Work and Pensions Committee

Oral evidence: Tax credits, HC 548-i

26 October 2015

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Watch the meeting

Members present: Rt Hon Frank Field (Chair), Heidi Allen, Mhairi Black, Ms Karen Buck, John Glen, Richard Graham, Mrs Emma Lewell Buck, Jeremy Quin,

Questions 1-76

Examination of Witnesses

Witnesses: **Paul Johnson**, Director, Institute for Fiscal Studies **William Elming**, Research Economist, Institute for Fiscal Studies, **Torsten Bell**, Director, Resolution Foundation, and **Adam Corlett**, Economic Analyst, Resolution Foundation, gave evidence.

Q1 Chair: Welcome to you. For the sake of the record and as some way of beginning our proceedings, William might I start with you and ask you to introduce yourselves for the record?

William Elming: Hello. My name is William Elming. I work for the Institute for Fiscal Studies. I am a Research Economist there and I was one of the co-authors of our recently published briefing note that analysed the new national living wage in the context of the tax and benefit cuts announced to come into place over the current Parliament.

Paul Johnson: I am Paul Johnson. I am Director of the Institute for Fiscal Studies.

Torsten Bell: I am Torsten Bell. I am the Director of the Resolution Foundation.

Adam Corlett: I am Adam Corlett. I am Economic Analyst at the Resolution Foundation.

Q2 Chair: Given that we have quite a lot of work we would like to get through with you and maybe ask you for other work afterwards, please don't feel you have to answer if the question has already been answered, but might I ask Paul and Torsten a general question. A great deal of coverage is given to the fact that eight out of 10 families will be better off as a result of the Budget, so two in 10 are not. Are you able to tell us of the two out of 10, are they mainly or exclusively people on tax credits?

Paul Johnson: I think the eight out of 10 number is a direct quote from the Red Book that is referring to working households. We don't know exactly how that has been calculated but it does sound in the right ballpark because most working households will have gained a little bit from the increase in the personal allowance and the increase in the higher rate threshold. Most of those losing will be the tax credit recipients, which would equate to something like two in 10. There are not very many losers other than those who are affected by the welfare changes.

Q3 Chair: So the eight out of 10 includes all those around the table today?
Paul Johnson: Quite possibly, yes.

Q4 Chair: Very good. Torsten, do you have anything to add to that?
Torsten Bell: One thing I would say is that from a lot of the analysis in the Red Book we should be clear about what the question is that they are answering with facts like that. If the question is what income levels will people have by the end of the Parliament compared to now, then there may be an answer to that question. If the question is what is the impact of this Budget on what income levels people will have in 2020 as against what they otherwise would have had without those changes in the Budget, then it does not answer that question.

Chair: Very good. Heidi, let's begin with you. Thank you.

Q5 Heidi Allen: We are predominantly interested, as you probably have gathered, in the overall package and everything that is in the Budget, how combined that will affect people or families. If you take the national living wage and everything else—and this is a question to anybody really—what do you believe will be the average net changes to household income for those people on tax credits?
Torsten Bell: We are starting with this April's changes; is that your focus?

Heidi Allen: Yes, that is right.

Torsten Bell: There are 3.3 million working households affected this April by the main tax credit changes. There are some other things but, given what has happened to inflation, those are very small. They have an average loss of £1,300 gross this April. Taking your point about the package as a whole, once you take into account the introduction of the national living wage, which is a 50p wage premium for the over 25s from April, we calculate that as an average £1,100 loss for those households affected.

Q6 Heidi Allen: As we look forward year by year—because the thing that concerns me certainly is April is a drop dead date but some of the measures that are coming are over time until we get to that magical goal of 2020—do you have a feel for how that figure will change as each year passes?
Torsten Bell: If we look at the Parliament as a whole, the way to think about it is the working tax credit changes that happened this April are a one-off large impact on family incomes that happens at once. We then see across the Parliament the impact of the freeze on all working age benefits. That includes in and out of work benefits, so that is a diffuse but building impact. We see a number of other small changes coming in that only affect the flow of benefit recipients, particularly for families over three and the family element is taken away. But the main impact is a large impact on working families upfront and then a diffuse impact on out-of-work families, but by the end of the Parliament that diffuse impact will probably mean that out-of-work families lose more on average because they won't have benefited from the national living wage and they will have had a larger stock of benefits that have had the freeze affecting them for the whole of the Parliament.

Q7 Heidi Allen: Does anybody else want to add anything to that?

Paul Johnson: That is broadly right. If you are looking at the loss for those on benefits without someone in paid work, the loss is significantly larger by the end of the Parliament than for those in paid work and the losses increase as a result of the changes to tax credits for new claimants, particularly for those with three or four children and there is the loss of the family element. That loss increases over the Parliament.

Q8 Richard Graham: Just so we are absolutely clear on comparing apples with apples, Torsten on your point about the diffuse impact on people out of work, are you taking into consideration the reductions in social housing rents?

Torsten Bell: This is not true for every case, but in general for people out of work a reduction in social housing rent will have no benefit because the housing benefit bill picks up the tab for their rent in general. The answer to your question—

Q9 Richard Graham: It benefits the taxpayer but not them specifically?

Torsten Bell: Yes, that is correct.

Q10 Richard Graham: Paul, on your point, in terms of the average worse off, and bearing in mind that you are on record here as saying, "Unequivocally, tax credit recipients in work will be made worse off by the measures in the Budget on average", are you implying that for the first year or the whole period of this Parliament?

Paul Johnson: That will be true for both of those groups. On average they will be worse off in 2016. They will also, on average, be worse off in 2020.

Q11 Richard Graham: Are you building into that any salary increases at all?

Paul Johnson: That would take account of the increase in the national minimum wage to the national living wage for those who are affected.

Richard Graham: And the tax free allowance?

Paul Johnson: And the tax free allowance.

Q12 Richard Graham: Are you making any calculation on salary increases given by employers?

Paul Johnson: We are not taking account of other salary increases. The two things we are not taking account of in that is general wage inflation—that is not something that we see as a result of the Budget and that is just different from policy—and, secondly, we are also not taking account of something that may be quite important, which is that those on above the national living wage may have their wages raised to keep differentials the same. On the other side, we are also not taking account in that of the fact that we would expect the national living wage to reduce employment by some level. The Office for Budget Responsibility suggests several tens of thousands of people fewer in work and significant reductions in hours in work as well. We do not have an estimate of that but it will clearly be in that direction.

Q13 Heidi Allen: Is that because you feel employers will have less money to spend on employing more people, that the number of jobs out there or hours available will perhaps reduce?

Paul Johnson: At some point that effect will come in. It looks like the minimum wage at its current level has not had much effect like that but we will be taking the national living wage to about 60% of median earnings, which is high by international standards and in many parts of the country it is 70% of median wages. The expectation is that that would have an effect on employment and in the end lower average incomes, but how big that effect will be and how quickly it would happen is genuinely difficult to tell.

Q14 Jeremy Quin: Paul, you will remember that at the time of the introduction of the national minimum wage there were quite blood-curdling discussions about what could happen on employment, which happily did not come to fruition. So let's hope not, but of course we will see.

Paul Johnson: Indeed.

Jeremy Quin: I totally understand and it is very clear how you come to your numbers, but it is possible that legislative change can itself provoke wage inflation and can create its own dynamic. A lot of companies have already introduced the national living wage prior to its formal introduction. Are there any signs that that could happen, any other international experience we could draw on in terms of creating a dynamic effect on wage inflation?

Paul Johnson: There are different models of the way that labour markets work and you will find in some continental European countries that you have for some groups higher wages than you have in the UK, not just related to minimum wages but related to labour market regulation because the way the labour market works almost forces higher productivity and higher wages. In those same countries you often also find higher levels of people disengaged from the workforce entirely. So what the long-run dynamic effect of this will be is incredibly hard to tell. It might be to push up productivity and wages; it might be instead or as well to result in higher levels of employment. I wouldn't hazard a guess as to how big any of those effects are likely to be.

Q15 Chair: Can I just follow up one point of Richard's? When you said that there might be wage inflation as a result of introducing the national living wage, isn't it true that introduction of the statutory minimum wage did not lead to a great deal of wage inflation but a bunching of wages around the national minimum level?

Torsten Bell: The experience from the national minimum wage is certainly as you say, you had a bunching in that. Our modelling on the wider impact of the national living wage introduction, which I think is the point you are raising, assumes that the ripple effect of it on other people's earnings who are not on the minimum wage but just above it peters out by the 25th percentile. It doesn't affect median earnings, so you won't see it appearing in the OBR's earnings forecast. Some people just above it, literally pence above the minimum wage, would see some uplift but the experience of the minimum wage is that that is small. You take a view about what that is going to be. We have taken a view of the 25th percentile. You will have seen this morning George Bain, the first chair of the LPC, saying that he takes the view that that will be a very marginal effect.

The point that both Paul and I are making overall is that when we are looking at the cost benefit analysis for individual families about the impact of the Budget in the summer, it is obviously not right to take into account earnings growth. You would expect in normal times, and we are seeing a growing economy now, to see earnings growth taking place. You would expect to see on average 2%, or a bit above that, taking place in normal times. We are currently at 2.9%. So we are saying we don't think it is right to attribute that to any given budget or event. We think that is just a thing that happens and that is a good thing.

Q16 Richard Graham: Since we are seeing a real increase in salaries, significantly over inflation, is it not legitimate from the Treasury's point of view to say that over that period, taking everything into account including forecasts for real salary increases, it is legitimate to come up with a view on whether people will be better, worse off or neutral than they are now, including what they believe is going to happen to salaries?

Paul Johnson: That is a completely reasonable thing to look at, to say how many people we think will be better or worse off in 2020, all things told, than they are in 2015. It is a different question but it is a perfectly reasonable question.

Q17 Heidi Allen: If we just look at the national living wage and the lift in personal allowance, are there circumstances in which families' loss of tax credits would completely balance out that and do you have a feel for what volume of families we might be talking about, the dream scenario, I suppose?

Paul Johnson: It is certainly possible to be in that position, particularly those who are working a lot. If you have a couple both working 35 or 40 hours a week, they are going to gain from the personal allowance, they are going to gain from the increase in the living wage, and they might be right at the top of the tax credit taper and so they have a relatively small amount to lose. There are people who will gain but they are in the minority. It is the case that the significant majority of tax credit claimants, even when you put all of those things together, will be worse off. There are only a small number of numbers here that really matter but if you look at the scale of the tax credit cuts, £6 billion by 2020, even the gross cost of the minimum wage is about £4 billion and then a lot of that is taxed away and it goes to a different group of people, it is just obvious in a sense that the majority will be worse off as a result of the combined package.

Q18 Chair: Paul, we have a whole sweep of questions. If afterwards you could go through, and we will go through with you, and put some numbers on Heidi's point that would be very helpful to us. How many of those at the top, loss in tax credits because they are at the top end of the income scale, their loss will be more than offset by the tax allowance increases? We will happily go through the evidence with you.

Paul Johnson: I should say, Chairman, it is surprisingly hard to get at some of these numbers because we have different data sets that tell us information about hourly earnings than tell us about family circumstances. So the numbers that we have put together are splicing different data sets and different models together and I think some of these questions are genuinely difficult, if not impossible, to give accurate answers to.

Torsten Bell: Through case studies you can get at the issue that you are raising. On reported tax credit incomes, it will be quite hard to get to that figure.

Q19 Heidi Allen: I would love to be in a position to understand what is the dream scenario, what does a family have to be doing to hit not even a golden ticket, is it, but that perfect position of hours and children and all the rest of it to be never mind even better off but just the same, and then how families fall beneath that? If it is possible, that is where I would like to get to and I appreciate it is very difficult.

Torsten Bell: Case studies to do that are very easy, looking at the population as a whole because of different family sizes and all other things aside.

Q20 Chair: No, but given that we are politicians, we are actually interested in numbers.

Torsten Bell: We can give you some numbers.

Chair: All of this is really valuable because we will hone the questions we ask you.

Q21 Heidi Allen: On the same sort of angle, I suppose, we have looked at the living wage and personal allowance increases and how that sets the perfect balance. Where is that magic point in the increase in free childcare?

Torsten Bell: Do you mean the increase in the three and four entitlement?

Heidi Allen: That is right, 15 to 30 hours.

Torsten Bell: That is clearly a welcome move. It affects lots of working families and the cost of childcare is a big hit for work incentives. When you are thinking about whether or not this compensates for the tax credit spend, there are two things to have in mind. The first is that this only affects three and four year-olds, to state the obvious, rather everyone, so it is not affecting enough kids to have a big impact. If you are looking at it as doing a job of compensation, it doesn't affect enough kids. The stats we have in this area are that fewer than 10% of tax credit claimants are making a childcare claim for a child under five, so not just three and four, under five. That is less than 10%. Clearly you can see that the number benefiting from the three and four year-olds offer will be low. The second thing is if you are on tax credits and in work you would already be receiving 70% of your childcare costs funded by the taxpayer, so you will benefit only for the 30% extra of the 15 hours. The real beneficiaries of the extra 15 hours are people above tax credits who receive no support beyond their vouchers, and that is what the extra hours—I will benefit from the hours. I don't benefit from any childcare tax credit support. They have intentionally done so; they were aiming to deliver different policy objectives.

To give you some numerical examples, it is probably worth around £2,500 or a bit less per child for that three and four, 15 hours, if you are in work. On the universal credit, 85% of that would be covered by your universal credit anyway, so you will only actually take home another £385 as a result. Even if you are in that small group of people, the numbers are not big enough. It is a good thing; it is just not a compensation tool.

Heidi Allen: Am I allowed to ask the question of what would work better?

Chair: I think maybe when we get on to Richard's section.

Q22 Ms Karen Buck: Torsten, you were referring to the Red Book analysis and the fact that it tells us some things but it does not tell us others. To what extent do you think that the distribution of families and the different assumptions made are representative? To what extent are they telling us what we need to know?

Torsten Bell: Everyone will have their own judgment on that. If you look at table 1.8 from the Summer Budget on page 40, there are some examples there, without going into details, of people who are earning the national minimum wage, all of the examples of those in work or people on the national minimum wage. Of the working population, only 4% of people are on the national minimum wage so clearly it is not representative—

Ms Karen Buck: 4%?

Torsten Bell: 4% or maybe 1% of, so in the ballpark of the national minimum wage, so clearly it is not looking at working people as a whole. You might reasonably say of course it is not, it is looking at low earners, but that is a fact. Secondly, tax credit claimants include the self-employed, who don't benefit from the national living wage, and they also include the under-25s, who don't benefit from the national living wage. Clearly there is a groups of population overlap issue. The table that most people are referring to, which is, as I say, on page 40, gives you a sense of the income impact of the national living wage and tax credits in cash terms on families that are on the living wage and not a lot else.

Q23 Ms Karen Buck: It might be helpful as part of the figures that we would ask for afterwards to have a summary of some of those key stats, so bringing together in one table the number of earners who are on the minimum wage, living wage and the childcare figure that you have just referred to. Also I think the assumption is that all of the families in the Red Book analysis are in rented accommodation on local housing allowance.

Torsten Bell: Yes, that is right, average LHA.

Ms Karen Buck: Is that representative of—

Torsten Bell: Well, two points. One is I should have said the 4% figure is for over-25s. Younger people have a higher percentage of minimum wage, for obvious reasons that you see when you walk into a restaurant. Clearly a lot of the population is not on the LHA but it is not an unreasonable assumption when looking at tax credit losses to take into account the interactions with housing benefit, not least because there is a straight forward interaction. If you lose some tax credits, you gain some housing benefit. As long as you are transparent about what you are doing, that is a reasonable assumption.

Q24 Ms Karen Buck: Absolutely. I think what we are interested in is the extent to which they are broadly representative.

Paul Johnson: To give you a sense of these, because as Torsten said they are all on the national minimum wage, it is very hard to estimate this but we think in the order of about a third of the losers from the tax credit changes would gain from the increase in the minimum wage. In the order of two-thirds are not actually gaining from the minimum wage at all; somewhere between 30% and 40%, in the order of a third.

Q25 Ms Karen Buck: I think it would be incredibly helpful just to pull some of those key statistics out to give us an idea, when we have the analysis in front of us from the Red Book, of how many people would be in those groups.

Torsten Bell: I think these are all what we would call just below full time but they are 35-hour workers. Half of in-work tax credit claimants have somebody working something similar to those hours. Half are not working full time.

Q26 Ms Karen Buck: Those figures give us the information up to 2021, but looking at the number of people who will be losing straight away from tax credit changes that come in next April and before, for example the move to the living wage, does that change the profile in any way from the Red Book table? Would we be seeing particular representative groups more or less affected during that transitional period?

Paul Johnson: It would be the same general picture. None of these people here are suffering from the third and fourth child change anyway. For this group, the biggest bit of the tax credit change will already have happened in 2016 and they will have had only about half of the increase in the minimum wage. For this group it will probably look a little bit worse in 2016, but the overall pattern is not terribly different because you have the significant cut to tax credits for people in work in 2016. You have a reasonably significant increase in the minimum wage, so the broad pattern is not going to be terribly different.

Torsten Bell: I would add one thing to that, which is that the main difference to have in our heads that is different in 2020 to 2016, apart from the individual numbers, is that out-of-work people lose significantly by 2020 and do not lose in 2016. To keep it in black and white, that is the difference.

Chair: I think as an MP, while that is a big political issue, I am more concerned, because that is what we are inquiring on, not how you might be relatively better off if you were out of work but what is happening to those strivers who are in work.

Q27 Ms Karen Buck: You know that the Lords Committee was quite critical of the Treasury analysis and the impact assessment and claimed it was quite hard to draw out a proper distributional analysis from those figures. Is that something you would agree with? The Treasury then also changed the way in which it presented the distributional analysis. Does it make it harder to do the kind of drilling down into the impact that we would like to see?

Paul Johnson: There are quite a lot of interesting numbers in the impact analysis but it is interesting that there is not the kind of straight forward distributional chart that you would expect to see. It does not show, as we have done in our analysis, the average loss by tax credit recipients, how these vary by overall income decile. I think it is quite interesting to see in particular what proportion of spending is received by particular quintiles and what proportion of taxes are paid, so that is one of the charts. I struggle to find the other chart that shows losses by decile of people who are receiving tax credits particularly interesting, I have to say. It is illustrating one thing, which is that the Government did choose to take more money away from better off tax credit recipients and less money away from the worst off, so it was a clear choice relatively speaking, even by 2020, to protect those out of work and those on the lowest incomes relative to those in work, and that is what that distributional chart shows you fairly clearly.

Q28 Ms Karen Buck: Do those changes make it easier in general? Torsten, you used to work in the Treasury.

Torsten Bell: Paul and I both used to work in the Treasury, as part of our diverse political culture, but at different times, I hasten to add. These are what they are and, as Paul said, it does not provide the normal simple distributional chart over 10 deciles of what the impact will be. You take from that what you will.

Q29 Ms Karen Buck: Would their systems enable them to do that distributional analysis?

Torsten Bell: If ours can, then theirs can.

Q30 John Glen: Can I ask for clarification: are you saying that a political choice has been made to present it in that way with an inadequate assessment of the true distribution of the changes, that somebody has made a decision to present the data that way rather than in a clearer, more transparent way?

Torsten Bell: I am definitely not saying that in the sense I have no idea what happened inside the Treasury when they decided what should go in there.

Q31 John Glen: But the systems are capable of presenting it more clearly in a sense that people of your ilk—

Torsten Bell: The Resolution Foundation, the IFS and the Treasury all have models that produce on a regular basis the by-decile impact of any tax and benefit changes, so clearly they could have done that.

Q32 John Glen: The Lords Committee is pretty scathing in its assessment of what it does not tell us.

Torsten Bell: They may be more aware of the decisions that were made in the Treasury than we are, but clearly they could have produced different tables.

Chair: There are quite a few permanent heads and permanent secretaries in there so—

Torsten Bell: That is my point.

Q33 Mrs Emma Lewell-Buck: My apologies for being in late. This might seem like a really simplistic question but because I missed the start of the questions I just wanted to clarify something. Am I right in thinking that the answers you have given so far are saying that there is no way the majority of people will be better off initially or in the long term from these changes, despite the personal allowance, the childcare and the living wage changes and that the majority of people are going to really struggle when these changes come in? You can answer yes or no if you wish, just to clarify for me because I missed the start.

Paul Johnson: The majority of tax credit recipients will be worse off as a result of these changes. The majority of the working population won't be worse off because they are not on tax credits and they will gain from the other things. But the majority of the tax credit receiving population will clearly be worse off as a result of the combination.

Q34 Mrs Emma Lewell-Buck: Thanks. Is that the same for everybody?

Paul Johnson: It is. Those are the facts.

Q35 Mrs Emma Lewell-Buck: Has anyone on the panel done any analysis of how these changes affect families with disabled children?

Torsten Bell: We haven't produced a specific piece of work on that. I think there are some exemptions within the changes they have made for those who are disabled, but overall this is a group that is very dependent on tax credits and will be affected by the freeze and by the threshold change across the piece.

Q36 Mrs Emma Lewell-Buck: I have seen some things in the media that about 150,000 families with children with disabilities are going to be far worse off as a result of these changes, but you can't comment on that?

Torsten Bell: That does sound like the right order of magnitude. The number of disabled families that receive tax credits is published every year by HMRC so that is a public figure but I don't have it off the top of my head, I am afraid.

Mrs Emma Lewell-Buck: No problem.

Q37 Jeremy Quin: Back on numbers, there have been various numbers floating round about the impact of the marginal tax rate of the changes coming through. Do either of you want to comment on that?

Torsten Bell: The changes to marginal deduction rates in 2016 is one of the larger changes from what happens. If you are looking at work incentives more generally, what is going on in April is that there is a large levels effect on the returns to work, so a straight reduction in the work incentive to go into work or out of work at the margins of around £1,000 from the change in the threshold. There is then a separate increase in the deduction rate that people face for each additional hour worked once they are in work. For most people on tax credits after the changes next April it will be 80%. That is because you have a 48% take for tax credits, a 20% income tax rate and a 12% national insurance level, and that gives us 80%. If you are on a housing benefit, it will be 93%. For every additional pound you earn, including via the national living wage, 93 pence will go in the reduced benefit bill, so that clearly is a damage to people's work incentives.

This has not featured in the debate in public. It is definitely worth us reflecting on where those figures were pre-crisis, because what we are seeing happening is that before the recession you would have faced in some cases some high marginal deduction rates but people in this basic situation would have faced a 70% marginal deduction rate. Then two things happened. There was a consolidation going on so Governments of both parties have increased the level of national insurance in particular at 12%. It wasn't that before the recession. Now the tax credit take is going to increase by 7%, which is a lot, the combination of which is a 10% rise in the deduction rates most people on tax credits will face over the course of this and that is a big change. There is one group who won't see a reduction in their work incentives and those are the people who are made worse off sufficiently that they drop off the tax credit system entirely. Those people are worse off but they face a lower marginal deduction rate, that is improved marginal work incentives.

Paul Johnson: It is worth adding that that focus is on the taper rate, the marginal incentives. For incentives to move into work it is a more complicated position than that. There will be some groups who will have a bigger incentive to move into work, partly because they are made worse off when they are out of work by some of these changes, partly if your partner is in work and is coming off tax credits then you have a bigger incentive to move into work if you are not losing tax credits the moment that you move into work. We think probably the average effect on incentives to move into work might even be a little bit positive if you take the whole population, but there is very different responsiveness among different groups. Torsten is absolutely right, the marginal incentives for a lot of these groups change but the absolute incentive to move into work is much more varied.

Q38 Chair: Jeremy, my guess is that both Adam and William probably played quite a part in the information that both organisations are presenting to us. Do you think your next series of questions might be addressed to them?

Jeremy Quin: I would be delighted to address my questions to them. Please anyone pick up the comment. Your last point was interesting, Paul, because we have heard the 80% discussed quite widely, and you confirmed it again today, but that is not the full picture, from what you are saying, because of the nature of other changes going on. There may not be such a fierce disincentive as it appears at face value.

Chair: William, might you answer, bring you in. How does that relate, William, to the earlier point that Paul made, that the freezing of benefits for those out of work will cumulatively have a bigger effect on work incentives of people who are out of work when they think about work? Even though there is this bus going down this lane with the tax credit changes and thresholds and so on, that the actual impact of freezing benefits for those out of work over this Parliament will have a cumulative effect that might answer the point about work incentives for those out of work, which we ought to reflect in our report. William and then maybe Adam.

William Elming: One thing to say here is that right now we are discussing the incentive to move into work as opposed to staying out of work. They have cut the benefits in work for these tax credit cuts that will lessen the incentive to move into work but they have also cut these benefits to out of work, so namely the child tax credit for the third and subsequent children and the family element. So these cuts to the out of work, of course when you cut the incomes to out of work, it will increase the incentive to move into work, both because you now get to keep more of what you earn when you move into work and because some of these families will have seen a decrease in their incomes and they might want to make up for some of this loss in their incomes. We have some work that one of my colleagues is undertaking right now and when we analyse together the full package of tax and benefit reforms, the new national living wage and the move to universal credit, what we see on average, as Paul was saying, is a slight increase in the incentive to move into work as opposed to not working but we see that there is varying incentive across different groups. For example, groups such as lone mothers do not see an increase in their overall incentive to move into work.

As Paul also alluded to, it is important when you want to look at the cumulative effect that you not only look at the different responses or the different effects for different groups—so some people will see a strengthening and some will have their work incentives weakened—but you also consider how responsive these different groups are to different incentives. We know from research that some groups have very little response to changes in work incentives whereas other groups, for example lone mothers, are very responsive when their work incentives change. It is a complicated analysis to get to the full impact.

Q39 Chair: Added to the complication, isn’t it, William, is that we don’t know when these families you are talking about, particularly those with children, are going to be affected by universal credit?

William Elming: That is another complication we don’t necessarily know.

Q40 Chair: When you provide us with more information, we would love the most optimistic scenarios and what is also a likely scenario. Adam, do you have more to add to that?

Jeremy Quin: The Chairman is always an optimist on these things and so he should be. But also on the behavioural consequences—William was just touching on it—for employees or those seeking to go into work, and for employers as well but starting with employees, are you able to have a stab at what the behavioural consequences might be: more hours worked, anything along those lines?

Adam Corlett: I think Torsten has some figures about the fact that people will have an incentive to work more hours but because of these changes we are talking about they might get quite a small return from that. Just on the point about universal credit, I can’t comment on the possible timeframe for that but it is important to remember that the system that is going to be in operation in future, if we take the Government at face value, will be universal credit rather than this tax credit take we are talking about. Some of these very highest marginal deduction rates will be reduced by universal credit but will still be very high at 76% at least.

Q41 Richard Graham: Can we focus on that very briefly? Adam, on the business of the speed of migration into universal credit where the marginal tax rate would effectively be 65%, that is significantly lower than under these changes to tax credits. What sort of difference would the speed of migration of the working families with children, which are the hardest hit by tax credit cuts, make?

Torsten Bell: If we look, first of all, at the difference in marginal deduction rates in tax credits and universal credit, the 65% taper is the universal credit taper, not the marginal deduction rate you will face after you are paying tax as well. That is the 76% figure that Adam is referring to. What has actually happened with the—

Chair: Also council tax is not included in that?

Torsten Bell: Ignoring council tax totally.

Chair: So there are two other marginal rates to add to it.

Torsten Bell: Yes, and other complications around free school meals. What has happened with the 7% increase in the tax credit taper is that the marginal deduction rate for the bulk of these families in tax credits has leapfrogged the universal credit one. It has gone from being 73% to 80% while the universal credit one has stayed put at 76%. That is a slightly odd thing to have happened but I am sure it saves money in the short term. Obviously it saves no money in the long term because tax credits is meant to cease to exist in five years' time, but that is the impact of these savings. The deduction rate in tax credits has leapfrogged that in universal credit.

On universal credit on work incentives, I think again it has not been a large part of the debate that there has been a large reduction in the work allowances in universal credit announced in this Budget, which is why the savings under what is called the threshold measure in the scorecard in the Budget continues after tax credits are phased out because the impact has moved into the work allowances. That work allowance change is so large that our view is that it to a degree fundamentally changes how universal credit is going to feel for people on low hours. I will give you one example. Before the Budget a single parent on the minimum wage could have worked 22 hours under universal credit before she had any of her universal credit entitlement taken away. After both the reduction in the work allowance, which falls to £5,000 for her next year, and the increase in the national minimum wage to the national living wage, if she is on that, she will now only be able to work 10 hours before she starts to see quite a significant, 76%, tapering of her entitlement. It is exactly that kind of incentive that the welcome purpose of universal credit was aiming to get around. When we are talking about these work incentives, more of the debate should be focused on what we have done to the original purpose of universal credit in these drastic cuts to the work allowances, in particular for single parents.

Chair: Particularly in broken Britain reports, the whole emphasis was that the reason why Britain was broken was because of the high marginal tax rates and what would fix this would be universal credit. What we see here, don't we, what you are explaining to us, Torsten, is the political pressures that the Secretary of State has been under to protect his scheme and that original vision? As time goes on it, it is more difficult for him to sell it in those terms, isn't it? We are having him back in two days' time and he can answer.

Q42 Jeremy Quin: On the impact on employers, it seems self-evident that if you have the tax credit system in place that has a depressing effect on wages. Is that the case and do you think there will be a reaction from employers when seeing what is happening to the income of some of their employees and how they may react to it?

Torsten Bell: This is quite a hard issue to get at in the data, but the evidence that does exist here and in the United States, where EITC is a similar although not identical product to our tax credits, is that that is not the case. There is an argument around, which is that tax credits came along, unscrupulous employers therefore suppressed their wages and if only we got rid of tax credits wages would shoot up. The initial evidence, which is principally us and the US, is that is not the case. Numerically it is a bit over 70 pence in the pound of tax credit spending goes direct to the individual not through lower wages. You may or may not think that is good value for money but the evidence is that on balance it goes to the employees.

Q43 Jeremy Quin: Sorry, can I understand that? The evidence you have is that 70% will go to the employee and 30% is a subsidy?

Torsten Bell: There is an impact on the supply of labour obviously, so it is not a wage subsidy in that sense. It goes to the individual but you are definitely not seeing a pound-for-pound cut in wages. It is not like a straight supply argument, which is a person needs £100 to live on; they get paid £100, then a tax credit comes along and gives them £20 so they get paid £80. That has not happened in the real world. I would also say that we did some work back in 2012 looking at what had happened to wages of those parts of the workforce that receive tax credits versus those parts that have not and there was no evidence that those parts receiving tax credits had had a lower earnings growth. You would see this through earnings growth, not through absolute cuts, obviously, because of nominal rigidities, but there was no evidence that it had had that effect. The evidence does not back up the argument that you are seeing a large wage effect from tax credits.

Q44 John Glen: How do you assess productivity in all of this? Clearly there is a situation there, while you may not see them meet each other, there is an attitudinal change of an employer towards that member of staff in terms of the tolerance of unproductivity or productivity. Is there any way that you would take account of that factor in your analysis?

Torsten Bell: The economic theory would tell you two things. One is that in theory the only thing that matters to the firm is whether the level of productivity of the worker is more or less than the wage they are paying. The Institute of Economic Affairs and others would, from a different perspective to ours, be saying that tax credits are largely irrelevant to the wage rates people receive because of the argument you are setting out. A separate thing related to this is that employers do not have sight of the tax credit entitlements of their employees and they do not have the capability to discriminate between those that do and those that don't, and if they did then legislation should probably have something to say about it.

Q45 Chair: It goes back to a point that Adam was beginning to answer for us. My guess on the effect of employers' feelings about the eligibility rules for tax credits is that the smaller employers began to shape job opportunities so their employees could maximise the advantages of working taking tax credits. If you change the rules that you have to work longer or you have assumptions people can work longer to offset or to gain extra marginal increases in pay, you are assuming that there are jobs out there that are flexible, not in the terms that we refer to but flexible that next week your employer is able to find you extra hours to work. Adam, that is not necessarily a good assumption for employees, is it?

Adam Corlett: I would agree that the working tax credit system has incentivised employers to create, say, 16-hour jobs in some cases to match with tax credit requirements. I am not sure whether that is relevant to the cuts coming in next year.

Q46 Chair: No, but it might be relevant in the sense that the DWP Secretary of State rightly wants people to work longer hours, where possible, and therefore have higher real incomes. It may not be possible for lots of people employed by smaller employers quickly to be able to respond to his wishes on that front. Isn't that right?

Adam Corlett: Yes, I would agree with that. Then when universal credit comes in you lose these hours rules and, as Torsten said, lots of people are facing the high marginal rates and the working allowances have been cut, so there is a risk that people might drift down from the 16 hours threshold and actually work fewer hours.

Chair: Sure, there is on that, but in the real world we expected to have a couple of million people claiming universal credit. We are some way off from that, aren't we? So I think we ought to be mindful of some of the advantages that might come but then they might be a long way down the road.

Q47 John Glen: I think it would be helpful to have a summary of the changes we have discussed in terms of your view of where it ends up with more people in work or not. It is very difficult for people watching us today to get a sense of what this analysis bottoms out at and I think people are very concerned about the overall effect and are desperate to try to get a clear understanding of the effect it will have on those in work.

Torsten Bell: Looking at the issue as a whole, taking work incentives in the tax credit system and in the universal credit system, our view would be that, first, people are worse off but, secondly, that overall the work incentives have been damaged by this package of reforms. That is clearly even taking into account the fact that a large number of people out of work by the end of the Parliament are poorer and, therefore, may have a higher incentive to go into work, but for working people in particular they are worse. Your question got at what is the employment effect of that and we are not in position to give that, not least because we hope that we are about to see five years of employment growth. I do not have useful facts to add to where does that then take you. Purely on have we improved or made worse incentives, particularly to increase your hours once you are in work, I think the answer is we have made it worse, unequivocally.

Q48 Chair: Paul, what would you say on that?

Paul Johnson: It is certainly true about increasing your hours, but in terms of movement into work, as we said earlier, it is quite a genuinely complicated picture. For some people it is a significant increase in their incentive to move into work, particularly for second earners in couples and for those who are losing significant amounts of money when they are out of work. So, overall there are some quite significant changes if you average out a small increase across the population. Putting all this together with universal credit is terribly important though. What you are seeing at the moment is a lot of people working exactly 16 hours a week or exactly 24 hours a week, which indicates how responsive the labour market is to some of these incentives in the system. That is not going to exist under universal credit and because the work allowances are falling then the incentives to move beyond the work allowance is going to be reduced.

Q49 John Glen: But the certainty of the tax credit changes, coupled with an uncertain trajectory in the rollout of the universal credit, leaves a very difficult analysis for you to make in terms of the impact on different segments of the population?

Paul Johnson: We can only work on the assumption that essentially it is populated either on tax credits or it is on the universal credit. We can't model half and half.

Heidi Allen: My brain is hurting at this stage. I think you guys are incredible. Just on universal credit again, if it is possible when we are trying to identify that sweet spot of when the stars align and it all works for people, can the rollout of universal credit be part of that analysis that says: would people be in a better position if universal credit was available for them now in their city? To me, that seems a fundamental part of this whole equation, appreciating that it is difficult to do half and half, but to almost have two sets of analysis, one that says assuming no universal credit and one that there is universal credit. I am searching for levers to make this better for people and if universal credit being rolled out more swiftly could be part of that I would be really interested in understanding how it affects the analysis.

Chair: In a sense that follows up on Karen's question. If one could add that factor into the analysis we would like you or may be asking you to undertake, that would be very helpful and then we can make a political judgment of how many people will be actually on universal credit by then. Is that all right, Heidi?

Heidi Allen: Yes.

Q50 Mhairi Black: I am very conscious that there is a lot of statistics being thrown back and forth, so I am quite keen to bring in the human aspect again. Are you able to give us some kind of illustrative examples of the kinds of people and households that are going to lose the most out of this? What do these households look like?

Paul Johnson: Those losing the most will be mostly families with children, clearly. A significant proportion will be lone parents. Those who are losing the most will probably be those losing both from the change in the work allowances and the increase in the tapers. Those earning maybe £20,000 to £25,000 a year, so towards the top of the tax credit taper, will be the ones who are losing the most and if they have two or three children they could easily be losing a couple of thousand pounds. So, significant cuts for those in work and particularly those who are earning towards the top of what they can.

William Elming: For new claimants of the child tax credits for the third and fourth subsequent child, they will be losing around £2,700 per year per additional child. So for new claimants and in the long run when this is fully phased in, this will be substantial amounts for the larger families from this one policy change alone.

Q51 Mhairi Black: Are the households that are losing the most equipped to be able to deal with such a substantial loss on their income? In effect, if you are losing £2,000, for instance, in reality what does that mean that you are not going to be able to afford anymore?

Torsten Bell: In general it is a dangerous game for people like us to start saying how people will change their lives. Clearly that is a large amount of their income. Another way of putting it is 43% of tax credit in-work recipients earn, the household earns less than

£10,000 but the average loss, including for those people, of this tax credit is over £1,000, so lots of these people will be losing a tenth of their income. They may have other income but we are talking large percentages of family incomes. The large cash losses will be at the top end of the tax credit income spectrum, in the £20,000s, and the ones there that will do the worst are those that do not benefit from the national living wage because they are earning slightly more than that. But you will have large hits to percentage of incomes down towards the bottom of the tax credit income distribution and those people who obviously historically we know find it hardest to adjust their lifestyles.

Q52 Mhairi Black: One of the other criticisms that has continually come up is that the changes to tax credit or the cuts to tax credit are not coming in at the same time as some of the aspects that could possibly mitigate some of the cuts, like the increases to the personal allowance or the increases to the minimum wage. What is the realistic prospect of being able to speed up the process of introducing the new minimum wage or the personal allowance?

Paul Johnson: The personal allowance is extremely expensive. To add £1,000 to the personal allowance costs a couple of billion pounds. It is very expensive to do and it is also not even nearly focused on the people who are losing from the tax credit changes. The vast majority of that money will go to people who are not on tax credits and those on tax credits will gain only a very small amount from it. So I think it is probably just a mistake to think of increasing the personal allowance as a way of compensating for changes in tax credits. If you were thinking about spending additional public money to support those who are losing tax credits, you certainly would not begin by looking at things like the personal allowance.

Torsten Bell: On your question about could tax and the national living wage be done faster, the personal allowance is a very badly targeted tool for compensating people. On the national living wage, because of this deduction rate issue we are talking about, for the extra pound they earn they lose 80% anyway, so even if it was £9.35 in April it wouldn't be compensating for these losers. I will give you an explicit example. Say the national living wage was introduced at £9.35 rather than £7.20 in April—that would be a very bad idea for employees and employers all over the country and definitely would cost jobs, so we definitely are not advocating that but say you did that—and you delivered on the Government's promise of a £12,500 personal allowance this April, rather than waiting to 2020—again, we don't think that is a good way to spend money but you could do that—in that world a single earner couple on £15,000 with kids, they are working full time on the national living wage, even before you take into account the benefit cut later in the Parliament, would still lose £320 this April and it would cost the taxpayer £9 billion to do it, which is twice the savings of tax credit in the first place.

Chair: It is unlikely, Torsten?

Torsten Bell: It is a bad idea, it is very expensive and it does not compensate people. Tax cuts and the living wage cannot compensate for these tax credit changes. That is not an option.

Q53 Mhairi Black: With that in mind then, in your opinion are there any credible options that can mitigate these cuts, whether that is through adjustments to tax or to the national insurance rates in bands? Is there anything that you can think of?

Chair: On that, is there anything in headlines because we are going to then move to Richard on what the proposals might be to mitigate.

Paul Johnson: I think the answer to your question of could you do anything with the tax system, could you do anything with national insurance, is no. If you want to mitigate these changes to the tax credit system you probably have to do it through the tax credit system. For example, by phasing in the changes to the work allowance or by doing the same as you have been doing for other things, which is doing it for new claimants, there are downsides to that as well because it creates a very big incentive to stay on tax credits at the moment rather than risk moving off and coming back on again.

Q54 Chair: Let's keep to the headlines. Apart from working on the tax credit system alone, you wouldn't see any effective mitigation strategy?
Paul Johnson: Not through the tax system, no.

Q55 Chair: Torsten, do you disagree?
Torsten Bell: No. The answer to tax credits is tax credits.

Q56 Richard Graham: That is really helpful. I think what we have heard so far today is that you are both agreed that eight out of 10 families will be better off.
Chair: Who are not tax credit families.

Richard Graham: Just in the country, but the two families out of the 10 who are on tax credits will be worse off and there is a slight disagreement on whether that will encourage work or not. On the options available to mitigate the effect of this on people currently getting tax credit, I think you are both agreed that doing anything on the minimum wage and tax allowance does not work. So we are down to tweaks to the tax credit system. On that, Resolution has written that, "Any given proposal can only achieve two of saving money, reducing poverty and improving work incentives". But if you had a Government plan on tax credits that delayed the savings in different ways—and I would love to hear what options you have both considered—could you not do so in a way that would reduce poverty and improve work incentives at the same time?

Torsten Bell: What you referred to is the iron law of welfare reform and what is happening in the example you suggest on transitioning is that you are saving less money.

Richard Graham: In the short term?

Torsten Bell: Correct, in exchange for in the short term not taking a hit to poverty and to work incentives, so it still fits within the options.

Q57 Richard Graham: Is that possible to do, bearing in mind that if you make too many changes, for example on child tax credits, that might affect work incentives? What do you think could be done that would be effective?
Torsten Bell: On transition?

Richard Graham: Yes.

Torsten Bell: It depends what question you are answering. If the question we are asking is if we think the timing is the problem—it is not a problem that they are losing on average £1,100 but that it is happening in April overnight—then you might think that transitional arrangements are the answer. They bring with them a host of administrative complexities, as anyone who has been involved in a tax credit system will tell you, and a very large incentive problem about whether people would ever wish to exit the tax credit system. Our view is that the timing exacerbates but it is the actual endpoint that is the problem, as in we do not think that it is a good idea to be having this large a reduction in family incomes and in incentives to work.

Q58 Richard Graham: Okay, but if you come from the starting point that a policy that was introduced to provide £1 billion of help now provides £34 billion and that is not sustainable and you want to change it and, secondly, if you believe that there will be a wider ripple effect to the national living wage on increasing pay, which you can argue has already happened, then you would look potentially at mitigating this, at delaying the introduction of the policy rather than just simply ruling it out. What sort of variations would you consider in terms of either the taper or the allowance, for example below the average minimum wage, which is roughly £25,000? If the bulk of the savings are generated at the top end, what could you mitigate for those on lower salaries without doing it also for those above median wages?

Paul Johnson: The obvious thing is just to bring this in gradually, whether that means reducing work allowances by a little bit this year, a bit more next year and a bit more the year after, or doing it just for new claimants. You have got to weigh up that in the first case you are having more effect on people's incomes who are staying on benefits and in the second case you are creating the incentive problems that Torsten referred to. I think it is difficult to do something that is protecting those on lower incomes while hitting the higher income ones because you can really only do that by increasing the taper rate even further, and I think we have mostly agreed that 76% under universal credit or 80% under the tax credits is quite high enough. I think the only way you can do it is just by introducing the changes more gradually rather than overnight and that will have the same long-run effect in terms of savings. It would just not hit people so suddenly.

Richard Graham: For example, you would implement the cuts of the first year over two or possibly over three?

Paul Johnson: Or something like that.

Q59 Richard Graham: Have either of you done any work on that?

Paul Johnson: It is difficult to know what work you could do. In a sense, the distributional effect would look the same in any modelling that we did because we can really only do that in steady state.

Torsten Bell: Any kind of transition that takes place—so we are really now talking about the threshold. If you are talking about phasing in the threshold over two and three years, then it does exactly what it says on the tin in the sense that you end up at the same point in three years' time. The increase in the national living wage, even taking into account what George Bain thinks is an optimistic version of the spill-over effects, the endpoint, as in are these people better or worse off, will look slightly different but not very different. An argument for phasing in on the thresholds is an argument that the reduction threshold is still a good idea and that the change in who is better and who is worse off is still a good idea, but that we do not want an income hit in April this year. There is not enough growth in earnings taking place to make a fundamental difference to that distribution in three years' time.

Q60 Chair: No, but I thought Richard's points are, first, that in real life there is a dynamic effect and if you phase it in, going back to the point we were trying to address to Adam, it is possible for employers to feel that people would be pressing for more hours. They then might be able to be making adjustments about what you would be earning off them, which I know is very difficult to model but having the proposals phased in gives individuals more time to scramble around to try to mitigate the consequences.

Richard Graham: And more time for salaries to rise if you believe that they are rising anyway, which would also mitigate the effect of losing, say, £500 if your salary has gone up £500.

Paul Johnson: Under the current tax credit system with the clear hours rules at 16 and 24, I think it is extremely unlikely that any of these changes would give people an incentive to move beyond 16 or 24. As Torsten was saying quite rightly previously, with the universal credit the point at which your work allowance runs out is a crucial point there.

Q61 Ms Karen Buck: I very quickly wanted to ask whether you thought in terms of options arising out of the taper of the threshold there were any distributional impacts of choosing one against the other compared to, for example, looking at lone parent earners or second earners. What would they be?

Torsten Bell: There would be implications. Of the two, our view is that the work threshold cut is significantly more of a problem—they are both problems but it is more a problem—because it is more regressive and it has a bigger impact on this year, leaving aside later cuts to out-of-work benefits but this year has a larger impact on work incentives. That is our view.

Just on the extra earning point that the Chairman has raised, if somebody worked an extra two hours, so say you waited a year, you phased it in, they ignored the pressure in the tax credit system to stick to exactly the hours they are on, which is pretty strong pressure but let us assume they ignored that, they worked two hours extra on the national living wage in April, they would bring in £750 more in earnings—you might think that is good; the average losses is £1,100—but they would only take home an extra £150 because they are facing such a high marginal deduction rate. That is what I mean by saying you do not solve the income hit by just waiting a year, people increasing their earnings or a small change in the minimum wage. The level, the impact, the size of the hit to their income is too big.

Q62 Chair: Except I do not think necessarily people are going to go for two hours if they could. You could say this is shock treatment and the idea they are going to be just governed by the rules of universal credit might cease given the size of the losses. They might just cast themselves adrift from the earnings rule. That is what I think might happen if employers have the work to offer them.

Torsten Bell: That is what is known as the income effect. That is possible if you believe that these kinds of people that are affected have a very large income effect from a hit, that a large hit to their incomes will lead to a large reaction in terms of hours worked.

Chair: But it is on the assumption they have time to negotiate these increases, not that they come in. I am slightly depressed by the answers you are giving Richard because here we are searching to suggest to the Government how they might mitigate this and you seem to be telling us it is all hopeless.

Torsten Bell: We are not saying that.

Q63 Richard Graham: I am not sure if either of you have done any specific research on this, and I would be interested if you can both confirm that, but also, Torsten, you said, I think, that for you the words "threshold cut" was the more aggressive one, the one that would impact working people more. Can I just check, does IFS agree with that?

Paul Johnson: In a static sense that is right because the threshold effect affects those on the lower incomes directly. In terms of the work incentives, that also has a bigger effect on the incentive to move into work at a particular number of hours. The increase in the marginal rate obviously reduces your incentive to work extra hours. It is just part of the trap you are always in when you are thinking about welfare reform. With a certain budget you are making things worse with one hand or the other.

Q64 Richard Graham: That is true of almost any policy, there are always winners and losers, but we are trying to explore how we can reduce the numbers of losers, particularly people who are working and who are not earning a great deal of money. Have either of you done any research on what you could achieve if you did increase the threshold at the halfway point between the £3,850 and the £6,420 and what that would mean in subsequent years?

Torsten Bell: It is basically linear. For every pound of that threshold the person is losing 48 pence difference. So, yes, you can literally take how much you have to spend, work out how much you can reduce the cut in the threshold by and you will save 48% of that as the hit to families.

Q65 Richard Graham: Chairman, I think we would be extremely grateful for dynamic spreadsheets from both organisations that offered some research on what the impact would be on the average and on particular types—families with children, families without children—if you did introduce a different dynamic in the equation and spread it over, say, two years or three years. You would then have the impact of rising salaries and so on that would make it much easier for people to absorb the same change over a greater period of time. Is that something you would both broadly agree with or dispute?

Torsten Bell: I think we can very easily model the impact of a phasing in on the amount people lose or do not in a given year. The points that Frank and you are making about people's change in their behaviour to employment are very hard to model, not least because of judgments, as Paul says, about how people respond to our rules. That involves a lot of judgment and so we would not model that, but we can model what happens year by year as you phase in and you can obviously take into account earnings growth.

Q66 Richard Graham: What is IFS's view on that?

Paul Johnson: I think you are talking about doing this, for example, for families. It is clearly something that is possible to do. There are a huge number of things that you could change within that. Honestly, I am not sure how much it would tell you that you could not work out on the back of an envelope.

Richard Graham: You may be better at working out things on the back of a fag packet than I am.

Chair: More people might pay attention if it is your envelope it is on the back of than if it is the calculations that occur if it is our envelope. Is that all right? But we are going to talk afterwards to bring together the sort of questions we might ask both organisations to help us with as this debate goes on.

Q67 Richard Graham: Frank, can we just finish on one question that I had not got around to telling you? If you were the Chancellor and you were committed to a significant amount of savings on the welfare budget in order to try to balance the books and you were finding this particularly awkward for whatever reasons, are there any other bright ideas from inside or outside the box that you think we could bear in mind or offer him to consider?

John Glen: And will achieve £4.4 billion in this next fiscal year?

Chair: We are not asking much, come on, very quickly from you.

Paul Johnson: The Chancellor has said for a long time he wants to find £12 billion of welfare cuts from working age families and it always seemed fairly clear that was going to be very hard to do if you are not going to cut tax credits, which have, after all, been the fastest growing part of welfare spending. What else could he do? Well, he could make more cuts to housing benefit. None of these are things I would propose, but essentially where is the big spending? Housing benefit is the other big spending. You could reduce local housing allowances further, but that is already becoming disengaged from private rents and so that will be difficult for all sorts of other reasons. You could do things like tax or means test disability living allowance, but there are obviously all sorts of very good reasons why you might not want to do that. You could abolish child benefit or roll it up within tax credits or universal credit. That would probably be the least distributionally regressive thing that you could do, but again there are lots of very good reasons why you might not want to do that. There just are not easy ways of finding £4 billion of cuts from the working age welfare budget.

Q68 Chair: But if you had thoughts—and you could put them on the back of an envelope—would you send them to us?

Paul Johnson: We published something at the beginning of the year in which we set out a whole series of different ways and options for saving the £12 billion that the Chancellor did—

Chair: Our minds are now differently concentrated from the beginning of the year. The same applies to you, Torsten.

Q69 Richard Graham: Can I put one option just to see how you react? If, for example, the Chancellor were minded to look at the tax-free contributions to pensions, it seems to me the size of the pot available is not the size that some people in the pensions industry have speculated because there would be significant behavioural change if we made huge changes to the tax rates we paid on those. Nonetheless, would there, in your views, be enough money to do something significant there to cover?

Paul Johnson: You are now looking at the whole of the tax and spending system and I have to say that is not the place that I would start looking. The Government have already taken £5 billion out of private pension saving through increased taxes on pension contributions through what it has done. I think there are things you could do on pension taxation, which is not on the whole what the Government are looking at. In particular, the way we treat pension savings for national insurance contributions is staggeringly generous in the sense that no national insurance contributions are ever paid on employer contributions to pensions. You could charge that upfront or you could charge it on pensions in payments and you could start doing that relatively quickly. There are all sorts of political and other reasons why that might be difficult, but if I was looking for something in the taxation of pensions it would be around national insurance contributions or the tax-free lump sum rather than the income tax allowances. But if you were looking at the whole tax system or the whole of spending, then there are obviously all sorts of places that you could look. I was in my answer constraining myself to the Chancellor's ambition to find £12 billion out of working age welfare. If we are looking for £4 billion out of anything in taxes and spending, we could be here for quite a while.

Q70 John Glen: The Government present the £4.4 billion as an absolute requirement in order to meet their objectives around reducing the deficit. I think for many people that £4.4 billion seems an arbitrary amount if we have discussed during the course of this afternoon's proceedings the different options that may exist. Could you give us your reflections on what it would mean if this did come in more gradually in terms of the impact on the wider deficit reduction strategy? How serious would it be for the public finances and what would it leave for the Government to address later on?

Paul Johnson: I think if you do the same thing more gradually the answer is it has very little effect on the long-run public finances. The Chancellor has a target to get to budget balance by the end of the decade and so what happens, whether it is £4 billion or £2 billion next year as long as it still has the £4 billion at the end, makes not a great deal of difference. I think it is important to say that without the large amount of welfare cuts that the Chancellor has announced in total then the scale of the spending cuts in the upcoming spending review will be even more dramatic than what I think we will see, which are some very substantial cuts in the unprotected departments. If you are looking at the long-run costs of savings from the welfare budget, then there is a very sharp trade-off with other spending cuts given, first, the actual that the Chancellor does want to achieve what he says he wants to achieve in terms of the deficit and, secondly, that he is not looking at tax rises. Given those two things, then you do have a straight trade-off between spending on welfare and spending on things like education, business, environment, police and so on.

Torsten Bell: I think it is important to say, though, that it is important that the trade-off between public service spending and welfare spending is obviously a choice and you obviously have as much choice as you want about the tax revenues, which is the point that you were making about pension tax relief can be brought into play. It is also worth saying that, forgetting the transition, even if you did not go ahead with any of these tax credit changes in April—

John Glen: He has already set certain constraints in a number of departments anyway, so those choices have come—

Torsten Bell: No, I am saying even parking those, even if you did not go ahead with all of this, which I am not suggesting, you would still meet all of your fiscal targets by the end of the Parliament because he has £10 billion worth of headroom in 2019-20 to meet his surplus rule. It would not stop debt falling in every year from 2016-17 onwards, which is what his rule is, so there is no—

Q71 Heidi Allen: So interest wouldn't be a blockage to anything like that?

Torsten Bell: I am afraid as a country we are borrowing a lot of money, so £4 billion, I am afraid, makes zero difference to the interest we pay. There are trade-offs. £4 billion is clearly a lot of money but there are a lots of different options about tax or about the deficit or about other areas of spending that you have choices to make about, including, as David Willetts highlighted this weekend, how much we spend on pensions. These are all areas where there is flexibility and I feel in some ways we should be careful about people arbitrarily constraining that debate because that normally comes from a point of view of not wanting to go to the places where the constraint might take you.

Q72 Chair: On that, Torsten, and David Willetts' point, it is clear the Government will not change the triple lock in this Parliament, but it would be proper, and we might discuss this as a Committee, that we look at what the restraint should be in the next Parliament before people make promises to the electorate. One of the difficulties in this area is that all the changes are concentrated on working people and those of us who are over retirement age are protected. If we are thinking of really long term we need to—

Richard Graham: Chairman, you could, of course, have a triple lock but change at least the size of one of the elements within it.

Chair: Yes, you could, what one of the locks means, I agree. Do you wish to come in on that, Emma?

Mrs Emma Lewell-Buck: It was just a final question from the panel, Chair. Are we there yet?

Chair: No, I have a final question, but maybe you want to ask it, go on. If we say "a" final question rather than "the" final question I think that will be all right.

Q73 Mrs Emma Lewell-Buck: It might be a tricky one for you to answer and I do not want to put anyone under pressure. Quite simply, I have heard nothing really positive about these changes to tax credits because people are very clearly going to be hurting because of them. If you were Iain Duncan Smith, would you just scrap these changes as they currently stand and go back to the drawing board?

Torsten Bell: If I was Iain Duncan Smith I would say I am glad that we are saving £4.4 billion because the country has a serious deficit, but if I was him I would be thinking very seriously about what has accidentally happened to universal credit. I would be thinking, first, there is a big impact on families this April that I am worried about and I would be thinking more fundamentally for him personally and other people, which is I am the architect of universal credit and I appear to have accidentally signed up to a very, very large removal of the original purpose of that entire project and was that what I meant to do.

Mrs Emma Lewell-Buck: Thank you. It is never going to happen.

Paul Johnson: I think the point is, as Torsten said, this is a big saving and if you look, even in 2020 spending on tax credits will still be at something like £25 billion, which is a multiple of where it was in 2000 and more than it was in 2005. This is a moving back significantly but it is not a complete dismantling of the tax credit system. I do think the structure of what will end up as universal credit has, as Torsten said, been fundamentally changed by the way that these are being introduced, so looking again at that structure, given the budget constraint, may well be worth doing.

Q74 Ms Karen Buck: Is it entirely fair to say that in the sense that has not the profile of the people who need tax credits changed because of what has happened to earnings over that period?

Paul Johnson: There have been a whole series of changes here, but even for most recipients—not all because it will depend on the distribution but for most recipients—the amount they will be receiving in 2020 will still be as much as if not more than or a lot more than they would have been receiving in 2000 and probably more than they would have been receiving a few years after that. It is not abolishing tax credits. It is not even taking us back to 2000, 2001, 2002. It is, though, stripping back significantly the increases that happened in the second half of the last Labour Government.

Q75 Chair: Can I ask a last question? During the election the Prime Minister promised that child tax credits would not be touched, would not be cut. Given the changes in the taper rate, they are being touched, aren't they? Am I wrong? Should I be supporting the Prime Minister in saying you have fulfilled that pledge with these changes?

Paul Johnson: In the long run we are clearly seeing that tax credits are not going to be available for third and subsequent children for new claimants and that the family element is going to be cut. That is not specifically a child tax credit but it is clearly paid in respect of the first child. As I said, whatever he may have said off the cuff in a particular use of words, the Chancellor has made it absolutely clear for at least two years now he is looking for £12 billion of welfare cuts from people of working age. I could not imagine and we could not imagine when we wrote about this back in January that you could have done that without reducing the generosity of the tax credit system.

Q76 Chair: No, but that is a different point; what information the electorate have in their heads when politicians are giving them pledges, that is all. Torsten, do you have anything to add to that or not?

Torsten Bell: I have nothing to add. I have no factual information to add to that.

Chair: All right, very good. It has been immensely helpful. I hope you are going to be even more helpful to us because we are going to go into private session now and talk about the other information, if you can, and whether you could provide the Committee with that information. On that happy note, can I thank Adam, Torsten, Paul and William for your contribution today? Thank you very much.