HOUSE OF LORDS

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The Select Committee on Economic Affairs

Evidence Session
with

CHANCELLOR OF THE EXCHEQUER

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TUESDAY 8 SEPTEMBER 2015

3.35 pm

Witness: Rt Hon George Osborne MP

Members present

Lord Hollick (Chairman)
Baroness Blackstone
Lord Forsyth of Drumlean
Lord Griffiths of Fforestfach
Lord Kerr of Kinlochard
Lord Layard
Lord May of Oxford
Lord Monks
Lord Sharkey
Lord Teverson
Lord Turnbull

Examination of Witness

Rt Hon George Osborne MP, Chancellor of the Exchequer

Q1 The Chairman: Chancellor, can I welcome you to the Economic Affairs Committee? We have some stiff competition from next door with the appearance of Angelina Jolie, but we have a good attendance today and thank you very much for coming.

We published a report on the economic case for HS2 in March and we have a debate on it next week. There has been some subsequent to-ing and fro-ing in correspondence with the Department for Transport. Disappointingly, we found the economic case unconvincing, in part because we were not able to receive certain information about capacity and in part because we felt that the case just had not been effectively made. I really just want to raise two issues with you today. One is cost, because I know that you have set David Higgins the task of bearing down on costs. Just a couple of headlines there: the cost of phase one, which is the only part of HS2 that has been effectively costed—the other half is, if I can put it like this, a "plug" number—works out at about six times the cost per kilometre as France. There may be some mitigating factors, but that is the bottom line. The speed at which HS2 is going to travel is significantly faster than the speed in the rest of Europe, and that is estimated to cost at least 9% more. The decision to tunnel under a large part of London and to re-model Euston station has added many billions, whereas the option of making a terminus at Old Oak Common and linking into Crossrail and the Heathrow Express seems to have been dismissed. I know you have asked David Higgins to look at all these things, but what target do you have in mind for a reduction in the cost of this project, which, although it is £50 billion in 2011 money, if we do it in today's money is probably nearer £56 billion or £57 billion?

***Mr Osborne**:* First of all, I am a strong believer in the economic benefits of High Speed 2. It will help change the economic geography of our country. In the end, Governments find all infrastructure decisions highly controversial. I represent a constituency in Cheshire. The book that was set in my constituency, *Cranford*, is based around opposition from the town of Knutsford to the coming of the railway; everyone is against it. I can tell you in Knutsford they want more trains at the moment rather than no trains at all. Big infrastructure is always controversial. Clearly it is expensive—and I will come on to your direct question—but in the context of a Government budget of £750 billion a year, spending £50 billion over the next 20 years to improve the nation's infrastructure is something we can afford and it will help address, albeit not single-handedly, the regional disparities we have in our economy, which is one of the biggest challenges the UK faces. I would say to make it really effective you also need the Trans-Pennine link—"HS3", as it has been dubbed—and we can perhaps talk about that.

I have not set any kind of parameters for David Higgins on how much money he needs to save. We have a budget. There is a very substantial contingency in that budget, as you are aware, of £14 billion. For those people who think you can never deliver these things on time and on budget, Crossrail, probably the most complex piece of infrastructure being undertaken in the western world at the moment, is on time and on budget. There we are tunnelling under some of the most expensive real estate in the world in one of the oldest capital cities in Europe and it is being done very effectively. David Higgins has been asked to look at the plans and see how they can be improved. He has not just got a remit for saving money. Obviously, if he can save money, that is good. You raise the question on the French example. That is something we ourselves have raised and asked him to look at. Some of the new French TGV construction in the south-west of France is a lot cheaper than Britain. I am always told, but I defer to the expertise around this table, that is because the British people place a lot of store by their property rights, and Parliament and our judiciary have over the centuries done much to entrench those rights.

The Chairman: What about the suggestion that the terminus should be at Old Oak Common? Is that something that you have looked at?

***Mr Osborne**:* I am not a city planner. Essentially, if we are going to build this project, let us do it right and bring it into the heart of our city. Old Oak Common is a fantastic and exciting development that will lead to a big regeneration of that part of London, but there is a compelling case for bringing it into the heart of our city and close to the Eurostar terminus at St Pancras. At it happens, we just today published our plans for the redevelopment of Euston station. The truth is that if you look at what the regeneration of King's Cross station has done there, it is fantastic and has totally transformed that entire area. Now what was frankly one of the less salubrious parts of London is thriving with business activity, universities and the like. Frankly, Euston is not our most attractive London terminus and I would use this as a big opportunity to regenerate the Euston area. If you look at the area around Euston, I think we could be making much more of that for local people as well as for the capital city.

Q2 The Chairman: Can we come to the point about regional imbalances? Clearly, one of the principal and most persuasive arguments for HS2 is to improve and help the economy, particularly in the north. The evidence we took really showed that it was the capital cities by and large that benefitted most from high-speed links; it gets people into capital cities. Inter-regional improvements in transport, such the "northern Crossrail" perhaps, would be the most effective way of improving the economy in the north and supporting the ambitions of the "northern powerhouse". Lord O'Neill, who is now part of your team at the Treasury, made the point when he appeared before us in January as chairman of the City Growth Commission that this should be prioritised. That view was shared widely. The city leaders in the north clearly would like to have both, but since the election the electrification of the Trans Pennine route has been paused—quite what that means perhaps you could explain to us—and therefore it would appear that that very important pillar in the argument for economic growth and the policy for economic growth is crumbling, or unlikely to be built at this stage.

***Mr Osborne**:* It is important to distinguish between the electrification of the existing line, which I would dearly love to go ahead, but all the engineering advice that we have been given is that Network Rail has not correctly estimated how long that is going to take or the engineering challenge involved or, indeed, the cost. We have changed the management of Network Rail, because that was one of the symptoms of a broader problem at that organisation, and we have asked Peter Hendy, who has delivered a lot of the London transport improvements of recent years, as new chair of Network Rail to look at that very specific project. It does not mean, by the way, that there are not plenty of improvements coming to the Trans Pennine route—new trains, faster journeys, more capacity—but clearly I would like to get that scheme under way. I am not a railway engineer, but my colleagues and I have asked someone who is a railway engineer to tell us what we can do about that. That is distinct from whether we are to build a new or vastly improved faster line across the Pennines. That would make the whole high-speed network more whole, and there is a compelling case for doing that. We are looking at that for the spending review on 25 November.

In terms of the argument, I do not think that HS2 prevents us doing other things. The railway budget is going up absent HS2, as is the broader transport budget. HS2 is just one of those big decisions that countries face. The M25 and the Channel Tunnel were both massively controversial. I defer again to the experience in this room, but the Treasury said that there was no value for money in the M25 and it was opposed bitterly in this Parliament by Home Counties MPs. The Channel Tunnel, again, was strongly opposed by a number of people. It cost the private contractor dearly, but I do not think that anyone would say now that that was not a sensible piece of our infrastructure. Each generation has a responsibility to take big, controversial decisions to improve the nation's infrastructure, and this is one of the ones that faces our generation.

The Chairman: So the pause on electrification is for operational review and operational reasons, not for financial commitment.

Mr Osborne*:* It is to make sure that this project can be delivered and in a cost-effective way, but I am determined to make it happen. For me it is a question of how, not whether.

Q3 Lord Layard: I wanted to ask about fiscal policy. Would you agree that the deficit that you inherited was mainly due to a worldwide financial crisis rather than expansionary fiscal policy, given that in 2007 the deficit was lower than in any year under the previous Government led by John Major? Given that that is our interpretation of how we got into this mess, what is the case for pursuing a contractionary fiscal policy right through to the end of this Parliament, as you are proposing, particularly when we have a hugely respected central bank standing behind our Government, so it is not at all like Greece or any other country with a deficit the size of ours?

Mr Osborne*:* I would make two points. First of all, when I became the Chancellor we had an 11% budget deficit. That was the highest peacetime deficit that we have had in this country by some margin and several per cent higher than either the one that Norman Lamont or Denis Healey faced. Although part of it had been caused by the cost of the interventions and the fiscal stimulus that the previous Government had undertaken in response to the financial crisis, it was also the case that the UK had gone into the crisis after a very long period of economic growth running, compared to our competitors, a high budget deficit and had not used that period, in my view, to put our nation's finances into better shape and to be running a surplus in what were the boom years of the middle part of the last decade. There were questions at the time about confidence in the UK. They were dismissed, as were concerns about confidence in other European countries, and then I watched over several years as one country after another entered into a fiscal crisis, or some version of a fiscal and banking crisis.

If you fast-forward to today, we have a budget deficit that last year was close to 5%—4.9%. If I had not had an 11% budget deficit, you would all be pretty worried about a 5% budget deficit. If you are not prepared to be reducing your deficit now, when the economy has been growing for six years, when we have above-trend growth rate and when your unemployment rate is at 5.5%, when exactly are you going to repair your public finances and try to bear down on your debt? The problem I have with people who advocate spending more money is, it seems to me, that they advocate spending more money in all circumstances. Their argument is that when your country is doing well and your economy is growing, you can afford it; and when your country is not doing well, you cannot afford not to. I would argue that a responsible Government, faced with the current relatively benign domestic economic conditions—there are lots of challenges, which we will no doubt talk about—faced with a 5% budget deficit and a national debt that has gone up to 80% of our GDP, would be wanting to bear down on that. The truth is that until you get that deficit down and eliminate it, you cannot reduce your debt in a sustainable way, bearing in mind that every now and then the world is going to throw a shock at you. It is not enough to run a permanent deficit, in my view.

Lord Layard: I accept that, but there is the obvious way of reducing the deficit by allowing growth to bring higher taxes without inflicting very big expenditure cuts, which are causing a great deal of hardship. That is the alternative strategy. It would be nice to know why you have rejected that.

***Mr Osborne**:* Indeed, but the interesting thing is that we have had strong economic growth for the last several years and it has still left a stubborn structural budget deficit. As you know better than anyone, the definition of a structural deficit is a deficit that it is not going to disappear with economic growth alone. You get yourself into a self-fulfilling cycle where you keep saying, "We will get ourselves out of this fiscal hole by spending more money and that will stimulate the economy and we will be able to pay down our debt or our deficit." Other countries that have attempted that have not really found that to work. The country has to confront a simple truth, which is that if you want to have a certain level of spending, you have to raise the taxes to pay for it. People who advocate simply borrowing-financed current expenditure—and indeed capital expenditure, if you want to talk about that—do not really have the courage to go to the British people and say, "You know what? I would like to raise taxes, because I would like a more generous welfare system", or, "I would like to spend more on my public services". Essentially, they are not willing to do that because they do not think the British public are going to give their consent.

Lord Layard: But how important is it to reduce the debt? You can reduce the debt-to-income ratio simply by holding the debt constant and having a bigger economy to support it by.

***Mr Osborne**:* Our debt to GDP is uncomfortably high. I am not saying that we are the only people in the world in this situation; there are many other European countries too. Since you and I do not know what is going to happen tomorrow, I would rather be in a position where we have used this period of economic growth to bring that debt to GDP down. The debt to GDP has been rising until this point; this hopefully is the year when it is going to turn around. That is certainly the forecast. Some people say that you can run a permanent small deficit, but the Treasury modelling says that if you assume that every, say, eight years you face an economic shock—and that, after all, has been the broad experience since the war—then simply running a permanent deficit does not bring your debt down in a sustainable way. If, however, you run a small surplus—and there are plenty of more socially democratic countries, such as Sweden and Canada, that run permanent surpluses in good years—you bring your debt down and you are preparing for the next event that the world throws at you. It is not particularly heroic or glamorous work and it is a lot easier going around the country opening things than it is explaining to the country that difficult decisions need to be taken, but it is ultimately the right thing to do if you are in this job.

Lord Griffiths of Fforestfach: I wonder if I could raise one issue: household debt to income. Our ratio is higher than a number of our competitors', and the OBR forecasts that in the next five years or so it is going to rise fairly sharply. If we were to have an increase in interest rates, what would your view of that be?

Mr Osborne: I will stay out of the interest-rate decision and leave that to the central bank, which, at least under Conservative leadership, we are determined to keep independent; we will see what happens with other political parties. Their assessment is that at the moment we have consumption growth driven by income rather than by borrowing. That is the Bank of England's assessment. The household debt ratio has come down and is lower than it was in 2007. The OBR forecasts for it to rise, although it points out that that is driven primarily by the purchase of assets, like housing, so the net wealth position improves for households.

To come to your question, should we nevertheless be worried about people's broader exposure? We have created a macroprudential committee in the Bank of England, the Financial Policy Committee, precisely to examine these questions and to make a judgment on them—to use the phrase minted at the time in 2007-08, to take the punch bowl away when the party gets going—and we have given them the instruments to adjust things like mortgage standards and loan-to-value ratios. These are difficult instruments to deploy, but we have put them in independent hands—the Financial Policy Committee's hands. We are leading the world in this development in our central banking, but I am pretty confident it is a good arrangement. Of course, the test comes when the test comes.

Q4 Lord Turnbull: I am strongly supportive of the idea that if your deficit is so big that your debt-to-GDP ratio is rising, you have to get out of that territory and get to the point where the ratio is not rising. That has been achieved. What I have not really understood is why the priority is given to getting the deficit down to zero by 2019-20 and then on into surplus, and why is it so wrong to borrow if you are creating assets at the same time. Why are you not looking at the total balance sheet?

The other issue is that you talk about debt as though it is impoverishing the future. The majority of UK government debt is owned by UK citizens, who have an asset: they own the gilt. They pay taxes to you, certainly, but then they get the interest in return. The idea that this debt is impoverishing people is an economic fallacy. The real argument is that you want a smaller state. There are good arguments for that, although some people do not agree with that, but you do not tell people that that is what you are doing; what you tell them is this story about impoverishment of debt, which is a smokescreen. I cannot see the justification for the whole idea of the urgency and the extent of reducing debt now that you have got to this point of safety.

***Mr Osborne**:* We just disagree. If tomorrow the financial crisis were to hit us, we would have a lot less firepower than we would have if our debt was half what it is today as a percentage of our national income. There is a responsibility to prepare your country for whatever the global economy throws at it. A debt-to-GDP ratio that, if we had not done anything about it, would now be approaching 100% of national income is a bit uncomfortably high, frankly. International observers of western economies tend to use that as a cut-off point. You only have to look at various European countries now struggling with very high debt levels that they were always told they would not have to worry about. As I say, that is just preparing for future contingencies. Again, this economy has been growing for six years. We are growing at above trend growth rate. For the last two years, we have been the fastest growing of the G7 economies. If you are comfortable running a budget deficit, essentially in more benign times, when are you ever going to take the difficult decisions required to bring that deficit down? I would say that running a small surplus, which is what we have set out in the forecast, is what countries like Canada and Sweden, which have gone through fiscal and banking crises in the last 30 years, have decided works for them, and I think we could draw some lessons from that.

As regards capital spending, this is an old chestnut. We no longer have Nigel Lawson on the Committee; he would explain at this point why he does not think there is a real distinction and why building a school is fundamentally different from training a teacher so that they can teach for the next 40 or 50 years. I am all for investment in big economic infrastructure, as we have just been discussing. In the end, if you want to buy things in government, you have to pay for it, and if you have to pay for it you have to get the money from somewhere. That means going to people and raising their taxes. In a democracy, if someone wants to present that as an option, fine—let the people decide—but I do not think the public really have an appetite for higher taxes.

Q5 Lord Forsyth of Drumlean: To follow Lord Griffiths' question about household debt, I do not want to tempt you, Chancellor, into talking about interest rate policy, but I think it is true now that the average UK home costs a first-time buyer five times their income. It was up to 2.8 times in the early 1980s. That reflects the fact that they are able at present, with low mortgage costs, to service those. Are you not concerned about what will happen if we move back to the kinds of interest rate levels that have been the average rate for the last 400 years and what the impact will be on those households?

Mr Osborne*:* Again, I merely observe that, since it is his responsibility and his fellow Committee members' responsibility, the Governor of the Bank has indicated that he believes the peak of the interest rate cycle will be lower than the peak of previous interest rate cycles. One of the decisions that the Monetary Policy Committee takes is on the impact of interest rate rises on the economy—indeed, that is the central judgment they make—and we have the Financial Policy Committee with the instruments to try to control mortgage standards, lending standards and so on, which we have never had before in our country. The root solution to the problem that you identify, which I agree is a very serious problem for our country, is the absence of housing. This country is not building enough homes—homes that people want to buy and can buy. That, to me, is a big economic challenge as well as a social challenge. I have worked with my colleagues to reform the planning laws, make public sector land available for private development, build starter homes that are more affordable, help with instruments to allow people to get deposits, and so on, but the supply of housing, I agree, is a big economic challenge and we need to build more homes in this country—quite a lot more.

Q6 Baroness Blackstone: I want to turn to housing. In doing so, I should probably declare an interest. I am the chairman of a large housing association. I wonder whether you are not concerned that there is going to be a further depletion of the social housing stock as a result of extending the right to buy to housing associations. If you look back at what has happened over the last two or three years, some 30,000 properties were sold by local authorities and only 3,000 of them have been replaced. That is a huge loss to relatively poor people, who are finding it very difficult to find adequate housing at a reasonable cost.

Mr Osborne*:* We are building social housing and there is a big programme under way on that front, but I fundamentally believe—I guess it is a matter of political belief here—that in our society we should give the tenants of housing associations, just as we gave the tenants of council properties, the right to buy their home. All the arguments made about availability were made in the early 1980s. There is no new argument in this discussion. I have visited people this year who live in identical properties who are next-door neighbours, where one home happens to be owned by a housing association and one happens to be owned by the council. The individuals concerned could not tell the difference. You would have to be somewhat versed in how we organise housing in this country to know there is a difference. One has a right to buy their property and one does not. That is an injustice. It could not have been a clearer policy in the manifesto. It was absolutely advertised. There was a clear election win for the party that proposed it, so I hope that we can now work with the housing association sector to implement the manifesto commitment.

Baroness Blackstone: But you would accept there has been a great deal of criticism of what you put in your manifesto, including by Conservative commentators. One of the criticisms is that you have spent a great deal of money supporting various schemes on the demand side, but whatever you may say about investing in more public housing that investment has been relatively small. It would probably have been far better if you put a bit more of the money that went into supporting the demand side into improving the supply of housing, particularly in London and the south-east, where it is desperately difficult for many first-time buyers to get into the housing market.

Mr Osborne*:* I do not think you should have to choose between the two. We have addressed the capacity of people to buy homes, because we have been in the aftermath of a financial crisis and subsequent retrenchment, of which one of the consequences has been that people have been asked for very much higher mortgage deposits than frankly—I suspect that everyone around this table owns their own home—the kinds of deposits we were asked for when we made mortgage applications. It is perfectly reasonable to intervene after a financial crisis to address an impairment in the financial system.

Where I agree with you is that you then want to address the supply of housing. When I became the Chancellor, no housing was being built at all. There was virtually no social housing programme and the private market had stopped because of the housing crash associated with the financial crash. You now have a social housing programme that is considerably larger than the previous Labour Government’s and private sector demand really picking up. But I completely agree with the thrust of the question, which is that it is not enough and that we need to do more.

When it comes to the housing associations, we are going to publish legislation and, as I am sure you are aware, we are talking to the representative bodies of the sector. We want to make sure that homes are replaced one for one with affordable housing, and we have ideas about how that can be financed. It is not that we want to reduce the housing stock; we want to increase it, but at the heart of it is a judgment, which is: is it right for someone who is in a housing association property not to have the right to buy when someone who is in a council property does have the right to buy? That is essentially a public policy anomaly and we are correcting it in giving people their right to buy.

Baroness Blackstone: Can I just push you? If you are concerned about the supply of housing, can you just tell the Committee a bit more about what the mechanisms will be for this one-to-one replacement of any housing association stock that gets sold? We have not seen that replacement in the local authority sector, so how are we going to get it in the housing association sector? We just need to know more about the mechanisms.

***Mr Osborne**:* That is a perfectly reasonable question. The detail will all come when we publish the legislation. We are at the moment involved in a discussion with the sector about that. Essentially, it is a component of the receipt of the property that is sold and a compulsion on councils to sell higher-value properties and to use some of the money that that releases, because quite a lot of the public housing stock in the country is very expensive and you could sell some of that housing stock and generate more housing in the area.

Q7 Lord Kerr of Kinlochard: Can I draw you out on what you say is the exact similarity between the housing association case and the local authority case? In the case of a local authority, surely we, the Government, are talking about another part of the public sector. In the case of a housing association, we are talking about a part of the private sector. As a Government, when this Bill goes through, we will be compulsorily requiring these private sector organisations, which have existed for quite a long time, with socially very respectable motives, to suffer an economic detriment to the advantage of the tenant who has the right to buy. If I lived in a house rented from another private citizen, the Conservative Government and the Conservative philosophy would strongly resist the idea that I should have a right to buy my house from my landlord. Is the housing association case not closer to that than to the local authority case?

***Mr Osborne**:* I do not think it is. First of all, we do give a number of rights to people who rent properties off private landlords—not the right to buy, but over many decades there are all sorts of restrictions on the rent you can charge, how you do rent reviews, the fees you can charge and so on. We already intervene in this space. Very specifically on the housing association, housing associations receive very large sums of public money, so they are not simply like a private citizen. They are classified to the private sector. That is one of the things the Office for National Statistics is looking at, and was looking at anyway, long before the Conservative manifesto turned up. We have to ask ourselves whether the housing association sector is doing what it was originally designed to do when it was created in its current form in the 1990s. Then, it was seen as a vehicle for building homes. The last data I saw—I am happy to be corrected—is that four out of five housing associations built no properties last year. I would not say that they are proving the dynamic source of new housing in our country at the moment.

Baroness Blackstone: Can I just comment on that? Many of these housing associations that are not building houses are very small. Most of the larger associations are certainly building housing and are very concerned that this policy is going to undermine their ability to build, because it will reduce their assets and make borrowing more difficult. That, combined with the Budget proposals that you made and have gone through on having a cap on rent, further will reduce any profits that they can make, which are recycled into building new houses. It is wrong to perceive the housing association sector as one that does not do anything to improve the supply of housing; it is doing an enormous amount to do so and wants to do more.

***Mr Osborne**:* First of all, the income of housing associations over the last six years has gone up pretty substantially, much more so than most private enterprises or, indeed, public bodies. They have had substantial increases. I will send to the Committee our understanding of how many large housing associations have built properties, but it is not particularly impressive, in my view. There has not been much pressure on the sector to be particularly efficient in recent years, even though that pressure has been brought to bear on many public bodies, Government departments and, indeed, private companies. Frankly, the housing association sector has a simple choice. It was in the manifesto, the Government got elected with a clear majority and they can either work with us to get this all done in a way that, whilst I understand your reservations, nevertheless recognises that the Government have a democratic mandate to deliver, or it can be a more confrontational relationship, but that is not one that we seek.

Lord Forsyth of Drumlean: Can I just pick up on the point that Lord Kerr made about whether housing associations are private bodies, and therefore whether you are attacking private property rights or not? From a more technical point of view, could you comment on the OBR's warning that if you were to start instructing housing associations as to their policies, this could have the unintended consequence of bringing them into the public sector, which you have almost been arguing today? If that were to happen, would their debt and borrowing not have to be recorded as public sector borrowing?

Mr Osborne*:* There are always classification discussions going on, as several people around this table will remember from their time in the Treasury and elsewhere. We had Network Rail reclassified a couple of years ago. This is all done independently of the Government by the ONS. The questions about the housing associations were being raised long before the Conservative proposal was brought about, which points to some of the ambiguity about their exact nature, but I leave that for the ONS to work on.

Lord Forsyth of Drumlean: What would the number be?

Mr Osborne*:* I do not have it to hand, but it is in the tens of billions, from memory. I can send the number to you.

Q8 Lord Kerr of Kinlochard: You will be astonished to hear that I want to ask you about the European Union and your reform negotiations.

Mr Osborne*:* I would be very disappointed, Lord Kerr, if you did not.

Lord Kerr of Kinlochard: You have just been galloping like a Teutonic knight across Scandinavia, and I am sure that the dossier at the top of your agenda is the most intellectually difficult and most important of the dossiers in this negotiation: the management of the relationship between the eurozone and the "euro outs". You advance from time to time a number of propositions, all of which I agree with: the proposition that the health of the eurozone is a UK interest; the proposition that the eurozone needs to integrate further in order to survive; and the proposition that the primacy of the single market and the equal rights of all members of the single market must be respected. All these are completely correct, but there is a circle there that needs to be squared. In Helsinki, Stockholm and Copenhagen you were talking to three Governments who all recognise the problem. Two of them are in a rather similar position to the UK, although they are pre-ins rather than outs, and the Finns have an extremely sophisticated approach to these issues. Can you give us an inkling, Chancellor, of how you think this is going to play out? What solution do you see to this? How will the circle be squared?

Mr Osborne*:* There is a fundamental issue, which is that the treaties of the European Union—and here I defer to you, as you wrote one of them—did not, to my mind at least, properly envisage a situation where you had a large number of member states with a single currency that were integrating to support that currency and then a number of member states that, at least in the case of the United Kingdom, are never likely to join. The treaties and the arrangements of the European Union do not really accommodate that situation. Essentially, there is an agreement to be had, which is: allow the eurozone to undertake the integration that is required, but protect the interests and the integrity of the outs and the integrity of the single market. Do not force Britain to choose between joining the single currency and leaving the European Union. Try to find, through this reform process, an ability for Britain to be in a reformed European Union where its interests are protected.

There is a lot of understanding of that challenge, not just in the Scandinavian and Nordic countries; the German Finance Minister has made this point, and the French Economy Minister made this point when I was in Paris just a few weeks ago. There is an understanding in the eurozone that it is not exactly working for the non-euros as well as for the euros. There is going to be a discussion of how we put it right. There was quite an interesting incident; I am not sure how noticed it was, because it was in the aftermath of the Greek deal. On the Sunday when the eurozone leaders met to do the Greek deal, they decided that an EU instrument, the EFSM, would be used to bridge Greece's financing needs until their deal would come into effect. There were no non-euro members present in the room. Indeed, they had been invited and then the invitation was withdrawn and the meeting cancelled. Britain is the second largest underwriter of the EFSM. We worked hard to put in place, over the next few days, a good deal for Britain that protected us; it put some money in an escrow account, essentially to make sure that if Greece defaulted on its EFSM loan we, and indeed other outs, would be protected. But when we first raised this issue of why we had not been told and why we were not in the room when the decision was made, the European Commission told us, in a written document, we have a QMV now, so we do not need to pay any attention to you. Lots of member states that are in the euro have disavowed that statement by the Commission, but it is just a straw in the wind of the problems coming our way unless we resolve this issue. I would say that this is one of the most important parts of our renegotiation. I would suggest to you—it may be a bit presumptuous of me—that even the most ardent believer in Britain's membership of the European Union, someone who does not question the benefits of that membership in the sense that they know how they will vote in a referendum, looking rationally at the situation can see that something needs to be done to improve and change and reform this relationship between the ins and the outs, because we never envisaged this situation in the European Union when the various treaties were created.

I have a lot of other issues with the European Union—about its competitiveness, about our ability to run our own welfare policy, about the role of national parliaments, and so on—but this area is fundamental to our national economic interest. Chuck in there the fact that we are the largest financial centre in Europe and you again have this tension between a eurozone that believes it needs to have more control over the financial markets that trade the euro and the fact that those financial markets are located here and there is another challenge we face.

These are all just examples of the problem we have. It is a problem that is pretty widely recognised now and it is a problem we can fix—indeed, I am pretty confident of that—but it is definitely a problem. Sorry, that was a long answer.

Lord Kerr of Kinlochard: I agree with everything you say, Chancellor. In particular, I agree with what you say about the Commission error in the Greek case, but the fact that that was quite easy to correct shows that, as you say, the problem is fixable. You have described the problem very well; you have not been terribly forthcoming on the solutions that you see. Can I draw you out a bit? Double majority voting, as in the EBA, does not seem to me to be plausible as a long-term answer, because the eurozone is likely to increase, and the chances of the diminishing outside group being able to maintain a veto, in voting terms, seem a bit unlikely. It seems to me, legally, that it is possible to reinforce the ban on caucusing—the need to have everybody in the room when something that concerns them is being discussed. Whether in the long term such a legal text would work in a crisis or not I do not know, but it seems to me there is something that you can do there. I do not know what you see as the solution. I do think that the strongest card in your hand is the one you referred to: the fact that London is the EU market, particularly for transactions in euro-denominated securities. It seems to me that the expertise of the UK is required for the health of the euro. We sometimes make a mistake in this country when we wrap ourselves in the Union Jack and defend the white cliffs of Dover against these evil foreigners rather than presenting ourselves—as is the case—as the people who are essential to them, because there will only ever be one global financial market in this time zone, and if it is not London there will not be one at all.

Can you give us some clues as to which way you are going on this? Secondly, do you think we could play up rather more the point, which happens to be true, that the health of the City is an EU interest?

***Mr Osborne**:* I agree with you that the health of the City is an EU and eurozone interest and you are right that if this financial centre was not in London, it would not be in Frankfurt or Paris; it would be in Zurich, New York or Singapore. There is a frustration that some of the requirements to run a globally competitive wholesale financial services centre are not always understood in all parts of the European Union. I think most people in most European Governments do understand that when forced to think about it. There is a big contribution that we can make. Indeed, we are making the contribution, because we have an excellent British Commissioner, who is the financial services Commissioner, and we have been very important in helping the European Union develop things like a single market in financial services. There is a big contribution that we can make.

On your question of how you address the ins and outs issues, this is the beginning of the negotiation. We have had ad hoc solutions to problems that have arisen in the five years I have been Chancellor. I negotiated the double majority voting on the banking union. When we had the ECB discriminating, as I saw it, against the location of a clearing house and saying that business could only be located in the eurozone if it was trading in euros, we went to the European Court and won part of the judgment on one aspect of the case that we brought. Through some hard telephone work and negotiation, we got a satisfactory resolution to the EFSM situation in July. But they have all been pretty ad hoc and we have had to react to the situation as it has come at us. It does not give you enormous confidence that you would be able to do that in every single situation. This is one of the reasons why we think this is one of the areas most likely to require treaty change, because you have to write into the treaty some basic principles of integrity of the single market and non-discrimination against non-euro members, which would all be along the lines of the kinds of things you put in European treaties; then you allow the institutions to interpret some of that. How we do that and whether we need additional protections, which we might well, are things for discussion other the coming months, but this is very important. I come back to my point; you can be a very ardent Europhile and still think this is incredibly important for the UK. The deal is there—I have suggested it before—at the same time as the eurozone is increasingly aware that it needs to proceed with its own integration to make the eurozone more stable. The French Government have been proposing that recently and the German Finance Minister, Wolfgang Schäuble, also acknowledges this. As you will well remember from your distinguished career, Britain has not been the biggest enthusiast of integrationist proposals in the EU, but Britain could say, "Let us let the eurozone do what they need as long as we get what we need".

Lord Teverson: Chancellor, I do not disagree with your analysis at all, but I just wondered, from your own point of view, who you saw as the long-term outs. Given the fact that since the Greek crisis the eurozone has grown by two states, are we going to become an increasing minority—if that is not a contradiction—as the outs, and will the outs be seen as more irrelevant as time goes on?

Mr Osborne*:* I hope they will never be seen as irrelevant, because in the UK you have one of the largest European economies—

Lord Teverson: I accept that.

Mr Osborne*:* And, indeed, our very important role in financial services. The only other country that has an opt-out is Denmark. All other outs are, in theory at least, signed up to be ins, but—I am taking a wild guess now; it would not be my decision but the eurozone's—I can imagine some hard questions would be asked these days before some of the central and eastern European nations were admitted to the euro. I think some of their own populations would ask some hard questions. Public opinion in Sweden, as far as I can see, is pretty firmly entrenched against joining, and although Governments in Sweden have in theory been committed to joining, they have been realistic about the prospects of that anytime soon. Yes, you have had countries like Estonia join, but I would not say you have seen a large or medium-sized economy in Europe make that decision recently. Not that this is going to be an issue for the UK, but these days, if you want to join the euro the first thing you have to do is find a load of money and put it in a bank account to bail out banks and the like, so it has become an even more difficult sell, I suspect, in some countries.

Q9 Lord May of Oxford: I would like to ask you the following question. It is my understanding that the Government have two new fiscal targets in the summer Budget, the first being to achieve a surplus in public sector net borrowing by 2019-20 and then every year after that, and for public sector net debt to fall as a share of GDP once that gets established. To the contrary of that, the Institute for Public Policy Reform has pointed out that the forthcoming spending review could "protect social care, expand free childcare, protect education for 16 to 19 year-olds, support young people into work, and invest in housing, science, energy efficiency and the northern powerhouse" while nonetheless targeting a smaller surplus in 2019-20. Given the public policy view, which is rather dissonant with the understanding of the person who prepared the document I am reading, I wonder what your response to that would be.

Mr Osborne*:* Of your list of things, I would hope that in the spending review we are going to be able to improve social care in this country, improve education in this country for 16 to 18 year-olds and do the various other things that you talk about.

Lord May of Oxford: It is clearly a list of things that nobody is against.

Mr Osborne*:* I would suggest that the quality of those services is not entirely dependent upon the quantity of money that goes into them. There are other things that you can do to improve education, as, I would suggest, this Government is demonstrating. Indeed, some of those things, such as school funding, we have explicitly protected. It comes back to the argument about the best thing that you can do to protect the country going forward and to improve your public finances while your economy is growing and your unemployment has fallen. Without repeating the arguments, I think it is right to try to run a surplus. We will see what happens on Saturday, but the consensus in this debate has been shifting in our direction, and increasingly institutes such as the IPPR, which I think would happily be described as on the centre-left of British politics, is now saying, "We can have a surplus; it just needs to be a smaller one". That would suggest to me that the argument is shifting in the right direction.

Lord May of Oxford: The points I just mentioned were written by a chap called Martin Wolf, with whom I am unfamiliar.

Mr Osborne*:* He has not been the biggest supporter of everything I have done.

Lord May of Oxford: You will be thoroughly familiar with the fact that he argued that the bigger the fiscal surplus the lower interest rates would be, and then he raised the quite significant worry that if that encouraged a run-up of private debt, the economy might end up yet more unstable than he feels it is at the moment. I wondered what you wanted to say about that.

Mr Osborne*:* I very much enjoy Martin's writing, but I do not always agree with it. He told me to ditch my plan A and that it would lead to disaster if we pursued it, and I see no evidence that that prediction has come right. I do not want to repeat the arguments to the Committee. It is right for our country, with a debt-to-GDP ratio that has gone up substantially in recent years, to bear down on that debt-to-GDP ratio to eliminate what in the last financial year was a 5% budget deficit, higher than most other countries in the West. Ultimately, it comes down to your question, which is implied in the IPPR report, of social justice. The people who suffer most when economies fail and Governments lose control of the public finances are not the rich in the country but the poor in the country. I am determined that that is not going to happen on my watch.

Q10 Lord Monks: I have two questions, Chancellor, one about nuclear power and a broader one about investment in infrastructure and perhaps manufacturing as well.

On nuclear power, are you optimistic that we will conclude a deal with the Chinese this autumn, perhaps when the Chinese President visits Britain, and that we can get some greater solidity into the arrangements for the development of nuclear power?

Secondly, that is an illustrative example of just how dependent we are, in large infrastructure projects, on inward investors—and in manufacturing, too, in what we might start, in the Labour Party, calling the "commanding heights of the economy", a large number of which are now in overseas hands, which are often making a better job of it than perhaps we did when they were in ours. Does it worry you that we have, on the one hand, the most sophisticated financial centre around this part of the world, for sure, and perhaps across the world and, on the other hand, a lack of British appetite for investment in major infrastructure and manufacturing projects?

Mr Osborne*:* That is a very good question. Let me start with Hinkley Point. I am pretty confident that we are going to be able to do a deal, but we are still in the negotiations. We are principally negotiating with EDF, the company that is building the nuclear power station, but we are also helping them bring in investment partners, of which the Chinese are the big show in town. When I was in China in the previous Government, we very much said to the Chinese Government and Chinese nuclear power companies, "We are open to Chinese investment in our civil nuclear power industry". It is a massive strength of the UK that we are such an open country to investment in things like civil nuclear power, which plenty of western democracies would find ways of erecting shutters to. I am going to be in China in a couple of weeks, we have the President of China coming here in October, and I am sure that more discussion will take place about this particular project. I think it is really important for two reasons. One is that it is important in its own right, because it is going to provide 7% of the UK's electricity. The current generation of nuclear power stations are all coming to the end of their lives. That is going to create a very big hole in our base electricity supply unless we do something about it, so this project, and indeed some of the other projects such as Wylfa in North Wales, are really important for our country. It is also important because, as you alluded to, this country stopped building nuclear power stations, which in my view is a tragedy. This is the country that had the first civil nuclear power stations in the world and we gave up at some point in the 1990s or the 2000s. When you are restarting anything, it is a real challenge, because the skills have dissipated and there are not the domestic companies, and we have had to—I say "had to"; the French company EDF has been a very important partner in trying to get this deal. But hopefully we can now make this a more regular drumbeat. Once we get a nuclear power industry building nuclear power stations again we can keep building them, and this is the beginning of a pipeline.

That brings us to the second question on investment in manufacturing and the like. A really important consensus in our country is that we are open to overseas investment and foreign ownership. It has been a consensus across the political parties and has been true whether there have been Labour or Conservative Governments. What an owner such as Tata has done with Jaguar Land Rover is nothing other than very good for the West Midlands and for our country. Why do you not get so much domestic ownership of these industries? I do not have a simple answer to that. Maybe it is because we are so open. It is a very attractive place for overseas investors to come, and we are getting the lion's share of overseas investment into Britain at the moment for Europe. There is a broader question, which we have sought to try to address, of why our pension funds do not invest in our infrastructure as much as overseas pension funds. We have had Australian miners and Ontario teachers investing in big infrastructure such as HS1, but now, at last, the British pension funds are starting to invest in infrastructure and are getting good returns.

It is a big challenge. Because we can provide the stability of a rule-of-law-based system open to foreign investment, and because people can see decent returns and a pipeline of infrastructure projects, I think we will see more of this investment. One of the interesting things is that one of the things the world most wants to learn from us is how we put together these public-private partnerships and these investments. The deal done on the new sewer system in London is a £6 billion deal—it has not received a huge amount of attention because it has gone incredibly well—involving a lot of public and private money in a very effective investment in UK infrastructure.

Lord Turnbull: On the question of Hinkley, are you not addressing the wrong question? It is not, “Can we do the deal?”, but, “Should we do the deal?” Since nuclear was brought back on to the agenda—quite rightly, in my view—a number of things have happened. One is that the view that fossil fuel prices could rise endlessly has been falsified. The second is that there was a stable, well-established design—the EPR—that we could use. The third is that there were several players that we could pit against each other—EDF, RWE, E.ON. All those assumptions are now falsified and this thing, at £92 per kilowatt hour, is turning out to be incredibly expensive and a huge commitment for a design that the French cannot get to work. They cannot build the thing; they are really having a trouble with it. Should we not go back to the drawing board and use gas and the Government’s shale policy, which I strongly support, as the interim that will enable us to get try to this thing right, rather than plumping for what I think will be a bottomless pit and a big white elephant?

Mr Osborne*:* First of all, we are not going to build a reactor that is not safe or does not work. I am not a nuclear engineer, but we have a proper certification process. Put it this way: there is a huge amount riding for EDF on getting this reactor design working, not just here but in Flamanville, the plant in France. Indeed, the deal is constructed in such a way that we do not bear the risk of that design not working. That is borne by EDF and its shareholders.

The strike price and so on are all subject to any final negotiation. It is still substantially cheaper than any other low-carbon technology, such as offshore wind, or indeed onshore wind, and it has, as nuclear power always has had, that baseload reliability. By the way, I am a believer in having an energy mix to cover your bets.

That brings me on to the final point. I would be all for more investment in gas-fired power stations. I do not see that as an alternative to nuclear power; I see that as complementary to nuclear power and, indeed, to renewables.

Lord May of Oxford: It has the problem of being incompatible with the recommendations that we have signed up to with respect to the Committee on Climate Change. That is a long-term problem of a serious kind.

Mr Osborne*:* I defer to your expertise, but if our challenge is to move away, in the immediate term, from coal-generated power stations, gas-fired power stations are very much less carbon-emitting and there is lots of technology to try to clean up the carbon that is emitted. We do not have a completely free market in energy—far from it—because we are trying to address certain market failures, such as the price of carbon, and to provide energy security so that we can be sure at all times that the lights go on. Those things lead to more expensive energy than if you had heavily carbon-emitting energy that was unreliable and might lead the lights to go out, so we already pay a premium for that.

Coming back to our earlier discussion, building your big-energy power stations is another kind of thing that Governments should be doing and not ducking—we were talking about railways at the beginning—and it is frustrating that this country gave up on that in the previous generation, but we are trying to get it off the ground now.

Lord Teverson: Perhaps I could just follow some of that up, Chancellor, because I know the Treasury takes a big interest in energy policy—and quite rightly. Dieter Helm has recently talked about the obvious way through, very much following Lord Turnbull's point, given the fact that this now is unlikely to be available until 2023 or beyond and we seem to be shadowing the problems that the French and the Finnish nuclear industries have at the moment. I would like nuclear to happen, but it seems to me, coming back to your infrastructure point, that if you really want it to happen in this country you probably have to go down something like the South Korean model, which is that the state pays for it and you build a fleet of 10 or 20 and you get the production line going. It is old fashioned; it is CEGB. I do not particularly like the model, but it seems to me that is the one that might make it work. At the moment we are not going to solve energy security because we have to wait a long time to do that, so perhaps the way to do that is to go strongly down the gas route and withdraw from coal as soon as possible; you would get huge decarbonisation benefits and you would have an investment strategy for gas that might work.

Mr Osborne*:* We are certainly trying something here that, as far as I am aware, no other country has managed to do, which is to build the nuclear power station off the Government's balance sheet. There are certain complex arrangements for guaranteeing the price for electricity, but it does mean that I am not bearing the construction risk or the design risk. You would be saying to me, quite rightly, at this point, "You cannot get your reactor to work", and that would be my responsibility, whereas at the moment getting the reactor design approved is the responsibility of this private investor, in the case of EDF.

Lord Teverson: It sounds a bit like—not "too big to fail", but I cannot imagine that we would get to the end of that process and somehow the Government would be able to keep out of all of that risk. I do not know.

***Mr Osborne**:* I do think it is important that, having assembled the skills again to build nuclear reactors, we continue with that in the future. Whether it is Bradwell or Wylfa, there is a whole series of power stations, with, by the way, coming back to Lord Turnbull's point, other companies competing to build those. Even if you do not have competition on one site, you have competition for the pipeline. It would be easier if we had been building these things for the last 20 years.

Q11 Lord Griffiths of Fforestfach: Chancellor, you received a great welcome in the summer Budget for introducing the National Living Wage. I think it was a terrific initiative. It was very bold and it really goes against the grain of so much that economists have said about increasing the National Minimum Wage. As an economist, frankly, I have been very surprised at the lack of an impact of an increasing National Minimum Wage on unemployment. I am totally behind it, but there are two questions in my mind. First, you are reducing tax credits and welfare by roughly £12 billion, and you are increasing the National Living Wage by roughly £4 billion, so there will be losers in this. The question is on the timing of it. How much flexibility do you have on the timing to minimise, particularly for people who are aspirational, the reduced income that will come overall from that?

Secondly, on the question of raising productivity and trying to minimise the increase in unemployment, one looks particularly at the service sector. For a number of years, I chaired Westminster Health Care, which had 100 care homes, and we bought The Priory. In that sector, quite a lot of residents were financed by government. I just wonder how that sector is going to cope with having to pay the substantial increase that you are requiring by 2020 in the National Minimum Wage.

***Mr Osborne**:* To come to that point first, I have acknowledged that the social care sector, as a low-wage employer, is one of the sectors that we are going to have to pay particular attention to in the spending review on 25 November. I did not announce at the Budget some of our ideas about addressing that sector and how we can deliver a better service for people, but I did flag up that we were specifically aware of the challenge of a National Living Wage.

On the first point you make, essentially I am proposing to the country a compact that says to businesses, "You get lower business taxes"—I cut corporation tax again in the Budget—"but you are going to have to pay higher wages". To families I said, "You are going to get fewer welfare entitlements, or some of you are, but you are going to have higher wages". To the country, I said, "We are going to have a welfare system that is smaller, but one that we can afford". That is essentially the package. For the typical family with someone on the National Minimum Wage at the moment, they will be better off as a result of this change over the years.

Essentially, I come back to the point I made earlier, which is that an unsustainable welfare system is not good for the lowest paid people in the country. They are the people who suffer when you have unsustainable public finances. With the changes that we are making to tax credits and the like we are bringing them back to the level they were at, in real terms, in the middle part of the last decade. I am not saying that these are easy decisions, but you should see it in that perspective. There is no doubt that ramping up tax credits in a way that was simply unaffordable was a very irresponsible thing to do, in my view. When they were introduced, I think the initial Treasury forecast was that they were going to cost £700 million, and by the time I became the Chancellor they cost £30 billion. In the space of just a decade, they came to consume a very large amount of public expenditure. Let us be clear: I know that we have had discussions about borrowing levels and tax, but, all other things being equal, if you are spending money on that it is a pound you cannot spend on education, housing or whatever. I think, therefore, that this is a more balanced and sensible approach.

Q12 The Chairman: A crucial difference between the National Minimum Wage and the living wage is that the former has to take very much into account the impact on employment, whereas the latter is a calculation of what you need to live. Therefore, it would appear—and the Resolution Trust, as you know, has done a lot of work on this—that the rapid cuts in benefits would require very significant 25% or 30% increases in low pay in the first couple of years to compensate for that. How do you see navigating this so that there are not very substantial losers? The losers are people who are in work, which is something we want to encourage.

Mr Osborne*:* We went to the Resolution Foundation's proposal for a living wage. There are several versions of the living wage out there. There is the London Citizens, an organisation that creates a London living wage; there is the Living Wage Foundation, which also calculates a living wage. The report by George Bain for the Resolution Foundation suggested that a more straightforward thing for a Government to do was to target 60% of median earnings, which is what we have gone for, rather than trying to construct a basket of things that we think, as the Living Wage Foundation does, constitutes a good standard of living. That would be quite a difficult mechanism for a Government, or indeed the Low Pay Commission, to use as an approach. Anyway, faced with a choice, we thought that the Resolution Foundation's proposal was the best one. That is the first point I would make.

The second point I would make is this. I have never pretended that these decisions on welfare are not difficult, and people see an impact on the welfare payments they receive, but my argument has been that it creates a stronger economy where people are more likely to be in work and their wages are more likely to rise, and, indeed, this is now underpinned by the National Living Wage. What makes this, I would say, the proposal of a Conservative Chancellor rather than anyone else is that the living wage has not just been introduced by itself; it has been introduced alongside reductions in welfare and reductions in business tax. That is what, I would suggest, makes it a Conservative proposal.

The Chairman: The concern is that the cuts in the first five years run ahead of the likely increases, which clearly creates a real problem of transition for poorer people in work.

Mr Osborne*:* People in work are seeing their wages going up at the moment at a considerably faster rate than they were. There is a lot more job security as well, and inflation is close to zero. As I say, welfare changes are not easy, but countries that duck them are not countries that are in great shape for the future.

Q13 Lord Sharkey: I declare an interest as a director of a financial services think tank. I want to ask you about our banks. Given the continuing scandals with LIBOR and forex, and given that bonuses are now, I think, in aggregate again near pre-crash levels in the banks, and given things like the sacking of the reforming Antony Jenkins in June, what evidence do you see of a change in banking culture?

Mr Osborne*:* There has been a change, but there is clearly more to do. First, there is much tougher regulation; we have new regulators. There are tougher rules in place, due in part to the work of the "Parliamentary Commission on Banking Standards", which Lord Turnbull sat on. We have the Senior Managers Regime, which is going to hold people more personally to account for the decisions they take, and we are bringing in changes to the way we police our financial markets as a result of the scandals in LIBOR and foreign exchange. There are a number of changes happening in that respect. In the banks, there is a growing understanding that they have had to improve their standards. I would not say that they have all done it to the same extent, but amongst the enlightened leadership of some institutions there is an understanding. There is a proposal amongst the industry to try to create more of a standards board that can disseminate good practice. Things are changing. Also, I would suggest, if you are running one of these banks, the cost now of getting some of these issues wrong is phenomenal. You get very large fines, not just from the UK regulator but from the US regulators, so the cost-benefit of having some dodgy trader has, I suspect, somewhat changed.

Lord Sharkey: Are you still getting any kind of push back from the banks about the ring-fencing?

Mr Osborne*:* Essentially, no. There is still the question of the exact detail, but they are all now living with ring-fencing. They were not all universally thrilled with it, but they are all now well advanced in their plans to separate, and I am clear that we will deliver what we promised to Parliament and what John Vickers recommended. As you would expect, some of the banks have, as I say, not been best pleased, but—

Q14 Lord Forsyth of Drumlean: Chancellor, can I ask you about your announcement in the last few days that you will compensate local authorities and other agencies from the overseas aid fund for the 20,000 refugees who you will bring directly from the camps, which I think is very sensible? Can I just ask why you have limited that support to just 12 months?

Mr Osborne*:* Essentially, that is what the OECD-monitored international rules around our 0.7% target allow us to do.

Lord Forsyth of Drumlean: I do not know if you had a chance to read the Committee's report on the 0.7% target, in which we said that we are all for providing support for overseas aid but we think that the target may distort priorities. Is this not a classic example of your not being able to use the aid budget to support the local authorities that are taking in these refugees without coming across the technical problem that after 12 months that money, although clearly directed in an appropriate manner, would not count towards the target? We are in a position where we have the resources, but you are prevented from using the resources sensibly to help local authorities, otherwise the cost would fall on the taxpayer. Is this not a classic example of why having a target, as opposed to a budget, which is going to be focused on overseas aid, is perhaps not so sensible?

***Mr Osborne**:* This country, with most other western nations, signed up to a commitment to spend 0.7% of its national income on overseas development. If anything, the events of recent weeks have probably increased public support for that commitment that we have not only made, but of course we are the first major country in the world to—

Lord Forsyth of Drumlean: That is not my point. I am not arguing about the quantity; I am arguing about the fact that you are hidebound by technical rules as to what counts as overseas aid.

***Mr Osborne**:* If you did not have those rules, I think everyone would claim that they were meeting 0.7% of their national income as an aid budget. As it is, the rest of them are all held to account.

Lord Kerr of Kinlochard: Given what Lord Forsyth has spotted and you have confirmed, would it be right to assume that although this could not be written down in legislation, local authorities could expect that the funding arrangements in year one would be replicated in years two, three, four and five?

***Mr Osborne**:* We want to support local communities and local authorities in giving a good home to the refugees that we take, so we will certainly take into account the burden on the local authorities as we look at the local government settlement. One would hope that that would be a diminishing burden. The expectation would be that people come here and contribute to our economy.

Lord Kerr of Kinlochard: I think it may be more.

Lord Forsyth of Drumlean: Is it really sensible, Chancellor, just to say to those local authorities in year two, "We are a bit strapped for cash, but we cannot take it from the overseas aid budget, which is protected, because it would not meet the technical rules as to what is allowable towards the 0.7% target."?

***Mr Osborne**:* I would suggest that it is going to be yet another decision that we have to take in deciding where we allocate resources within the Government, but the aid budget should largely be directed towards overseas aid. In this instance, we can use it to house refugees for the first year. Those are the international rules. As it happens, there are plenty of things that we could be doing with our aid budget usefully overseas to try to mitigate this crisis by putting more money into these refugee camps. There have been plenty of reports in the last few days about how these refugee camps are seeing a challenge in funding and how many people are not staying in the camps because they do not feel that is the best place to have their family at the moment. We can use the British aid budget to do a lot to help that and make it more directive towards this crisis. That does not mean that we should not do the very good work that we do on poverty reduction elsewhere in the world, but here is the big crisis that Europe faces and we have a big aid budget that we can now deploy. Indeed, that is not to be underestimated. The fact that Britain spends 0.7% of its national income on aid and 2% of its income on defence now makes us unique in the world, and it says a lot about British soft power and hard power, and the British presence in the world in the years ahead, that we can do that.

Q15 The Chairman: Can I, finally, come to another report that we wrote, on the reform of corporation tax, where we urged the Treasury to consider taking all steps for multilateral measures to try to sort out all the tax gaming that international companies do, but we also urged the Treasury to look at unilateral measures? You announced in the Budget a proposal that was dubbed the "Google tax". Whether that is fair or unfair on Google we do not need to discuss. Are you confident that you can introduce unilateral measures to stop international companies benefitting hugely from our market but paying very little tax?

Mr Osborne*:* The diverted profits tax, as we call it in the Treasury, was quite an innovation. It was saying that we want low corporate taxes in Britain. We are going to have an 18% corporation tax rate. We started with a 28% rate. Lord Forsyth made a proposal to me some years ago about reducing our corporation tax rate, and I hope he can see that we are delivering on that in government. We want low taxes, but taxes that are paid, and for economic activity that happens in this country to be taxed in this country. What is interesting is that the diverted profits tax, although it was a unilateral act, has been noticed by quite a lot of other Governments—the Australians, for example, are just about to introduce something similar. Action is also needed in a multilateral sphere. The truth is that that is quite difficult to do when it comes to an issue like tax, which tends to be an issue of national sovereignty, but I am quite optimistic that later this year the OECD will pull off quite a feat, which is updating the international corporate tax rules. It will not be perfect—it can never be when you are trying to get every country in the OECD and wider participant countries to agree—but it will be a very substantial reform that has been achieved in the space of two years, which is very much shorter than most previous international tax negotiations that have taken place. Britain, as we initiated this project with Germany, can take quite a lot of pride in pushing it along.

The Chairman: But it is disappointing that so much of this activity depends upon tax arbitrage on countries within the European Union. The European Union appears to be unable to get its act together on this.

Mr Osborne*:* Britain is amongst the foremost respecters of national sovereignty within the European Union on tax issues, so I do not think we would want to go down the route of European corporate tax rates, because I can have a wild guess they would not be 20%, which they are in this country. What is interesting—brought about by a number of issues—is that the Competition Commissioner is looking into so-called “sweetheart deals”, which, it is alleged, some member states not too far from us have undertaken with big multinationals, and whether they constitute a breach of state aid. We have talked about some of the challenges, but one of the good things about the European Union is the state aid framework and the way it acts against countries unfairly subsidising their industries to compete. We will see what conclusion they reach.

The Chairman: This Committee was very enthusiastic to combine lower corporation taxes with companies actually paying them, so we wish you well in that regard. Thank you very much indeed, Chancellor, for your most helpful answers.