HOUSE OF COMMONS

Treasury Committee

Oral evidence: Budget 2016, HC 929

Tuesday 12 April 2016

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Watch the meeting

Members present: Andrew Tyrie (Chair); Mr Steve Baker, Mark Garnier, George Kerevan, Mr Jacob Rees-Mogg, Rachel Reeves

Questions 267 -376

Examination of Witnesses

Witnesses: **Andrew Sentance**, Senior Economic Adviser, PwC, and **George Buckley**, Chief Economist, Deutsche Bank, gave evidence.

Q267 Chair: Thank you very much for coming to give evidence this morning. We have quite a busy day, so we intend to begin right now. We also have another session immediately afterwards with the IFS. Can I begin with you, Mr Sentance? You are very familiar to this Committee, so I think that you, as the old lag, should start.

Andrew Sentance: It is good to be back.

Q268 Chair: We can always supply further opportunity. Is this current fiscal surplus rule that we have of much use for bolstering confidence in economic and financial policy?

Andrew Sentance: You could say that, directionally, it is pointing the Chancellor in the right direction, but the fault with it is being so specific in a legal framework, when there are so many things that can move public finances around. We have seen examples of that. It is quite right for the Chancellor to have the broad principle that, if the economy continues to grow at around 2%, which is the OBR forecast, he should be able to achieve a surplus by the end of this Parliament. Probably more important to economic policy is not hitting a precise figure in 2019-20 but ensuring that, over the medium term, public finances are being well managed and that the public sector debt is coming down. I am not sure that I find the exact formulation of this fiscal rule very appealing. There is a tendency to put too much into a legal framework, which should really be about broad direction of policy and strategy.

Q269 Chair: How did we get into this mess with these very tight legal frameworks?

Andrew Sentance: The Labour Government, under Tony Blair and Gordon Brown, started down this track of setting more specific fiscal rules. We learned quite a bit there about the limitations of those rules.

Q270 Chair: You are thinking about when the golden rule ended up with its base being moved in 2005.

Andrew Sentance: Yes, and we were in a situation when we were at the peak of the cycle, but the Chancellor did not feel any obligation from his rules to perhaps do what George Osborne is now planning to do, which is to run a surplus. He was still running a deficit at the peak of the cycle. That meant that, when the financial crisis hit, public finances deteriorated quite a lot. There have been previous periods when we have had to get the deficit down, from the mid-1970s through to the 1980s and in the 1990s, and Chancellors have done that quite adequately without these legal fiscal rules, using a broader medium-term policy framework. That is probably the way that I would prefer we were setting policy.

Q271 Chair: When, very early on in your response, you talked about moving things around—I think that was the phrase—in fiscal policy, in response to this tight legal framework, was that a reference to the fact that it appears, every six months or so, we are adjusting fiscal policy to take account of relatively small changes in the forecast? Did you have some other point in mind?

Andrew Sentance: It was the way in which the Government have had to respond to the forecast from the OBR, which actually gave them a slightly better-than-expected environment in the Autumn Statement. As the OBR has done a review of the longer-term growth position, in my view, it has moved to a more sensible longer-term growth projection. Those have moved in opposite directions. The Chancellor, who is trying to hit this specific figure of a surplus in 2019-20, has had to do some fancy footwork in the budget to make sure that he actually hits it.

Q272 Chair: Just to be clear—and I do not want to put words into your mouth, because I have already expressed my view about this on the Floor of the House, so I am not neutral—as I understand it, you are saying that it does not add to the credibility of fiscal or financial policy that we are required, every six months, to make these fine adjustments. It might add something if we had a strong statement of sense of direction in a medium-term framework.

Andrew Sentance: That is broadly correct. The danger, if you set a very precise figure on a very precise date, is that you are too geared around that specific date and that figure, and are not necessarily focusing so much on the broader medium-term direction.

Q273 Chair: Mr Buckley, what would you like to add, qualify or challenge in all that?

George Buckley: I would suggest two things. First of all, the fiscal rules are a good addition. The problem is that they can be changed depending upon which Government is in power. In addition, there are no consequences from missing these rules.

Q274 Chair: I am sorry to interrupt so early. I just want to clarify. When you say they are good, are you disagreeing with Mr Sentance in that you think it is a good idea that policy should be adjusted every few months to take account of the forecast?

George Buckley: No, I agree when he says that there needs to be some framework to at least think about how policy should be set. It may not need to be so tight, and there are no consequences from missing these rules, so I am not entirely sure what happens when you miss them, apart from the small embarrassment factor.

The other question that you asked specifically was about the small adjustments that need to be made on account of having fiscal rules in the first place. I would argue that that is almost a feature of the fact that, right now, we start from a position of being in deficit to the tune of about 4%. The point at which we would get into surplus is exactly the point at which the Chancellor would like those rules to be met and when the rules are required to be met. The problem is that any small change in the economy over the next four to five years would necessarily mean that you switch very quickly from the rule being met to the rule not being met. It is almost a temporary feature from the starting point, being far into deficit, that, when you are in surplus, in the future you are more likely to be in surplus again.

Q275 Chair: You are saying that these rules are good for times of plenty and bad for times of thrift.

George Buckley: I think rules can be helpful.

Chair: Have I correctly summed up what you are saying?

George Buckley: I think so. The rules are helpful, but there are lots of different incarnations of these rules.

Q276 Chair: I have not heard anybody else articulate the case for having a rule that only works in the boom times.

George Buckley: I would be much more concerned if they ditched the rules as opposed to having rules. Rules are useful. The problem is that, by virtue of the fact that they are changed, they are not fixed.

Q277 Mr Baker: Good morning. I would like to turn to productivity, because the OBR, as you know, revised down its forecast for trend productivity growth from 2.2% to 2%, with all of the consequences that that will have. Mr

Buckley, could you tell me a little about what you think is driving underwhelming productivity growth? Do you think that it is a general problem or that it is more concentrated in certain sectors?

George Buckley: It is certainly a general problem to the extent that low productivity is something that is not just relevant to the UK. We have seen weak productivity in many countries. When you look at the level of productivity relative to where it was 10 years ago, let us say, in the G7 and a number of other competitor countries, we are pretty much middling in the UK, in terms of our outcome. We are not worse or better than the average of all of the other countries. It is relatively middling when you look at output per employee. It is a general issue that has happened since the crisis. When you compare productivity relative to what has happened in previous recessions and recoveries, the rate of growth of productivity in all countries has been much lower than it was in the wake of previous recessions.

Q278 Mr Baker: To what do you attribute that?

George Buckley: You can look at a few factors. The first factor is that it may not exist at all, because we get revisions to the data. That only accounts for a very small portion of this so-called "productivity puzzle". There are cyclical demand reasons why this existed. During the very initial stages of the recession, companies decided to retain employment, but you cannot explain it now as hoarding, because we have seen substantial increases in the level of employment. Therefore, I think what we are seeing right now are largely structural issues. That could be because of specific sectors, the finance sector for example, and the oil and gas sector, which have seen substantial weakening in productivity for various reasons. It could be because of forbearance. It could be for a lot of reasons. If you look at most of the research on this, you could probably attribute it to about 15 different factors. I suspect that each one of those is contributing a small portion to that explanation of why productivity has been so weak.

Q279 Mr Baker: Writing recently, Sir Charles Bean said that it was time to rethink the way we measure economic activity because of the way technology has changed. There are some charts here showing millions of units of music sales surging, but the revenue from music sales collapsing. Do you think that there is a case for changing the way we measure economic activity? One of the things you have just said is that this productivity problem may not exist at all, so are you arguing, with Charles Bean, that it is time to change the way we measure economic activity?

George Buckley: When I said it does not exist at all, I was saying that one of the factors that may limit or explain the productivity puzzle could be that we will eventually have revisions upwards to GDP.

Mr Baker: But you are happy with the way we measure things today.

George Buckley: It is very difficult to measure GDP, especially these days, because we are a much greater service sector economy than we used to be. Back in the 1970s, about one third of all output was manufacturing, which was much easier to measure. It is even difficult to actually decide what manufacturing is and what services are, these days. For example, should an accountancy arm of a manufacturing company be classified as a service sector part of the company or manufacturing? It is very difficult to even measure what services and manufacturing are. Given that we are now a much greater producer of services than we were in the 1970s, for example, it is by its very virtue, for all economies, a lot more difficult to measure output than it used to be.

Q280 Mr Baker: Andrew Sentance, you wrote a fascinating article in June 2015. You said, "The second myth that the Chancellor needs to be wary of is the notion that poor productivity performance is a widespread business problem." You said that it was declining in a small number of sectors—the public sector, agriculture, energy and water and financial services—but you said that it was better in manufacturing, construction, retail and distribution, professional and business services, etc. Could you give us a bit more insight into why you think productivity is more of a problem in some sectors than in others?

Andrew Sentance: Yes. In some parts of the services sector, it may be a measurement problem. It may be to do with the characteristics of those services that productivity growth looks very low. Parts of the services sector that are in the public sector—health and education—are examples of that. That is one of the reasons why the public sector has been affected.

The financial sector has been affected because of the financial crisis, the shock that that has created and the extra burden of regulation that has come along with that, which may have changed the ratio between inputs and outputs in the industry. They are having to put in more inputs to get the same amount of output, because of regulation.

In the energy sectors, it is a combination of factors, some of which are to do with energy policy. Some of the energy sources that we are now prioritising—renewables—do not show up as being as productive in conventional productivity terms, but there are perhaps good policy reasons why we need to move in that direction. There is also what has been happening in the North Sea sector, which is an important part of the energy production of the UK.

There is a bit of a cocktail of factors in the special categories box, but I would agree with George that there are some underlying forces at work here. I think that the OBR is still being too optimistic about underlying productivity growth. If I had to come up with a figure for the UK, it would be somewhere between 1% and 1.5%. Actually, they are being too pessimistic about employment growth, so it does not necessarily take you very far away from their trend growth estimate, but I would expect the mix between productivity and employment to be slightly more employment-rich and less productivity-rich than their forecast.

Q281 Mr Baker: You are saying that, as a matter of policy, we have chosen to produce energy in a less productive way.

Andrew Sentance: That is the way it shows up in the conventional productivity figures. Now, people who are in support of shifting our energy mix to renewables, and I would probably put myself in that camp, are saying that there are good broader economic reasons for making that shift, to do with the transition to a low-carbon society, etc. You might say that those are not being captured in traditional GDP accounting and that has been a longstanding debate about environmental factors not being properly or well captured in GDP accounting.

Q282 Mr Baker: Given the relationship between productivity and earnings growth, do you think these sectoral differences in productivity improvement might be related to a rebalancing in the economy, which is quite healthy and desirable, away from the public sector and financial services, into those sectors which you have listed?

Andrew Sentance: I wrote another article a bit before this one, which argued that the rebalancing of the economy was taking place within the services sector, exactly as you are describing. It may be associated with these productivity trends. Some parts of the services sector that trade quite actively, like business and professional services, have actually been growing quite strongly and employment has been growing quite strongly there. Yes, I would agree with the proposition that there has been a rebalancing within the services sector. That has some of the features—not all of the features, but some of the features—that the Government were looking for in terms of helping our services export performance, which was done reasonably well over the last few years.

Q283 Mr Baker: Mr Buckley, are the Government missing out on any magic wands that could deliver an immediate improvement to productivity growth?

George Buckley: If you look at successive budgets over the last 20 years, I would suspect that very few of them have not contained some idea of trying to improve productivity. It has been something that everyone has tried to do, certainly in all the time that I have been in my current position. It is something that is very difficult to achieve.

Q284 Mr Baker: Was there anything in this budget that caught your attention as something that would be particularly helpful?

George Buckley: There was not necessarily anything over and above what I have seen over the last 20 years. For example, the reduction in corporation tax might be helpful. There were a number of other things that may be helpful in supporting productivity. As an entire package, I am sure that the intention, as we saw back in July last year as well, is to improve productivity.

Q285 Mr Baker: Finally, could I ask you both about the Government's productivity plan, which states that Britain should become the richest of all major economies by the 2030s, which of course is an aspiration I support. Given how far behind the USA we are, how realistic or useful do you think this target is?

Andrew Sentance: I am not so sure it is the target that I would want to focus on. When I have looked at this plan before, there are too many elements of it and perhaps not prioritisation of the sorts of things that the Government can meaningfully do in a short-to-medium-term time horizon. There are 15 or so elements in this productivity plan, but there are probably four or five that are really going to make a difference. Investment in infrastructure is obviously an important component, but I would be prioritising some other things more as incremental improvements we could make in infrastructure, not just the big prestige projects like HS2, for example. Skills and education are clearly very important, and they are always part of the productivity mix. Making sure our economy is open to international trade and that we take advantage of the globalisation of the world economy are other aspects.

The other element that I would say has been a disappointment over the last 20 years or so has been medium-term tax reform. We have had reforms of parts of the tax system, but there are lots of other parts of the tax system that have not been reformed. The tax system has become very complex.

Q286 Mr Baker: If I may say so, you are giving us some very useful and very interesting information, but you are not really answering the fundamental question. Do you think that it is a useful or realistic target to aim to be the richest of all major economies by the 2030s?

Andrew Sentance: I am not so sure that it is the right target. We should be aiming to be among the richest, but there is a whole host of other factors that determine, on any particular measure, whether your GDP per head is above or below some other countries'.

Q287 Mr Baker: That is of course difficult to measure, but thank you. Mr Buckley, is there anything that you wanted to add on the particular point of this target?

George Buckley: One thing I would say is that, if you look at overall business investment over the period when we were growing relatively quickly in the first half of the 2000s, total business investment was pretty stagnant, during that period, in real terms. Since 2010, the average rate of growth of real business investment has been almost 5%, which is double what it was in the decade before the crisis. There is a common misperception that we have not seen strong business investment yet. We have seen quite a recovery, and yet that still has not delivered the sort of productivity growth that we would be expecting. It is more than just investment; it is investment in the right places and the right sectors that is important.

Q288 Mr Baker: I cannot help myself, given you have said that. Do you think that there might be a problem of capital allocation arising out of the way that we have handled monetary policy?

George Buckley: I think there might have been a problem with capital allocation in the run-up to the credit crisis, which could account for the weakness in productivity right now. I am not so sure about monetary policy. I suspect that Andrew would probably argue that interest rates should potentially be higher than where they are right now. I am not sure how much of a capital misallocation that might or might not have caused.

Mr Baker: I had better stop; the Chairman is giving me that look.

Chair: It is only that we have another session after this one, and a number of colleagues want to come in.

Q289 Rachel Reeves: Thank you very much, Mr Buckley and Mr Sentance, for coming to the Committee this morning. In the latest forecast by the OBR, it expects household debt to increase by almost a third by 2020, compared to the previous forecast, jumping from £49.5 billion to £65.5 billion. Should we be worried about household debt, in your opinion, either or both of you?

Andrew Sentance: George has written something about this recently, so I will let him go first.

George Buckley: One thing I talked about in the piece I wrote recently on this subject was the difference between debt levels relative to income and debt levels relative to earnings, the argument being that there are a lot of things that are in incomes that are not in simply earned income. Earned income is probably the most important denominator. When you go and buy a house, you go to your bank with your wage slip rather than anything else, rather than your dividend payments or your unemployment benefits. It is earnings that are most important. When you look at how much debt to income has fallen, as opposed to debt to earnings, debt to earnings has fallen much less than debt to income, so that is one thing that I would worry about.

The other concern I would have is that, when interest rate increases do inevitably come, at whatever point that may be, households will be quite vulnerable. A rise in interest rates of 100 basis points could have a more meaningful impact on the repayment-to-income ratio of the household sector than it might have done in the past. There is a lot greater sensitivity to changes in interest rates now than there used to be, because of higher debt levels.

Q290 Rachel Reeves: Within the debt that is being built up by the household sector, is there any particular type of debt that you are more worried about?

George Buckley: There has been a much swifter increase in consumer credit over recent months, but what has really driven the rise in total debt over the past 10 years, let us say, has not really been consumer debt; it has been mortgage debt. That is largely because of what has happened to house prices and the housing market. You need to take on substantially larger mortgage debts now than you did before, in order to buy a house, simply because of how high prices are.

Q291 Rachel Reeves: That of course leaves people more exposed if anything were to happen to the housing market, if they have taken on more debt to buy the house.

George Buckley: Yes, and of course debt levels have increased and asset prices have increased, but the problem with asset prices increasing is that those are illiquid assets, rather than liquid assets. It is not something that you can liquidate very quickly. As we know from the past, there are times when housing market valuations do not remain at such high levels. They do fall, and of course that could happen.

Andrew Sentance: I would just add to what George is saying there by emphasising that, if we look at what has happened over the recovery so far, George has some tweaks that he would like us to look at, but the conventional ratio for household debt has come down from borrowing at about 170% of household income to about 140%.

Rachel Reeves: It is forecast to go up to about 163%.

Andrew Sentance: That is right. It is levelling off and is now possibly beginning to increase. This is less an issue for fiscal policy in the budget and more an issue for monetary policy. We are in danger of getting ourselves caught in a trap of low interest rates, where the signals that are being sent to households are not necessarily the right long-term signals. There is a danger that households gear up, from what has actually been a very prolonged period of very low interest rates. Therefore, borrowing increases and it becomes more difficult. You get yourself into a bit of a trap: because borrowing has gone up, it is then more difficult for the Bank of England to raise interest rates, because of the consequences that that will have. To my mind, this is why the Bank of England should have already been trying more actively to make those first moves in interest rates to send a signal to the household sector that, over the longer term, we will have a better balance in interest rate policy between the needs of savers and of borrowers.

Q292 Rachel Reeves: Does it not create problems for the Chancellor, as well as the Bank of England, in that the forecasts for growth are dependent on consumption continuing to contribute towards those economic growth rates? If that does not materialise because households decide to pull back or are forced to pull back, by interest rate increases for example, it could mean that the outlook is more positive than it perhaps might turn out to be.

Andrew Sentance: Until now, on average over the recovery, consumption has not been over-strong in terms of its contribution to growth. Actually, investment in exports has contributed perhaps more than it had in previous recoveries. The concern about what has happened in the past should be less, and we should be more concerned about what could happen in the future. There is a risk that the very low level of interest rates that we have had over a prolonged period of time has unintended consequences, in terms of encouraging an unbalanced recovery in the future. That is something that monetary policymakers should be concerned about.

George Buckley: I completely agree. The contribution that consumption has made to economic growth has not been that much different over the last four years, relative to the size of consumer spending within GDP. One thing that I have been concerned about, in terms of the rate of economic growth, is looking from an expenditure point of view. None of the components of expenditure is without concern. First of all, consumer spending is growing quite strongly. You can easily see, especially with the saving ratio at the lowest it has been since at least the 1960s, it would be very difficult, if interest rates rise, for consumers to continue to lower their saving ratio to support consumer spending.

On the investment side, you have the issue of weaker oil and gas capital expenditure and also the fact that the EU referendum might have an impact on investment spending in the near term. You have government spending, which I very much doubt is going to be particularly strong over the next five years, given austerity, and then you have net exports, which is the only thing left within the expenditure detail of the GDP statistics. Exports will be negatively impacted by world growth, which last year was the weakest since the crisis, and also the fact that, even though sterling has fallen, it is still a lot higher than it was. It is about 10% higher on a trade-weighted basis than it was back in 2013. That could impact our competitiveness.

Q293 Rachel Reeves: Going back to the issue of the household sector, the OBR says that the persistence of a household deficit of this size, 3% of GDP between 2016 and 2021, would be unprecedented. I do worry about the ability of consumption to continue providing a stimulus to growth, but also the fiscal consolidation that you spoke about earlier, Mr Buckley, depends arithmetically on what happens in the current account and the household sector. To what extent is that fiscal consolidation dependent on those moves in the balance of the household sector and the current capital account? If the persistence of that household deficit does not continue, because it is not sustainable or whatever, does that affect the Government's fiscal consolidation plans?

George Buckley: It might do to the extent that, if you see a weakening in economic growth that is driven by the consumer, that may push growth below 1%, which would then suspend the fiscal rules and allow the Government to spend a bit more, whether that is because they explicitly want to spend more or whether they want to allow the fiscal stabilisers to take effect. It would make sense if economic growth weakened sharply enough to continue with the same government austerity plan, but of course that is not something that is forecast at the moment. We are forecasting that growth will continue at reasonable rates but, I suspect, because the consumer is such an important component part of GDP, it could have quite a meaningful impact on economic growth if consumer spending slows.

Q294 Rachel Reeves: To turn around the fiscal position from a deficit of 4% of GDP to a surplus of 0.5% depends on the current account deficit reducing from 5% to 3.5% of GDP and the household balance staying at minus 3% of GDP. I guess what I am asking is whether those forecasts for the current account and the household balance are realistic. If they are not realistic, does that mean that the fiscal consolidation plans are not realistic?

George Buckley: Within the forecast that the Office for Budget Responsibility has put together, they are still looking for net trade to be a negative contributor to GDP, over that period of time.

Q295 Rachel Reeves: The current account deficit falling from 5.2% of GDP last year to 3.5% is quite an improvement of our current account position, even if it is still a deficit.

George Buckley: One of the main reasons why the current account has been so sizeable in terms of the deficit has been the incomes balance. One of the reasons that has been the case is that the incomes we have received in the UK from investments overseas have obviously been very low, because Europe has been doing very badly or at least not been growing as strongly as the UK. The UK growing very strongly means that we are expatriating quite a lot of positive returns on investments that overseas people own in the UK. That has caused the current account to become very sizeable. To the extent that we see weaker growth in the UK and stronger growth in Europe, that might well switch the other way round.

Andrew Sentance: The components of demand that we would like to see stronger would be exports, net trade and investment. It is very difficult to predict, when you look at a forecast, exactly how these balances are going to move. The benign scenario, as the Government reduces the deficit, is that we have stronger investment and the trade balance improves a bit. The less benign scenario is that the household sector deteriorates, so that is something that needs to be monitored.

Q296 Mr Rees-Mogg: Good morning. Let us move on to taxation and perhaps Mr Buckley to start with. The forecast of tax as a percentage of GDP is that it will go up to 37.5% from the current 35.7%, which is very near the highest historic level that the country achieves. Do you think this is realistic?

George Buckley: I have had a look at the total tax and non-tax receipts, according to the OECD's latest estimates, across different countries to see whether they seem reasonable in the middle and at the end of the spectrum. If you look at the G7, it is fairly in the middle, I would say. The OECD estimates that tax and non-tax receipts are worth just under 40% of GDP, compared to the top end, which is France at about 53% and, at the bottom end, Japan and the US, which are about 33% to 34%. I do not see that as being unreasonable.

Q297 Mr Rees-Mogg: On the other side, does it effectively set a maximum level of spending? This is going back to your earlier answer on the fiscal rules that are being introduced. On the OECD figures, rather than the OBR figures, getting to the 40% level after the best part of 10 years of consolidation, if expenditure is much above that, you will always have a deficit. Is that broadly fair?

George Buckley: If you stick to the fiscal rules and you want to run a zero balance, that will obviously be restrictive. That does not mean to say that the Government will always beat the fiscal rules, as we have seen from this budget.

Q298 Mr Rees-Mogg: On your point on the G7 and being in the middle of the pack, do you think that is a sign of international competitiveness or are the ones at the top end of the pack, particularly thinking of France, structurally uncompetitive? To be a competitive nation, do you need to be heading down towards the US level?

George Buckley: There is more to it than simply the level of taxation. There is an international tax competitiveness index. The UK scores 11th out of 34 countries on that index, which is down from 13th last year. The reason for that is a reduction in corporation tax. When you look at total tax competitiveness, it is important to look at not just the total level of tax, but how easy it is, how simplified the tax system is and which taxes are being moved, for example, rather than just the total level.

Mr Rees-Mogg: That is very helpful, because it leads on to corporation tax, which is the next thing I wanted to ask about. I do not know, Mr Sentance, if there is anything you would like to add before I do.

Andrew Sentance: The move in the tax ratio or the ratio of receipts to GDP is not massive over the five-year time period we are looking at. It is probably slightly higher than we have seen, but not out of the range. I would be more confident if the Government had a broader reform agenda, making sure that the tax system was in good shape in the medium term. While they have focused on corporation tax reform, and we will probably talk about it, some other areas of tax have not really been reformed in the same way.

Q299 Mr Rees-Mogg: Absolutely, corporation tax is the next area. Mr Buckley, do you think the reduction from 28% to 20% has had an important effect on attracting businesses to the UK?

George Buckley: It is very difficult to work out what would have happened had we not reduced the tax rate. I am sure that it has been helpful at the margin, in terms of encouraging business investment. As I mentioned, business investment has risen quite well over the past few years. It has come from a low base, admittedly, but we have seen 5% increases in business investment. Whether we would have seen substantially different rates of growth of business investment had we not seen a reduction in the corporation tax is unknown, of course, but I am sure it has helped at the margin.

Q300 Mr Rees-Mogg: Which nations do you think we should view ourselves as being competitors with, in terms of corporation tax level? Should it be the US or should it be Luxembourg and Ireland?

George Buckley: That is probably a question for the Chancellor to answer.

Mr Rees-Mogg: You are here and he is not.

George Buckley: Yes, that is true. It is good to reduce the corporation tax, because business investment will eventually be helpful, to go back to an earlier discussion, in bringing back productivity. It could be helpful in supporting productivity, to the extent that one of the reasons productivity has potentially been weak is that we have had a prolonged period, in the run-up to the crisis, of relatively weak investment, but sizable expansions in the labour force. It could be that we simply have employment that is not associated with a sufficiently large increase in capital at the same time. It could be helpful in that sense.

Q301 Mr Rees-Mogg: Mr Sentance, if I can go back to what you were saying on needing a more broad-based tax reform, that is a very important and interesting question, because there are a lot of commitments not to do things: not to change income tax and not to change national insurance. Then other things have happened like apprenticeship tax and sugar tax. Do you feel that we are in fact going in the wrong direction? Rather than having intelligent tax reform, we are having little add-ons and growths that are making the system less coherent.

Andrew Sentance: If you look back over the last 20 years, not just under this Government or the previous coalition Government, there has been a tendency to complicate the tax system, rather than streamline and simplify it. There are occasionally simplifying measures but, in my view, tax reform has to be done on a much more holistic basis. It is not something that a Chancellor can attempt in one budget and pull a rabbit out of a hat. He or she needs a much longer-term strategy.

Looking at the interactions between taxes, if you take income tax and national insurance as being a good example, we have raised the income tax threshold, but the national insurance threshold is still affecting people, both indirectly from what their employers pay and directly, at a much lower level of income. You then have to say that, if we are going to relieve taxes in some areas, maybe we will need to try to reduce some exemptions in others, so it needs to be a much more holistic process. Looking back over the last 20 years or so, the observation I would make is that the tax system has become more complex. You can see that in terms of the number of regulations and the number of allowances and exemptions that exist.

Q302 Mr Rees-Mogg: What do you think are the economic disadvantages of that?

Andrew Sentance: They are more at a microeconomic level, rather than a macroeconomic level. The corporation tax reform has sent a signal to business that this is going to be an attractive place to do business, from a corporation tax point of view, but the surveys we do at PwC that look at the overall tax burden suggest that, while that part of the business tax burden has been coming down, other taxes are becoming more important, like national insurance, business rates and so on. It is very hard to quantify exactly how much of an impact a slightly over-complex tax system has on growth, but it must have some negative consequences, I would have thought.

Q303 Mr Rees-Mogg: One of the consequences does indeed seem to be further complication, because corporation tax comes down and, therefore, more anti-avoidance measures come in to try to prevent individuals making their earnings corporate earnings. Therefore, you increase by an extra level of complexity, rather than reducing. Do you broadly agree with that?

Andrew Sentance: Yes. Obviously it is important that you have anti-avoidance measures to ensure that companies are paying the right amount of tax, but it is also important to make sure that the bulk of business, which aims to pay its tax, is not being penalised because of a small number of examples of where things are going wrong. Some of these measures catch everybody, but they are perhaps targeting quite a small issue in the economy.

Q304 Mr Rees-Mogg: Is there an economic price for the political promises not to change certain tax levels throughout a whole Parliament?

Andrew Sentance: It does hem the Chancellor in and it means that a broader tax reform, which aims to look at the overall picture and adjust the whole structure of rates and allowances, is much more constrained. Now, maybe we can move into a situation in the next period of government when, with public finances in better shape, hopefully we can then move into thinking about more of the microeconomic aspects of the tax system, but it seems to me that this is an issue that has been neglected over the last 20 years or so.

Q305 Mark Garnier: Mr Buckley, maybe I can bring you off the reserve bench. Can I carry on with taxation but, in particular, income tax and national insurance rates? My first one surrounds the concept of the Laffer curve. We have seen the Government claim that dropping the top rate of tax from 50p to 45p has generated an extra £8 billion worth of revenue. Do you think that a significant reduction to the tax rate between now and 2019-20 is going to have a similar effect on the overall tax take? Do you think the Laffer curve works, in short?

George Buckley: There seem to have been a lot of studies done and there is no convincing answer either way to say that this is going to be a policy that will either make people work harder and bring in more revenue or make people work less hard. I am not convinced that it is so easy to work out the precise elasticities of income tax changes as well as we would like to.

Q306 Mark Garnier: Following on from Rachel Reeves's question a bit earlier about the effect of households and consumption, surely there is an argument that, if people have more disposable income in their pockets, it is going to help the consumption argument.

George Buckley: It would, but I guess you have to think about where that money would not otherwise be spent. It will potentially help consumption, especially when people's savings ratios are so low. Interest rate increases in the future may well limit how much disposable income people have, so it could be helpful in that sense.

Q307 Mark Garnier: To pick up on that point, you said where the money would be spent otherwise. Presumably, if they get more money in their pay packet as opposed to tax, that question revolves around the key point of whether individuals spend their money more effectively or whether Governments spend money more effectively, in terms of economic activity. Do you have a settled view on that?

George Buckley: It could be the case that people spend their money on things that are not associated with as strong a multiplier as investment spending by the Government, for example. There is a decision to be made between those two competing objectives.

Q308 Mark Garnier: Just on behavioural change, obviously we are taking a lot of lower-income households out of tax altogether. Within your answer, I would be interested in your views on whether we should be harmonising national insurance starting points or not. What behavioural changes do you think this makes within the economy itself? Do you think that, at the end of the day, if your household income is so low that you are benefiting from this, your ability to change the economy is very limited?

George Buckley: Lower-income households potentially have a larger propensity to consume any extra pound of income they receive than the higher-income households. If you give a higher-income household an extra pound, they may well save it. If you give a lower-income household an extra pound, they are more likely to consume it. In that sense, it would be supportive of consumer spending if you reduced taxation at the lower end of the income scale, rather than the upper end of the income scale.

Q309 Mark Garnier: You have much more effect on the economy helping people out of tax altogether at the bottom end than you would do by reducing the top rate of tax from 50p to 45p.

George Buckley: Yes, on consumer spending. That is not to say that it is necessarily a good thing to support consumer spending. It may be the case that your objective is to increase the saving ratio, in which case that would not be the most appropriate policy. There are a lot of different competing objectives, which you could analyse in terms of whether you want higher spending or whether you want higher saving. At the moment, we have a very low saving ratio.

Mark Garnier: I suspect we probably need more spending in order to get the economy going, although I suppose the social thing would be to have more resilient households, which I have been arguing for a long time. You are trying to move me on, aren't you?

Chair: Only to bring you to the question.

Q310 Mark Garnier: Thank you, Chairman. My third next question will now be my final question, to keep the Chairman happy. What impact will these reductions in income tax have on the UK trade balance? How are households going to be using this money, if they do increase consumption? Are they not simply going to be buying more foreign television sets and cars with this money? Is it going to make a difference to our trade balance?

George Buckley: Typically, when you see stronger consumer spending, you also see stronger imports, so it may well suck more imports in. They of course appear in the national accounts in the expenditure detail, with a negative sign on them. The more imports you have, the weaker economic growth is, but of course you have to balance that against the fact that consumer spending is stronger, which is a much larger portion of the economy than imports.

Q311 Mark Garnier: Is all this inflationary?

George Buckley: Inflation is exceptionally low. We will have some numbers this morning, of course.

Mark Garnier: If it is, it just brings it within the realms of the target.

George Buckley: The bigger concern may be that, if we see a weakening in the economy, it may make inflation persist at these low levels for longer. I think inflation will rise over the course of the next couple of years, whether that is because of base effects or because of an output gap that is turning positive. If you look at most estimates of the output gap for 2016, the difference between actual GDP and potential GDP, they are more positive, but only just positive. The OECD, IMF and OBR are all seeing the output gap starting to turn positive.

Q312 Chair: You do not believe in the measures of the output gap, do you, Mr Buckley?

George Buckley: I believe in the concept of the output gap.

Chair: We all believe in lots of concepts. I am asking you whether you believe the numbers.

George Buckley: Given that there is such a range in the different measures of the output gap from different forecasting institutions, it is very difficult to place a precise number on it.

Chair: Is that a yes or a no, sorry?

George Buckley: I fully believe in the fact that there is an output gap. It is very difficult to measure, and the output gap has an impact on inflation.

Chair: It is rather like Heisenberg's uncertainty principle. You know it is there somewhere, and it could be everywhere, all the time, but you are not quite sure what number to attach to it.

Q313 George Kerevan: Once you try to measure it, it disappears. Good morning. I am interested in the relationship between business tax and incentives. Since 2010, the Chancellor has clearly signalled has desire to cut corporation tax and, indeed, this budget has cut it in principle to 17%, which is quite a dramatic cut. Is there any quantitative evidence that links corporation tax cuts with business incentives? In Germany, corporation tax is over 30%. In America, corporation tax is nearly 40%. That seems to be a different signal from the one that the Chancellor has suggested.

Andrew Sentance: When businesses are looking at locations for investment, a whole range of factors come into it. You cannot say that the tax regime would have no impact; it must have an impact. From the UK's point of view, the thing is to be seen to be attractive and competitive, in terms of our tax system. That is not just a product of the headline rate because, in countries where taxes are higher, sometimes you find that there are many more allowances against taxation, so looking at the rate is only one part of the equation.

We have moved to a world where business activity is moving around more internationally. We are in a more globalised world economy and, in that environment, I cannot quote any studies, but the perception is that companies are looking at the broad business environment and trying to choose the best location that they can find for their investment. That is not purely to do with tax; that is a whole package of measures that includes the skills they have access to and the transport infrastructure. It is the UK's competitiveness across all those dimensions that is going to be important.

Q314 George Kerevan: I appreciate that. Mr Buckley, the Chancellor has made a point about cutting a particular tax. It leads to a loss of revenue. Is there quantitative evidence to say that it will produce the result that he has suggested it will, in that it acts as a business incentive?

George Buckley: Lower corporation tax at the margin will encourage investment. It will encourage business in the UK to set up. It will potentially encourage infrastructure spending but, as Andrew said, there are a lot of other things that may not do that. I am sure that there are a lot of studies that have looked at this and come to completely opposite conclusions, but I suspect that, on balance, a lowering of the corporation tax would encourage business.

Q315 George Kerevan: Is there a lower bound to where we would set the corporation tax to achieve these results? Does that exist?

George Buckley: I imagine that a lot of research has been done to judge what the optimal rate of corporation tax might be, but you have to set it with an understanding of what other tax rates are and, as Andrew says, how many loopholes are available for corporations. The overall burden of taxation is more important than one particular rate, although it is clearly a big flag internationally that we have such a low corporation tax rate that it might encourage investment in the UK.

Q316 George Kerevan: Would it encourage investment in areas that, in your view, are strategic to increasing productivity?

George Buckley: It might do but, as we have seen in the past, there have been misallocations of capital that might have caused investment in areas that do not generate increases in productivity. To repeat what I said before, the limited rise in investment during the first half of the 2000s did not restrict very sizable increases in economic output.

Q317 George Kerevan: This specific budget, while corporation tax is being cut to a 17% headline figure, has a broadening of the base of corporation tax. There are restrictions on loss relief. There is a limit to debt/interest relief. From the way both of you have presented it that you have to look at the overall package, do the changes to reliefs offset and counteract the cut in the headline rate?

Andrew Sentance: We will find out over a period of time. When you look at the tax system as it affects business, it is not just about corporation tax. It is about other taxes like national insurance, uniform business rate and so on. It is not even just looking at those allowances and the corporation tax rate; it is looking at the overall picture and how competitive the UK looks, in the round.

Q318 George Kerevan: I appreciate that but, because we are dealing with this budget, I am trying to tease out from you what you think is the impact, given the overall package, on business incentives. For instance, one could argue that the reductions in profit relief, compared to international competitors, actually reduce business incentives in the UK. Would that be fair?

Andrew Sentance: It depends on the type of business that you are, effectively. These different tax allowances and tax reliefs affect different types of businesses generally. We have also had a strand of our tax reform that has been trying to encourage businesses that are quite innovative and involved in research and development to invest more in the UK.

Q319 George Kerevan: As a result of this budget, they will now get lower relief on losses. New high-tech start-ups conventionally make big losses in the first few years. That is very typical in America: they run losses. They can offset that in the far future. This budget reduces the losses that they can offset. Internationally, does that not make the UK, as a destination for new high-tech investment, less competitive than the United States, say?

Andrew Sentance: What you are describing is a budget where there are swings and roundabouts, in terms of business taxation. We will find out. As the economy progresses over the next five years, we will observe how those swings and roundabouts take place. The big shift that we have seen in the corporation tax rate is getting down to a rate of around 20%, when it used to be over 30% going back. That has clearly made the UK more attractive as a business location. These further moves are shifting the dials a little bit but, as you point out, they are offset by other moves. We will find out, over a period of time, what the overall response of business is.

Q320 George Kerevan: As a final question, is there not the danger that other countries will simply follow us down the line of cutting their headline rate of corporation tax?

Andrew Sentance: There has generally been a downward move across the major economies in corporation tax rates, but there is a countervailing influence that Governments need to raise money to finance public services. They need to raise money from a range of different tax bases. The farther down you move corporation tax rates, the risk is that you generate less money from corporation tax and then have to raise more money elsewhere to finance your public services. Where are you going to raise that? I do not think that this is just a straightforward one-way bet for Governments. One of the strengths of a well functioning tax system is that the Government are raising revenue from a range of different bases and are therefore not having to put very high tax rates on one specific tax base, in order to raise the revenue that they need. A healthy tax system will always maintain that degree of balance.

George Kerevan: As you say, we will see.

Q321 Wes Streeting: I am going to pick up the topical issue of tax avoidance and, in particular, the measures contained in the budget. I am interested in your view as to whether you think the anti-avoidance measures brought in through this budget would have made any difference to what has come out through the Panama leaks.

George Buckley: I have the page open in front of me and I see that the OBR's assessment of a lot of these measures, which are announced in terms of the impact that they will have, is either high or very high in its uncertainty. It is not known. What I am saying is that we should take these numbers with a pinch of salt. We are talking about many years down the line as well, so it is very uncertain how much this will actually raise, in terms of the evasion measures that have been announced. That does not go for just this budget; it goes for all announcements on avoidance and evasion.

Q322 Wes Streeting: I want to probe the numbers further but, Mr Sentance, is that your view as well?

Andrew Sentance: There is always a lot of uncertainty in these more technical measures, as George is saying from the OBR figures, about exactly what impact they will have. The more technical the measures become, the more uncertainty there is in HMRC about exactly how much revenue they will raise. Yes, I agree with that.

Q323 Wes Streeting: Mr Buckley, you talked about the scorecard yield of some of these measures and questioned whether those numbers would be delivered. I was particularly interested in the scorecard yield for the disguised remuneration scheme. There is quite a significant jump. In 2019-20, for example, the scorecard says it would yield £1.2 billion, which is a significant hike on the first three years. It starts off with £100 million then goes to £335 million and £645 million; then there is this leap. There is little explanation in the red book on what is behind that revenue and the profile in particular. Is there any explanation that either of you could offer as to why the yield would be profiled in that way?

George Buckley: I can honestly say that, being a macroeconomist, I have not looked at these numbers line by line. I have simply taken the numbers that the OBR has calculated at face value. It has a lot more resources available to it to do these calculations. The fact that it notes that the uncertainty behind those projections is very high probably tells you that that exact profile may or may not come about.

Andrew Sentance: There is a lot of uncertainty about the impact of these measures. The OBR has tried to reflect that in the way that it builds them into its calculations, so we need to be careful about putting too much weight on some of these extra sources of revenue. The OBR, with the resources that it has, has probably made a sensible judgment based on the information that we have. I have no reason to doubt its judgment.

Q324 Wes Streeting: Do either of you have a sense of how many businesses are likely to be affected by the offshore property developers measure? That is expected to raise around £0.5 billion a year when it kicks in properly. Do you have a sense of what that would mean in practical terms? I am probing for some more detail.

Andrew Sentance: There are probably some people within PwC, who are technical tax experts, who are much better placed to answer that question. I do not have a figure.

Q325 Wes Streeting: Finally, I would be interested in your personal view. The Panama leaks have now thrown open a whole debate about tax policy, and the fairness of the tax system and behaviours, particularly in terms of aggressive tax avoidance. How legitimate do you think this degree of public concern is and how big a problem do you think we have to tackle, in terms of aggressive tax avoidance?

Andrew Sentance: There has already been a lot of emphasis, both within the UK and also within international organisations and the OECD, to try to make sure that the tax system is working as well as it can, efficiently and fairly. My perception is that, when people talk about things that are going badly wrong, they relate to a very small proportion of what is really happening in the economy. The majority of businesses that PwC deals with are trying to organise their tax affairs on a sensible and rational basis. That has been the direction in which we have been moving for a number of years. Some companies are very transparent about the amount of taxes that they pay, and I think that is a good thing.

Q326 Chair: Thank you very much. Is there anything else that you have come here with a burning desire to say, but have not had the opportunity?

Andrew Sentance: No, we have covered a lot of ground, so that is fine.

Chair: Thank you very much. If something occurs to you, do put it on paper. We are very grateful to you for giving evidence to us this morning. Thank you particularly, Mr Buckley, as it is your first time up before the Committee.

Examination of Witnesses

Witnesses: **Paul Johnson**, Director, **Helen Miller**, Associate Director, and **Rob Joyce**, Associate Director, Institute for Fiscal Studies, gave evidence.

Q327 Chair: Thank you very much for coming to give evidence to us. It is still this morning. We are running slightly behind schedule, but it often happens when we have a double-header evidence session. Can I begin by asking you, Mr Johnson, about fiscal rules and the fiscal framework in which policy is currently being conducted, much the same as I asked in the first session? Do you think that the current fiscal rules we have add much to the credibility of fiscal and financial policy and, if you come to the conclusion that they have their shortcomings, what, if you were Chancellor, would you be designing?

Paul Johnson: The current main fiscal rule, which is that you want to get to surplus by 2019-20, has one great advantage, which is that it is extremely straightforward. We can all see what it means and whether we are on course to get there. The downside is that it is fixed at a particular year. That requires, for example, as we have already seen, things changing every time we have a fiscal event. If you really are fixed on that, you need to change policy each time the forecasts change, or at least that is the way the Chancellor has been behaving thus far.

Q328 Chair: I just want to home in on that. I am sorry to interrupt your flow and I hope I have not lost a major thought you wanted to make, but I am sure you will get it in. When you said that that is the way he is behaving thus far, it seems to me, but I am asking you, that one does not necessarily flow from the other at all. You can have a medium-term target, four, five, six or eight years out, which does not require adjustments, twice a year, to small changes in the forecast, or am I wrong?

Paul Johnson: You can certainly have a target some distance out that does not require that. You could allow yourself a degree of room for manoeuvre in that you say, as long as we are not off course by a certain amount over a certain amount of years, we will not adjust, because we know that the forecast will change again next time. Of course, you take the risk that the adjustment, when it comes, has to be really quite big.

One of the things that I thought was quite good about the set of rules that the Government were following in the last Parliament was that it was always forward-looking. Effectively what the Government did over that Parliament was to set out a tax and spending regime in the first year and effectively keep to it, which meant that it did not achieve as much of a reduction in the deficit as it had hoped to by 2015, but the tax and spending policy was pretty constant. The idea was then to move forward through this Parliament. That had quite a lot to commend it.

The thing that was problematic about it was that, if the economy continued to get worse relative to expectations, then you continued to push out the point at which you get to balance, which was the ultimate objective. The point about these fiscal rules is that you inevitably need to trade off the degree of flexibility that we had with the rule in the last Parliament, with the degree of inflexibility that sticking at a particular moment in time going forward creates. It would be nice to have a rule that is somewhat more flexible and forward-looking than the current one that we have, at least in the way that it creates behaviour, not least because you can see in the scorecard here that it has created behaviour in a way that has focused attention very specifically on that very particular year.

Of course, there is nothing magic about 2019-20 as a year for reaching balance. 2020-21 will be almost identical economically, and yet all of the action is in 2019-20, in terms of where we see the spending cuts and the tax rises.

Q329 Chair: Overall, do you think that making adjustments twice a year, sometimes quite small adjustments, adds, subtracts or has no bearing on the overall credibility of fiscal and financial policy?

Paul Johnson: I really do not think it helps in terms of credibility.

Chair: By that you are saying, in a typically English fashion, it hinders.

Paul Johnson: I think it does hinder, yes. The fact is that we may or may not get to balance in 2019-20 but, over a decade, an extraordinary amount of progress will have been made towards balance. Whether we are £10 billion in deficit or £10 billion in surplus is almost economically neither here nor there.

Chair: That is what adds to credibility, but that is in a medium-term framework.

Paul Johnson: That is precisely right. Moving things up and down every six months to hit a very particular number four or five years out is actually a problem for stability, rather than an advantage.

Q330 George Kerevan: Following on from that, given that the rule is very simple and it has earmarked a particular date, is the way that the Chancellor has organised finances in this budget in order to hit the target problematic or more problematic than normal, from your perspective?

Paul Johnson: What happened is that the economic forecast became less good, and hence the structural state of the public finances became less good. All of the things that are ensuring that we still have the same forecast surplus in 2019-20 are not, between them, a structural fiscal tightening. They are largely moving spending out of that year into earlier years and moving taxes out of earlier years into that year. The only additional structural thing is an unspecified set of spending cuts in that year.

I suppose it actually depends on what you think would be helpful. If you think that the intention of the rule is to structurally tighten in the face of worse economic news, that has not happened. Equally, you might think it would be inappropriate to structurally tighten in the face of what may turn out just to be temporary worse economic news. In that case, what you have is a range of moving the numbers around, moving the deckchairs around, rather than anything terribly real in that year. What is real, or at least is real in the numbers, is another year of spending restraint the following year. That is a structural tightening, but it comes after the 2019-20 target, if it ever happens.

Q331 George Kerevan: We could keep the target for 2020. We could make structural changes and pin down that target. You are saying that the Chancellor, rather than make specific structural changes to revenue, spending and taxes, has chosen to make some accounting changes, where he has brought forward some of the corporation tax; he has moved further forward into the spending period infrastructure spending and cut it from the final year. From a sound fiscal perspective, is what he is doing the correct thing to do to reach his target?

Paul Johnson: As I say, he has three options and he has chosen the one that is the least real, in terms of actual change. He could have opted to say, "Let us allow ourselves some flexibility; we are going to lose that £10 billion surplus on the forecasts", and see how things happen. He has not decided to do that. He has not decided to do a structural fiscal tightening in response to the worse news. What he has decided to do is largely to move money around, plus the real potential thing is to promise some additional spending cuts. He has chosen to do the minimum change in real economic terms, by doing everything he can to move money around.

Q332 George Kerevan: As an economist, if the Chancellor's rule is actually to hit a surplus every year after 2020, except in really exceptional periods of economic shock, then logically he has to make structural changes to hit the surplus, rather than doing it for one year.

Paul Johnson: That is what he has said he is doing in 2020-21. I am not sure how much time I should spend focusing on the spending forecasts five years out, but the big longer-run structural change here is essentially another year of very significant spending restraint pencilled in for 2020-21. That is the big structural change that is pencilled into the long-run forecasts.

Q333 George Kerevan: Would there be another way of managing the rule by splitting current and capital spending, and having a rule that said to run a surplus or balance on the current spending, separating out capital spending funded by borrowing? What advantage or disadvantage would that have as an approach to this single rule?

Paul Johnson: That is certainly another possibility. At least the last two sets of fiscal rules have separated out capital and current spending, and treated them differently. Clearly, the advantage of doing that is, first, it gives you more flexibility in the short run. Secondly, if you think that spending on investment is something that it is sensible to borrow for, because it is giving you higher growth in the future, you might want to provide that additional flexibility. The obverse is that it means that overall national debt falls potentially quite a lot less quickly into the long run. On our calculations, even with constant growth, you do not get back to pre-recession levels of debt until the mid-2030s with the current rules, and you would not get there until the 2060s or something on a borrowing-to-invest rule. As ever with these things, you are trading off those things.

Q334 George Kerevan: As a final question, how do you assess the fiscal rule in the sense of what would happen to the economy, what the ups and downs for the economy are, if we successfully run a permanent budget surplus on the Chancellor's lines?

Paul Johnson: As you know, we are not the right people to ask about the macroeconomic effects, but clearly a long-run surplus is going to have a number of effects. Particularly if you keep tax at its current level as a fraction of national income, running a long-run surplus is going to make it increasingly difficult to fund public services, pensions and health. You may feel that you end up having to do that by raising tax, on the one side.

Clearly, in terms of the demand in the economy, if the government bit of the economy is continually saving and taking money out of the economy in that sense, you might think that that would have two effects. It may crowd in private sector spending and investment, rather than saving. It may reduce the amount of demand in the economy.

Q335 Mark Garnier: Good morning. Can I concentrate on the distributional analysis of the budget? I have a couple of run-up questions. In your analysis, you talk about the long-run impact of tax and benefit reforms. Can you give us an idea of what you mean by "long run" in terms of timing?

Paul Johnson: It would be fair to say that, if you look at the distributional impact of this budget, it is extremely small in terms of the tax and benefit changes. They were not very big at all, in terms of how they impact individuals, and they just get lost on any chart looking at the period from 2010 or something like that. In terms of looking at the long run, it essentially means taking account of everything in here that goes up to 2019-20.

Mark Garnier: It is a five-year forward view.

Rob Joyce: Specifically as well, some measures are being phased in gradually. For example, the two-child limits on tax credits are coming in gradually. We have those fully in place whereas, actually in 2019, they will only be partially in place. That is what we mean by long run and that is different from the Treasury.

Q336 Mark Garnier: It is really helpful to clarify that point. To my other point, I should know the answer to this, but have you done an analysis on everything that the Government have done since 2010, to look at a complete analysis? A budget is not necessarily an isolated event. It is part of a long-term programme. Have you looked at the long-term programme, in terms of distribution?

Paul Johnson: We have.

Rob Joyce: After this budget, we looked at the budget specifically and also at all measures coming in over this Parliament. We did not go all the way back to 2010 this time round. We have of course done lots of distributional analysis of measures that came in over the last Parliament.

Q337 Mark Garnier: It is very useful. Again, I am not trying to make a political point about it. Admittedly, it was a slightly differently shaped Government in the last Parliament, but nonetheless the person who is trying to drive forward these changes is the same individual. It would just be quite useful, if it is possible, to combine all that together from the starting point in 2010 all the way through to here, to get a bigger picture of the long-term programme, as opposed to individual things.

Paul Johnson: We have essentially done that, if not including this budget then including everything before it. As I said, this budget is very small in the overall picture.

Q338 Mark Garnier: I appreciate that. Another thing is that the Chancellor is very signed up to his programme to raise the starting point of income tax to £12,500 by the end of this Parliament, but that now seems to be helping the second decile, rather than the first decile. At this stage, would it not be a better idea, in order to try to get the distribution aimed at the bottom decile, rather than raising the starting point of the income tax rate, to increase the starting point of national insurance contributions, so to harmonise those two over a period? It would cost the same amount of money, but it would help people who are worse off.

Rob Joyce: Yes, it would be better targeted at lower-earning people.

Q339 Mark Garnier: It is entirely possible, is it not? There is no reason that you know of why you cannot do that.

Rob Joyce: No.

Paul Johnson: You could spend the same amount of money increasing the point at which you start to pay national insurance contributions. That is a choice. Of course, the one distributional effect that the current policy has is to help people who are not in work. In particular from about now, pensioners are beginning to gain from the increase in the allowance, which they clearly would not do from an increase in the point at which you started to raise national insurance contributions.

Mark Garnier: Just to be clear, the pensioners would not benefit from the national insurance thing.

Paul Johnson: That is correct.

Q340 Mark Garnier: That is a perennial problem with getting rid of national insurance and merging it with income tax, is it not?

Paul Johnson: It depends on how you did it. You could of course integrate it. A lot of the problems at the moment are from a lack of administrative integration. You could integrate the whole thing administratively and then have a different rate for pensioners or indeed for investment income, for example. That would be straightforward.

Q341 Mark Garnier: There is also an analysis of the distributional effect at the top end. The Government look at quintiles, as opposed to deciles, and they state that the top 20% were paying 43% of income tax receipts. They are now paying 53% of income tax receipts. Is that a sign that the divide is getting bigger and that the top 20% are now earning a lot more? What is it a sign of? How would you interpret that?

Rob Joyce: I would have to check whether there was more than one kind of number in the Treasury's document, but certainly part of it that they explicitly show is about policy change, because they split out the effects of policy change. Keeping constant how much different groups are earning, what is the effect of policy changes on the amount of tax that they pay? That shows that the share of tax paid by the top quintile has gone up and that is because of a lot of tax measures specifically target the very top, a smaller group than the top quintile. Mostly it is the top 1% or so. We are seeing a lot of measures affecting that group.

More broadly, the amount of tax paid or the share of tax paid by that small chunk at the top also depends on trends in earnings inequality. The more earnings inequality there is, of course, the higher share of tax will be paid by the highest-income people, all else being equal.

Paul Johnson: It is worth saying that we do not have much evidence of growing inequality over this period. There have been significant policy changes. Of course, the amount of tax paid by people towards the bottom has fallen, because a lot have been taken out of income tax or have had the amount they pay reduced by the personal allowance. Their policy is to reduce the amount of income tax paid towards the bottom. A significant policy is to increase the tax paid towards the top. I do not know exactly which year this analysis refers to, but clearly the last year for which we have data from HMRC is the year in which you will see a lot of reverse forestalling, so you will a lot of tax being taken in that particular year.

Q342 Mark Garnier: That is very interesting. The other thing I wanted to talk about was indirect taxes versus direct taxes, so VAT versus income tax. Indirect taxes tend to hit the poor twice as hard as direct taxes. How would you resolve this problem? If one fundamentally believes that the poor should be paying less taxes, how would we change indirect taxes in order to try to make it easier for the poor?

Paul Johnson: In a sense, what matters is how the tax system as a whole impacts people at different points. It is perfectly legitimate to have some taxes that are progressive and others that are not, because what matters is how the system works as a whole. It makes sense to have the direct tax and benefits system being the bit that does the redistribution. It is actually very inefficient to try to get things like indirect taxes to do redistribution. Within the indirect tax system, clearly parts of it are very regressive, tobacco tax being the most obviously regressively one, but you may think that that is entirely reasonable, given the things that it is trying to achieve.

Mark Garnier: It is a behavioural thing, rather than distributional.

Paul Johnson: Exactly, given that you are compensating through the benefits system. The other thing to say about the VAT system is that it really depends through which lens you look at it how regressive or otherwise it is. If you order people according to their income and look at the amount of VAT they are spending, it looks like people towards the bottom of the income distribution are spending quite a high proportion of their income on VAT. If you order people according to their spending, which may actually be a better measure of their long-term welfare, you do not see that; you see something much flatter across the distribution.

This is partly related to difficulties with some of the data. We see that some people towards the bottom of the income distribution are spending quite a lot, which probably reflects the fact that either we are measuring their income wrong or, actually, they are quite well off in the long run, in a period of very low income. Even looking at it in the round, I am not sure that it would be right to say that VAT is as regressive as it sometimes appears in some of these straightforward pictures.

Q343 Mark Garnier: That is very helpful, thank you. I have just a couple more questions. According to the Treasury document, at the lower quintiles support has shifted from cash transfers through welfare to benefits in kind for things like public services. Do you think that this is a fair description of what is going on?

Paul Johnson: Cash has not shifted, in the sense that there has not been a big increase in spending on education, for example, where there has been a cut in welfare. As a fraction of total spending, because welfare spending has been cut more than health and education spending, the total support through those areas has clearly moved towards health and education, and away from welfare. Actually, welfare has not been cut very much more substantially than most unprotected areas and the problem is, of course, that it is quite difficult to allocate spending on police, justice, defence, environment and so on to households. For those that are most directly applicable to households, yes, there has been a significantly bigger cut in working age welfare than there has been in health and education spending.

Q344 Mark Garnier: I have just one more, if I may, Chairman. This is the slightly difficult question: given the fact that all public spending is funded through taxation at some point, should you be borrowing money at the moment and therefore pay higher tax rates in the future? Let me just read the bit from the Treasury: "Because all public spending has to be funded in the long run, the analysis abstracts from the level of government borrowing rather than presenting an extra pound of borrowing as necessarily being a gain to households. It does this by presenting relative proportions of tax paid and spending received across the household income distribution, rather than cash impacts." Does this seem like a sensible approach?

Paul Johnson: Alongside something that actually shows cash impacts, it is a useful way of thinking, as the Treasury distribution chart shows, about what proportion of tax and spending is hitting or benefiting particular parts of the population. That is an interesting analysis, but it is, without question, an interesting analysis to know, in cash terms, in terms of the tax and benefits that affect people directly, the impact of the decisions that are made. These are both interesting and useful.

Mark Garnier: It creates a very rounded and three-dimensional picture, rather than just looking at one particular thing.

Paul Johnson: Yes.

Q345 Mr Rees-Mogg: Good morning. Can I move on to sugar taxes, because there are some very interesting charts that you have done on sugar taxes? Do you think that retailers will pass on the cost to consumers, as a starting point?

Paul Johnson: That would be the normal starting point. On average, for example, retailers pass on alcohol taxes to consumers, but not always and in all circumstances. There are clearly some new situations. In some ways, there is quite a close analogy with alcohol taxes, so it is worth thinking about how we see alcohol taxes working. It is pretty clear that, on average, most of alcohol taxation gets passed on to consumers, but not always and not in all circumstances, where retailers are wanting to have particular sales points or particular ways of attracting people into their stores. I would expect something rather similar.

I do not think that there is any particular reason to expect anything dramatically different from a sugar tax on fizzy drinks. On average, we will see the price of fizzy drinks rise by something not very different from the increase in tax, but probably not all of it. That will be reflected less in the fact that, on average, 90% of it is passed on everywhere, and more that it is mostly passed on, with some efforts to promote sales and so on.

Mr Rees-Mogg: It could be used as a loss leader under certain circumstances but, in normal circumstances, it feeds through.

Paul Johnson: That would be the place to start. This is actually quite a complex issue and we will not know for sure until it has been in place for a while.

Q346 Mr Rees-Mogg: Which households do you think will bear the greatest burden from the sugar tax, assuming it is primarily passed through?

Paul Johnson: We know that households with children consume more fizzy drinks, as a fraction of their total consumption, than other households, so one would expect it to be particularly households with children. That is of course the aim of the tax and one reason why you might think it is reasonably well targeted. I do not know if we have it by income distribution.

Helen Miller: I do not think that we do, at least not from what I am seeing here. It is definitely the households that have children, because we know that households with children are getting lots of their calories from sugar. Assuming that they do not just stop buying all of this stuff, it will be those households that are most affected but, no, I do not think we have it by income distribution.

Q347 Mr Rees-Mogg: You have criticised the sugar tax as being levied on a sugar content threshold basis, which is then applied by 100ml of drink, not on the total sugar content of the drink. That has the perverse effect that a very sugary drink pays proportionately less tax than a moderately sugary drink. Why do you think this is done? Is it cheapness of administration? I noticed that you have used a chart of wine tax as well, which is done in a similar way. It seems to fail to meet its objective the more sugary you get.

Paul Johnson: Our presumption is that this is done for ease of administration. Again, I do not know enough about how people will respond to that. People clearly responded to the cider tax, or manufacturers responded to the cider tax, by manufacturing very strong cider, because that is a very cheap way of getting a lot of alcohol down yourself. Whether the same kind of behavioural response will apply for sugar, whether people just want a big sugar rush, may be less of a problem.

Q348 Mr Rees-Mogg: I do not know if you know this answer, because I do not. How is it going to work if you have pre-mixed alcoholic drinks, where the sugar that is put in alcohol is exempt but, if it is put in the fizzy drink, it is included? If you have a pre-mixed glass of Pimm's sold, which I believe you can get in little cans, where do you think the tax will fall on this? As it is alcoholic, is it out of it?

Paul Johnson: My understanding is that this only applies to soft drinks and that would count as an alcoholic drink, but I do not know for sure.

Helen Miller: I do not know.

Q349 Mr Rees-Mogg: We are in the rather splendid position that, if you mix your own gin and tonic, you will pay a tax on the tonic but, if you buy it pre-mixed, you will not.

Paul Johnson: I do not know if that is true, but it does seem to say that this is only for soft drinks, so that would appear to be true.

Q350 Mr Rees-Mogg: Do you think that organising a tax for administrative efficiency, rather than necessarily achieving its objective, is the best way of going about it? Would it have been better to have gone to the broader gram of sugar content, not to have excluded fruit juices, milk drinks and so on, which can have lots of added sugar, to pre-empt these anomalies?

Paul Johnson: You should certainly start from the presumption that you would design the tax in a way that is intended to achieve what you are looking for. There are two different points that you are making. One is that the straightforward exemption of a bunch of drinks that have a lot of sugar in them seems to risk undermining what you are trying to achieve. Secondly, reducing the amount of tax per gram of sugar, because of the way that it is designed, is again likely to reduce its effectiveness.

It is quite difficult to know, from where we sit, how to trade that off. I do not know how big the additional administrative difficulty would have been of having something that varied constantly with the sugar level. With that said, we know that that is achieved in terms of alcohol, with beer and spirits. That varies with the alcohol content. If you can do that, I do not know the reason why it is so much more difficult to do that for sugary drinks.

Helen Miller: It is also not the case in terms of how much information you would need about the drink. You would not need any more information. You would still need to know the quantity and how much sugar was in it, so it is not the case that this requires firms to hand over less information. You would still need the same amount of information as you do currently, if you wanted to have a nice smooth profile.

Mr Rees-Mogg: It should not be that much more complex administratively.

Helen Miller: There may be a reason that we do not know about.

Rob Joyce: The reason why it is done like that for wine is that it is constrained by European regulations. That excuse does not apply to sugar.

Mr Rees-Mogg: It is always a good thing to blame the European Union for inefficiency in the tax system. May I just finish, Mr Chairman, by noting my Register of Members' Interests? Not in that is that my sister is involved in a campaign against the sugar tax and my company, Somerset Capital Management, may have at times in the past invested in companies that are interested in sugar.

Q351 Chair: Thank you for that declaration. I just want to go back to the first part of the last question that Jacob posed, which you did not fully answer. I think you were giving very interesting answers to all the questions. The question really has to be, since we have already identified so many anomalies in this structure and so many curiosities in its likely administration, and you have identified another—that they have to collect the information anyway, so it does not seem as if they are getting any relief from a burden—what logical resting place the IFS might propose to the Government. I think that that is a reasonable question to ask you. Jacob has strongly implied that a broader-based tax directly proportional to sugar content may be more logical. What is your view? I have been spinning my question out to make sure you had time to formulate a reply.

Paul Johnson: Sugar tax is much more complex than alcohol tax, in some ways, because sugar appears in all sorts of foods with different sorts of nutritional content. For example, if you were to treat sugar like alcohol, you would tax sugar wherever it appeared, not just in fizzy drinks. If you were just going to put it in something, you would have to say, "It is in this and here is the point at which it is not in this. Here it is just in soft fizzy drinks." You could extend that to fruit juices and milk-based drinks but then, if you are trying to get to sugar, why not go to all sorts of other things, like chocolate, confectionery, baked beans or whatever else you find sugar in? That is actually much more complicated or risky, in a sense, than simply putting on an alcohol tax, because a lot of these other foods that have sugar in are nutritionally good themselves. Indeed, we do not know how people will respond to reducing the amount of sugar that they consume, because they might move to salty things, fatty things or what have you.

Q352 Chair: I do not want to prolong this, but I do think it is a rather arbitrary, almost bogus, distinction. Alcohol is put in all sorts of things that also have nutritional value. A good Christmas pudding I am sure most people would consider to be highly nutritious.

Paul Johnson: My point is that we do not know how people would respond to a sugar tax. For example, if it increases the cost of a tin of baked beans, which has a bit of sugar in it, would people move to something healthier or would they move to something that has a lot of fat in it?

Q353 Chair: That is not the point that we are discussing here. There may be collateral lack of benefit. That is what you are describing, but we are interested in whether there is a straightforward tax that can affect behaviour in the way intended and avoid some of these anomalies.

Paul Johnson: A straightforward tax would be one where you would take something like soft drinks, which would probably be extended beyond the current definition, where it was based on the sugar content in a fairly straight-line kind of manner. What is crucial here is that, because this is a new thing in this country, we evaluate and learn from the policy as it is put in, and then determine future policy on the basis of what we have learned about the effectiveness of the current policy.

There is a series of big choices here, and one of the big choices is about how broad you make this. I do not think it is an unreasonable decision to have a fairly narrow one that is just on soft drinks, because you know that there is essentially no additional nutritional benefit to having a sugary drink. That is probably a good place to start with, as we discussed, a slightly broader base and a more rational structure. Then it would be incumbent on HMRC to be evaluating this very clearly to see what the effect has been and then potentially piloting different formulations to see how that works. There is a lot to learn here. Keeping an eye on its effectiveness and really making sure that this is one tax that HMRC actually evaluates would be really helpful.

Chair: I think we have made a tiny bit of progress there.

Q354 Wes Streeting: You have had a sneak preview of the questioning that I have on tax avoidance. I am going to put to you the same questions that I put to the previous panellists. First, thinking about the anti-avoidance measures in this budget, what difference do you think it would have made to what has come out through the Panama leaks?

Helen Miller: I think relatively little. There are a few things worth saying. One is that a lot of the Panama leaks stuff is on individuals' tax affairs. We are not experts in that area. A lot of the stuff that is coming through this budget, either side, is to do with the BEPS process, and that BEPS process was tackling multinational tax avoidance. It really was not to do with these problems of secrecy and hiding the beneficial owner. Relatively little of what is in this budget and what has come either side of it is designed or is trying to tackle the kinds of stuff that is going on in Panama. It may tackle some of them around the edges to the extent that those types of structures are being used to get away with some of these things, but it was certainly not a package of measures that was designed with those lack of transparency problems in mind.

Q355 Wes Streeting: Again referring back to the previous panel, we were talking about the higher level of uncertainty risk that the OBR has attached to these measures, particularly when you look at some of the projected income yield. Could you try to help us to understand some of the underlying assumptions that the Treasury has made, particularly on the disguised remuneration measure, for example, and the way in which the Treasury has profiled the scorecard yield, where we have £1.2 billion projected in 2019-20, but far less over the other years of the forecast period?

Helen Miller: I do not what HMRC is assuming explicitly. I know what is written in the booklet, but you know that too. I would say that it is not entirely surprising that revenue is increasing over time. It usually takes time for these measures to come in, so you do not get the revenue overnight. It obviously is in 2019-20, happily for the Chancellor. I do not know exactly why that it is, but I am not entirely surprised that there would be some assumption that says that we are going to start tackling these things; it is going to take a couple of years for it to come through the system. No, we do not know the precise assumptions that HMRC has made.

Q356 Wes Streeting: It is quite a leap, is it not? Again, do you have a sense of how many businesses are likely to be affected by the offshore developers measure?

Helen Miller: We do not. We would love to know that, but we do not have data on it. That is actually one of the problems underlying all of the costings for the CT stuff, not just for us, but for HMRC too. We do not have good data on where firms hold all of their loans and all of their individual subsidies or how the income flows between those. Even if you wanted to make a stab at it, we cannot just go and look at some data. You have to make an assumption about how many firms there are, how mobile they are and how they are structured. I do not know exactly which assumptions HMRC has picked for all of these, but those are the kinds of calculations that are going on underneath. No, we do not know how many offshore property developers there are, sadly.

Q357 Wes Streeting: Is it just a coincidence that the biggest yield on avoidance comes towards the end of the decade, just at the time when the Chancellor has a bit of a hole to plug in his budget?

Helen Miller: Being sympathetic to the Chancellor—

Wes Streeting: You do not have to be.

Helen Miller: I am going to deal with both sides; do not worry. It definitely stands out that it is in 2019-20, for sure. You can see it throughout the scorecard. One thing worth saying is that part of this is a response to the BEPS process, which wrapped up last year. This would have been the first budget after the BEPS process in which he could have done some of these things. Except that they take time, I am not surprised that they end up bringing in revenue by the end of Parliament. Sure, there are clearly some timing issues, which you can see most clearly in the change of the timing of the corporation tax payment, which drags a lot of income into that year, as a pure timing matter.

Wes Streeting: Thank you. Apologies for dashing off, but I am down for an FCO question, Chairman.

Q358 Chair: Thank you. We are just going to pursue that, but do go if you need to. I am just going to pursue that last question in a different form with Paul Johnson. You have said that the forecast surplus is being achieved by "a simple movement of capital spending forward, and corporation taxes back". Robert Chote referred to this as "shuffling", which gave an indication of what he thought about it: shuffling around tax and spending plans. Is the Chancellor generating a fiscal surplus just through accounting guises—well, not just through them, but is that going on?

Paul Johnson: Yes. It is exactly as you have described it. It is moving capital spending forward; it is moving corporate tax back. Of course, the other big thing is this unknown £3.5 billion of spending cuts, which are pencilled in and which the OBR has accepted and put into the scorecard. We are not going to find out what they actually are until the review is announced.

Q359 Chair: In that case, is that not a further nail in the coffin of very precise fiscal rules requiring changes in the policy twice a year?

Paul Johnson: Coming back to our original conversation, it is not helpful to have all of these things aimed at that particular year. If you look at 2018-19, the numbers get worse by £17 billion. In 2019-20, they do not change at all. It is pretty clear what is going on.

Chair: That was a very clear steer there, although, I have to admit, a steer in which I might have been doing my best to get a particular answer, having set out my view so firmly on a number of previous occasions.

Q360 Rachel Reeves: I am going to be looking at issues around welfare and also around the savings measures in the budget. The Office for Budget Responsibility forecast that the Government will miss their welfare cap in every year up to 2020-21, in total by about £20 billion over the forecast horizon. Do you think that the welfare cap remains a meaningful target or cap?

Paul Johnson: In its current form, no. We know the history of this, which was that the cap was set last July, on the assumption that the tax credit cuts would happen over this year and subsequent years. Of course, as soon as they did not happen, then the welfare cap over those years was going to be bust, unless there were some really big additional changes.

What is more interesting, in a way, is the fact that it is now forecast to be broken after that. The main reason that it is forecast to be broken after that is because of forecast increases in disability spending, particularly the personal independence payment, which in a sense was precisely what the welfare cap was there to try to encourage Government to do more to control, in the way that it controls or tries to control spending on health, education or whatever, even when demand rises. Now, the fact that that has proved more difficult, so difficult to do that the cap has not been met, is an indication that the cap in itself has not been enough to create the behaviour change that it was actually intended to create. Given that that is now where the forecast sits and my understanding that there is some kind of statement that further cuts will not be made, it is hard to see how that is going to be met.

You might think, in that situation, that it would be worth resetting the welfare cap and then trying to keep within that cap, but of course history tells us that the cap may not be effective in doing that. It is difficult to see its continuing value.

Q361 Rachel Reeves: To try to untangle these two points, do you think that it is a cap in general or a cap at the level it is set that is the problem? I am asking because the reason you have never had a cap on welfare spending in the way that you do for departmental expenditure limits is based on demand. You could argue that there is no point in having a cap, because it is just not the same as education spending, for example. It might be that it is wrong in principle or it might be that it would be okay if it was just £20 billion higher over the forecast.

Paul Johnson: I am not sure that it is wrong in principle. There is a continuum of these things. We may be beginning to see this in health. Health is at least partly demand-led and the way that Governments have controlled that historically is essentially to allow the quality of the service to deteriorate, in terms of allowing longer waiting periods or what have you, by imposing caps. Sometimes those caps on spending have been broken.

Historically for welfare spending there has been no cap at all. As demand has increased, the numbers of people on disability benefit or whatever have increased. There have often been quite belated responses to that, in terms of policy change. You can see that the point of the cap was to try to change behaviour and to try to get on top of those changes, before they actually set in. Clearly, that has proved more difficult than the Government expected to implement, because, not surprisingly, it turns out to be politically more difficult to take cash away from people than it is to make them wait a bit longer for their operation. That is kind of the way that one should see it, in terms of the sense in which the political constraints bite on spending control.

Q362 Rachel Reeves: When the Chancellor was in front of this Committee, just before Easter, we pushed him on whether, at the Autumn Statement, there would be further cuts to social security spending, given the welfare cap and given the £4 billion black hole in the budget, because of not going ahead with the PIP changes. He said that they had no further plans to cut welfare, which is not exactly the same as saying that they were not going to, in my view. Would your view be that, to meet the cap, they would have to come back with more cuts? If they were going to continue with the cap as it was set out last summer, they would have to make further cuts, in some way, to the social security budget.

Paul Johnson: Of course, it may turn out that the economy moves in a way so that is not necessary but, forecasting changes aside, yes.

Q363 Rachel Reeves: The forecast already has earnings growth reasonably strong and employment growth pretty strong, so what sort of forecasting changes would you need?

Paul Johnson: Those would need to get stronger.

Rachel Reeves: Is that in any realistic way, or going out to work at 14?

Paul Johnson: It is most likely that, if you are going to stay inside the cap, you will need to take policy action to do that, but not necessarily.

Q364 Rachel Reeves: Specifically on the disability benefits, even before these changes to personal independence payments, there has been an issue with forecasting. For the last five OBR forecasts, the OBR has had to revise up spending on disability benefits. Do you think, in your understanding of the models that DWP or OBR use for benefit spending, particularly for disability benefit spending, that they work? Should we have any trust in the forecast as it currently is for disability benefit spending?

Rob Joyce: One of the striking things that OBR said in the budget was not so much about the details of what DWP is modelling, but the fact that the details it had were so few. Talking about the original intention and assumption, back in June 2010, that the shift from DLA to PIP would save about 20% of spending, the OBR said, "We would no longer certify costings where detail on policy design and delivery is so sparse."

Since then, some assumptions have been made, and they have systematically turned out to be wrong in the same direction. I do not know enough about exactly what process goes on internally within DWP to come up with these forecasts. I know that they are repeatedly revising them on the basis of new evidence they are getting about success rates when people have these medical tests. That is about all I know, and then they have been repeatedly revised up, as a result of that process. It does look like there is clearly a systematic tendency to make mistakes in the same direction here, which should be looked at.

It is very difficult. It is not like when you are changing the rate of a benefit, where there is a fairly simple mechanical effect and you can have a pretty good stab at the cost of that, quite easily. It is harder when there is a structural change going on, which involves reassessing people medically. We would not want that to be a reason not to think about these kinds of reforms, just because the effects are not certain, but there does seem to be a real problem with anticipating what effect they are going to have.

Q365 Rachel Reeves: With your experience, Mr Joyce, would you expect that in the Autumn Statement later this year, based on the history, you might see those forecasts for disability benefit spending rise again?

Rob Joyce: The OBR thinks that its current forecast is a central estimate. It thinks that the balance of risks around that is balanced, but it has repeatedly been wrong about that in the past. Yes, if you extrapolated from the graph that we reproduced here, which shows successive revisions to spending, it would not be surprising if there were another revision. In principle, this is a central estimate, so it should not be surprising if there is a downward revision either, but clearly history suggests that these things can move a lot. Actually, the policy change, the cuts to PIP that were subsequently abandoned shortly after the budget, was going to save less money than just the upward forecasting revision since November. That gives you a sense of the scale of the revisions in a quite short period of time.

Q366 Rachel Reeves: We had the OBR in front of us, and I asked Robert Chote and Stephen Nickell about this. In your reading of the forecast—and, as you say, more information is becoming available as more people are going through this test process—your experience and the evidence of the past would suggest that revisions are more likely to be upwards than downwards.

Rob Joyce: I would not quite go that far. That is simply describing the fact that revisions have been upwards in the past. As I say, the OBR thinks that the current forecast is a central estimate and I am not sure that I am in a better place than the OBR to second-guess whether it is a reasonable central estimate. I think it is fair to say that it would not be surprising if we had another revision, because that is what has happened repeatedly in the past.

Q367 Rachel Reeves: It would be interesting, Mr Johnson—and I do not know whether this is something the IFS would be able to do—to know what would need to happen to earnings or unemployment to meet the welfare cap. Under which scenarios could the welfare cap possibly be met now? Is that something the IFS could look at or is it something that I should go elsewhere for?

Rob Joyce: There are lots of ways in which one could do that and lots of different reasons why forecasts could change. It would be pretty straightforward to have some kind of sense of scale. If you look at the end of the forecast period, so 2020-21, at the moment, after allowing for the margin of error that is built in with the welfare cap, the 2% forecasting change margin of error, the Government are breaching the cap by about £1 billion a year by the end of the forecast horizon.

Rachel Reeves: That is without the personal independence payments.

Rob Joyce: Yes, so it would be more than that now. That is true. It would be more like £2 billion a year. The upwards forecasting revision to spending on PIP between November and March was a very similar number to that, about £2 billion, so that gives you some idea that things can change quite easily, in a way that would be enough, if they go in the other direction, to bring the Government back within the cap. Obviously market developments are another thing that could change, and there have been some pretty big revisions to things like forecasts for earnings, which have pretty big effects on the public finances, which have been quantified in the Green Budget. I cannot remember offhand. If you want some other sense of what effect that would have on the welfare cap if this changes, I am sure we can provide you with something.

Q368 Rachel Reeves: Including the PIP changes that are not going ahead, there is a gap of about £4 billion in the last year of the Parliament. I would be interested in knowing how strong earnings growth would have to be or how much unemployment would have to fall by to meet that welfare cap. Is that something you are able to do?

Rob Joyce: We could do something like that, yes.

Rachel Reeves: That would be very useful. It would give us an idea of what would be needed now to meet the welfare cap. If it is okay, I will just move on to issues around savings briefly.

Chair: If you would.

Q369 Rachel Reeves: Thank you, Chairman. The Office for Budget Responsibility forecast sees the savings ratio lower in 2020, 3.9%, than it was in 2015. Does this mean that the measures announced in the budget around ISAs, both the increase in the limit to £20,000 and the Help to Buy ISA, are not having any impact on savings at the margin, or would savings have been even lower if those changes had not come into effect?

Paul Johnson: I do not think you can conclude from that fact that these things will not have an impact on savings. Nevertheless, most experience tells us that, when savings tax regimes are changed in this kind of way, the great majority of the behavioural effect is for people to move savings that they already have into these newly available forms, rather than to significantly increase savings in total. I am afraid that I have not looked at the particular bit where the OBR says this, but my expectation is that the OBR's estimates would be that the policy changes in the budget would not have a very significant effect on overall levels of savings.

Q370 Rachel Reeves: For example, if you have money in a normal ISA, you might move it or, next year, you might put it in a Help to Buy ISA. There are no new savings; it is just saving in a different vehicle.

Paul Johnson: One of the problems we have is that we do not have and cannot get information from Treasury or OBR on how they have costed the combination of the increase in the ISA limit with the introduction of the Lifetime ISA. If you look in the scorecard, those things are put together as a single thing, at a cost of knocking on for £1 billion, if I recall—£800 million by the end of the Parliament—which is not an insignificant amount of money.

How much of that is from the increase in the ISA limit, how much of it is from the LISA and what the assumptions underlying that are we do not know, because they will not publish it. Actually, people have asked and they will not tell us. Where those numbers come from we do not know, but my expectation would be that much of the money going into LISAs would be from already existing ISAs or potentially from parents helping their children or whatever. No doubt some will be additional savings at the margin, but all experience, both here and internationally, is that most of these things result in savings moving around.

Q371 Rachel Reeves: I have two things, very briefly, Chairman, if I may. First of all, to what extent are you worried about people putting money into ISAs rather than into pension savings, and therefore losing the employer contribution, so people perhaps making the wrong decisions? Secondly, have you done anything to look at the distributional impact of the ISA changes? Maybe I should know this.

Paul Johnson: In the broader picture, we are clearly seeing a move from a tax regime that very substantially favoured pension-style savings to one that is favouring ISA-style savings much more. If you look at the relative limits, you have moved from a position in which the pension limit was 20 times as big as the ISA limit to one in which, for most people, it is only twice as big. Indeed, for the highest earners, the ISA limit is now twice as big as the pension limit, so there is a very big move away from tax relief upfront towards tax relief at the end.

I do not know what the evidence is. I would be surprised if there was a big problem with people losing their employer contribution. It is clear that the employer contribution to a pension is valuable. With auto-enrolment, most people see that very clearly, and we know that auto-enrolment has auto-enrolled nearly everyone who has been affected by that. With the employer contribution, pensions still remain a better deal for almost everybody.

It is interesting that, for LISAs, ignoring the employer contribution, now for the first time we have moved to a world in which, if you expect to be a higher-rate taxpayer in retirement, you are better off putting your money in a LISA than you are in a pension. That is certainly a big change from where we have ever been in the past. It is only obviously a rather small minority who are going to expect to be higher-rate taxpayers in retirement, but the balance is clearly moving.

Q372 Rachel Reeves: The other question was just about the distributional impacts. I think that these changes to ISAs are going to cost around £2 billion. That is a combination of the higher limit of 20 grand, then the Lifetime ISA and the Help to Buy ISA. Distributionally, have you looked at whether this benefits people in different income deciles in different ways?

Paul Johnson: We have not, but it is very important when you are thinking about savings to think about these things over the lifetime. The large majority of ISAs are held, as you would expect, by people who are somewhat older and have somewhat more disposable income. That was one of the reasons for changing the playing field in favour of younger people. Inevitably, it is people who can afford to save who will, so this will help people more towards the higher end of the distribution, but that is as you would expect from anything that is ensuring that income that is saved is only taxed once, which is another way of thinking about this. In that sense, you can think of it as avoiding a penalty, rather than offering a benefit.

Q373 Rachel Reeves: This is a lot of money for the Government to spend. It would be useful to know who is benefiting. You are saying that that is very difficult to do or meaningless.

Paul Johnson: We can look at the wealth and asset survey, so we can see who currently has ISAs. As I say, it would be misleading simply to do a standard decile chart of that, because what you will find is that they are mostly older people, rather than younger people, rather than lifetime-well-off people relative to lifetime-poorer people. We can think about ways of showing that.

Rachel Reeves: Perhaps you could think about it and get back to us.

Q374 Chair: I just have one last question I want to ask, a very general question, which comes out of questions on the welfare cap earlier. You have made clear that you think that cuts in cash receipts are more painful than lengthening a waiting list for a hospital, for example, as a means of getting some cash in, which implies that you think the burden of public expenditure reduction should be spread differently from the way that it is currently spread. You have repeatedly said that so much public expenditure being ring-fenced is forcing the squeeze on a narrower and narrower base. Is it not beholden on all of us who do not like that and who think that that is going to become very problematic, as the remainder of the deficit is addressed, to say how we think that burden should fall, either through higher taxes or through other parts of the spending framework? Have you a view on that, Mr Johnson?

Paul Johnson: On your first point, what I was observing was just how difficult it is to cut cash benefits, rather than it necessarily being the wrong thing to do.

Chair: I had elided two points in order to speed things up.

Paul Johnson: To be fair, cash benefits have been cut over the last Parliament and, for new claimants, there will be some significant cuts in universal credit, if and when it rolls out.

Q375 Chair: You have implied that, if you were Chancellor, you would have a political preference for lengthening waiting lists before taking cash out of people's pockets.

Paul Johnson: I observed that that can be easier to do politically. With that said, working-age welfare spending will be at its smallest fraction of national income at any time since 1990. If that is their aim, the Government have been really quite effective at reducing spending on working-age welfare to about its lowest level since 1990. A lot of that is to do with the fact that it is really constrained indexation and so on.

In terms of your broader question, it is very difficult to know where to go with the next spending cuts. One of the areas that has been protected is health and, whilst I am no expert in the finance of the National Health Service, I observe a lot of respected people saying that this is becoming more and more difficult, even though this is the one area that has been significantly protected. The other area that has been protected, which one could clearly look at, is spending on pensioners, in one way or another.

Q376 Chair: I am asking you what you would do.

Paul Johnson: I do not have a view as to what the right place to cut public spending would be or what the right level of taxation is, I am afraid.

Chair: The answer is that you do not know.

Paul Johnson: I do not.

Chair: That is a very helpful and honest place in which to end. Thank you very much for giving evidence to us this afternoon. If we need more, we will come back to you in writing.