that is close to a citizen’s pension or one that is universal, essentially based on a history of having lived in the UK for the past 30 or 40 years. That feels to me like a relatively straightforward, rational state to be in. There is a different rational state to be in, which is a fully contributory system, but it seems to me that would have involved 30 years of moving in one direction and then start moving in the other direction. It may be that we should just stick with the place that we are then comfortable.

Q117 John Thurso: We have chosen and probably should not change the concept of universality in relation to the state pensions.

Paul Johnson: My sense is that the changes we are seeing towards that single-tier, pretty much universal state pension has moved us into a pretty sensible position in terms of the structure.

Chair: Thank you very much for coming to give evidence. We have run on just a little. We have Treasury questions that a number of colleagues will want to attend and so we have to bring the session to an end. Thank you very much indeed.