House of Commons

Treasury Committee

Budget 2012

Thirtieth Report of Session 2010–12

Volume I

HC 1910–I

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The Treasury Committee

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Committee staff

The current staff of the Committee are Chris Stanton (Clerk), Lydia Menzies (Second Clerk), Jay Sheth, Adam Wales, Dr Renée Friedman, Antonia Brown (on secondment from the Bank of England), and Lara Joseph (on secondment from the FSA) (Committee Specialists), Phil Jones (Senior Committee Assistant), Steven Price and Lisa Stead (Committee Assistants) and James Abbott (Media Officer).

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1 Introduction

1. The practice of the Treasury Committee has been to report to the House on the Budget in time for the Second Reading of the Finance Bill. This year this has not been possible because of the timing of the Budget and the Finance (No. 4) Bill which will implement it. The Budget was on 21 March 2012, and the Committee held three oral evidence sessions: one on 26 March and two on 27 March, the day the House rose for the Easter adjournment. The Finance Bill was published on 29 March, and Second Reading was on the next sitting day, Monday 16 April. The Committee agreed this Report on 17 April in order to publish it in time for the beginning of the Committee stage of the Finance Bill on the floor of the House on Wednesday 18 April.

2. The publication of the Bill only after the tabling on 27 March of the Motion committing certain provisions to the Committee of the Whole House, and the two day gap between Second Reading and the Committee of the Whole House stage of the Finance Bill, allow very little time for amendments to be prepared and tabled. The scheduling appears to be the result of a lack of parliamentary time to pass the Bill before the summer adjournment. The Commons Public Bill Committee stage does not, by convention, start until the Committee of the Whole House stage has ended. Following completion of the Public Bill Committee stage on 26 June there needs to be time for the Bill to be reprinted for the two days allotted to Report stage and Third Reading. There is then the customary two weekends before consideration begins in the Lords. The new pattern of Prorogation and State Opening in April and May, applying for the first time this year, reduces the sitting time available between the Budget and the summer adjournment. There are also special factors this year that reduce the parliamentary calendar: the Whitsun recess is longer than usual because of the Queen's Diamond Jubilee; and Parliament rises earlier than usual because of the Olympic Games. **The timings of the Second Reading of the Finance (No. 4) Bill and the Committee of the Whole House stage are highly unsatisfactory. While we recognise that there are exceptional circumstances this year, the new pattern of Prorogation and State Opening risks making the timing of the stages of future Finance Bills tighter than in the recent past. We therefore recommend that the Treasury and the Business Managers work together to plan the timings of future Budgets and Finance Bills so that the House has longer between publication of the Bill and Second Reading and, particularly, between Second Reading and Committee of the Whole House. This may require the Budget to be somewhat earlier in future.**

3. The Committee took evidence from five panels of witnesses during the three meetings we held, as follows:

26 March: Office for Budget Responsibility

Robert Chote, Chairman, Graham Parker, Member, and Professor Stephen Nickell, Member, Budget Responsibility Committee.

27 March (morning): Experts and interested parties

First panel: Roger Bootle, Capital Economics, Dr Brian Hilliard, Société Générale, Dr Jens Larsen, RBC Capital Markets, and Jonathan Portes, National Institute for Economic and Social Research;

Second panel: Paul Johnson and Carl Emmerson, Institute for Fiscal Studies;

Third panel: Gillian Guy, Citizens Advice, Professor Dieter Helm, Oxford University, Steve Hughes, British Chambers of Commerce, and John Whiting, Chartered Institute of Taxation.

27 March (afternoon): HM Treasury

Rt Hon George Osborne MP, Chancellor of the Exchequer, Sir Nicholas Macpherson, Permanent Secretary, and James Bowler, Director, Strategy, Planning and Budget.

The Committee is very grateful to those who gave oral and written evidence to us. Their flexibility in adjusting their schedules to fit in with our necessarily compressed programme of evidence is much appreciated.

4. The Committee has asked three professional accounting and tax bodies—the Association of Certified Chartered Accountants, the Institute of Chartered Accountants of England and Wales, and the Chartered Institute of Taxation—to submit memoranda on the extent to which the provisions of the Budget and the Finance (No. 4) Bill which will implement them meet the criteria set out in our Report of 2011, *Principles of Tax Policy.*[1] The publication of these memoranda is intended to assist colleagues in scrutinising the Bill in Committee.

The Office for Budget Responsibility

5. As is our custom, The Committee asked the Chairman of the Office for Budget Responsibility (OBR) whether the OBR had had the co-operation it needed from government, and whether he had any evidence to suggest that it had been put under inappropriate pressure. He told us that there had been no such pressure, and he raised no concerns about the co-operation the OBR had received.[2]

6. Since its creation two years ago, the OBR has become a part of the Budget process. The Treasury Committee recommended in 2010 that the OBR should be subject to fundamental review after five years.[3] After some reluctance the Government agreed that, subject to consultation with the Chairman of the OBR, there will be an independent, external review of the OBR after its first five years of existence.[4] In the meantime, we intend

1 Eighth Report of Session 2010–12, HC 753

2 Q 111

3 Fifth Report of Session 2010–12, *Office for Budget Responsibility,* HC 385, para 41

4 Sixth Special Report of Session 2010–12, *Budget 2011: Government and Office for Budget Responsibility Responses to the Tenth Report from the Committee,* p 14

to assess the OBR's performance against criteria drawn from the conclusions of our Report on the OBR published in September 2010. These criteria are set out in Box 1.

Box 1: Reviewing the effectiveness of the Office for Budget Responsibility

There are five principal criteria against which the Committee will measure the success of the OBR. They are:

- Accuracy

"The OBR should seek to avoid significant bias over time in its forecasts, its assessment of trend growth, or its judgements about the probability of the Government's mandate being met on the policies announced".[5]

- Political independence

The OBR should demonstrate "a commitment to transparency, objectivity and impartiality over a sustained period" in order "to command and retain public confidence".[6]

- Accountability

"We will take evidence from the organisation regularly as part of the budget process. We will intervene if we believe the OBR's independence is threatened. We expect the members of the Budget Responsibility Committee or the non-executive directors to report any concerns they have to us". [7]

- Contribution to a balanced public debate

The OBR should be "informing public debate through disseminating better understanding of fiscal policy and long-term economic trends, identifying possible risks in the structure of the economy and provision of data".[8]

- Care and restraint in preventing undue influence on the policy making process

"The OBR provides a forecast and commentary; it has no responsibility for policy on which it comments or which its work may influence internally".[9]

The Red Book

7. The format of the Budget Red Book[10] has improved considerably. The average length of the Red Book under the previous Government was 264 pages and under the present

5 Fifth Report of Session 2010–12, *Office for Budget Responsibility,* HC 385, para 128

6 Fifth Report of Session 2010–12, *Office for Budget Responsibility,* HC 385, para 23

7 Fifth Report of Session 2010–12, *Office for Budget Responsibility,* HC 385, para 58

8 Fifth Report of Session 2010–12, *Office for Budget Responsibility,* HC 385, para 128

9 Fifth Report of Session 2010–12, *Office for Budget Responsibility,* HC 385, para 12

10 HM Treasury, *Budget 2012*, HC (2010–12) 1853

Government has been 110 pages. At less than half the length, it has more factual and less subjective material. In recent years the Treasury Committee has requested greater transparency to enable both winners and losers to be more easily identified.[11] As the Committee said in our Budget Report last year, we welcome the analysis the Red Book now contains of the distributional impact of the Budget measures.[12] The Chancellor told us that:

> Not just the Ministers but the official Treasury has put a huge amount of work into trying to get this into a shape where it is a factual document that is packed full of information people might find interesting. We would be very willing to take on board any suggestions you have for improvement, because improving the Red Book is a work in progress.[13]

8. The Treasury Committee welcomes the changes to the Red Book, its increased value as a source of information, and the Chancellor of the Exchequer's openness to suggestions from the Committee for further improvements. We invite evidence from interested parties on how the Red Book can be improved further, and will make recommendations in time to enable HM Treasury to respond at the time of the Autumn Statement.

11 Fifth Report of Session 2006–07, *The 2007 Budget*, HC 389, para 41

12 Tenth Report of Session 2010–12, *Budget 2012,* HC 897, para 41

13 Q 241

2 Macroeconomy

GDP growth forecast

9. Following the substantial revisions to the OBR's GDP growth forecasts in November 2011, there were only relatively small changes in the OBR's March 2012 forecast for GDP growth. As Table 1 shows, the OBR has revised its forecast for GDP growth to be 0.1 percentage points higher in 2012, and 0.1 percentage points lower in 2013. This leaves the shape of the forecast for GDP much the same as it was in November 2011, with GDP growth forecast to rise sharply from 2013 onwards.

Table 1: GDP growth forecasts

	Percentage change on previous year						
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
March 2011	1.3	1.7	2.5	2.9	2.9	2.8	
November 2011	1.8	0.9	0.7	2.1	2.7	3.0	3.0
March 2012	2.1	0.8	0.8	2.0	2.7	3.0	3.0

Source: OBR, Economic and fiscal outlook, March 2011, p 8, Table 1.1; OBR, Economic and fiscal outlook, November 2011, p 11, Table 1.1; OBR, Economic and fiscal outlook, March 2012, p 11, Table 1.1;

Figures in bold are outturns. All other figures are forecasts.

Risks to growth

10. Two major risks to the UK economy were identified by the OBR and the Chancellor: continuing uncertainty around the state and impact of the eurozone crisis and the rise in oil prices. Despite the OBR's central forecast, which assumes the euro area finds a way through its current problems, the OBR stated that "the situation in the euro area remains a major risk to our forecast."[14] Although the OBR expects inflation to continue to fall, it has recognised that higher or lower externally-generated inflation remains a risk to its central forecast. For example, a shock to oil prices would generate higher inflation than within its current forecast.[15]

11. For the first time the OBR has conducted scenario analyses of these two major risks:

- a eurozone event's effect on the UK based on an OECD stylised downside scenario in which a disorderly sovereign debt restructuring leads to a tightening of credit conditions and significantly lower growth, and
- a temporary oil price spike in which a temporary shock raises oil prices significantly in the short term.

12. The Chancellor told us that:

14 OBR, Economic and fiscal outlook, March 2012, p 8, para 1.22

15 OBR, Economic and fiscal outlook, March 2012, p 9, para 1.26

> I do not think the euro crisis has disappeared. I think the action from the European Central Bank is extremely welcome, but that is not a long-term solution to the problem. I think that high oil prices are a cause of concern for every western Government at the moment, and indeed other Governments. I think there is also the challenge that the OBR always puts to us, which is whether we have properly assessed—it includes itself in this—the depth of the effects of the financial crisis.[16]

13. When considering the risk to the UK emanating from the eurozone, two particular transmission mechanisms were discussed: the trade route and the banking sector. We asked witnesses to consider which transmission mechanism was of most concern. Banking sector risks were perceived to be greater than through the trade route. As Dr Hilliard of Société Générale told us:

> I think that the banking sector is the greater risk. What I would also add though is that I think that the risks are diminishing. I am not saying that in any way we are out of the crisis, but the stabilisation measures taken by the ECB in particular are going a long way to reassure people.[17]
>
> [...]
>
> I have to say that one of the hopes rather than forecasts in a lot of these OBR forecasts and others, is the increasing contribution of net exports over the medium term.[18]

The Chancellor's view was that:

> I think the financial crisis [...] has potentially the most catastrophic effects. [...] I think the fear last autumn [...] was that there was going to be some catastrophic event—either a collapse of a eurozone bank or a failed sovereign debt auction for one of the peripheral countries. In November or December, that was a very acute fear. You can see that the impact on business investment in this country, let alone in eurozone countries, was pretty acute.[19]

14. As noted by the OBR and others there is a definite risk of an oil price spike resulting from increased political tensions in the Gulf region, from a drop in supply, or by a "fear premium" in the markets pushing up prices.[20] When asked about the impact of an oil price spike Mr. Chote responded that:

> People are a bit more concerned about the possible implications of higher oil prices than they were before, but that has been a change over a couple of months, and

16 Q 321

17 Q 119

18 Q 120

19 Q 322

20 Office for Budget Responsibility, Economic and Fiscal Outlook, March 2012, p 175, para 5.42, "Scary Oil," Nouriel Roubini, *Project Syndicate*, 15 March 2012

> doubtless the balance of things to be worried about will change in the coming months.[21]

> The oil price story is part of a broader one which relates to the last question of how quickly inflation will inflation fall. Will there be other factors—food prices, for example—that might mean that the fall in inflation is not quite as quick as the central forecast suggests, and therefore how soon will it be and with what strength will it be that earnings growth outpaces price growth? That remains an uncertainty, and it is not just down to oil.[22]

This view about the potential impact of an oil price rise on inflation was echoed by Dr Larsen of RBC Capital Markets:

> I don't think from the demand side that the UK economy is directly that vulnerable to an oil price increase. However, it could obviously be very important for the global economic outlook, therefore eventually for our export markets, and certainly for market sentiment. In that sense, it is a very important issue in terms of the global outlook. The direct issue for the UK might well be pressure on inflation; that we end up with higher inflation and further erosion of real income and a further difficulty for the Bank of England—for the Monetary Policy Committee—in supporting the view that inflation is going to come down quickly. I have certainly shifted up my inflation forecast significantly on the back of the news we have seen about oil prices and commodity prices more generally. That would be a worry for monetary credibility, but it would also be a worry for the outlook for the consumer.[23]

15. We asked our witnesses to consider the balance of these two major risks: the eurozone and a spike in oil prices. In response to our question as to which risk was worse and whether the OBR had considered other scenarios, Professor Nickell stated that:

> Specifying the kind of disaster and ranking them in terms of probability, is not something we have devoted a great deal of time to.[24]

> The eurozone disaster has an especially severe impact on the banking system of the eurozone, whereas an oil price spike, which we have in another scenario, does not have such a detrimental impact on the banking system of the Eurozone. That is the key. A eurozone disaster has one of its main impacts on the UK because of its effect on the banking system so we get a repetition of what we had in 2008, but from another direction.[25]

Mr. Chote noted that:

21 Q 13

22 Q 14

23 Q 122

24 Q 22

25 Q 25

> So much depends in all these systems, again, on the extent to which the impact of the crisis on the UK manifests itself in a further structural deterioration of the sort that we have seen over the course of the last crisis. That is why [...] one would be particularly worried about the sort of crisis that led to severe difficulties in terms of the credit crunch—which, at the moment, is the best explanation we have for why the path of potential GDP seems to have moved so much off the previous, pre-crisis path—versus other sorts of crises that show up as a temporary hit to demand, movements in exchange rates or a change in Government bond yields, for example.

16. **We welcome the OBR's use of scenario analysis to further its understanding of the major risks to the UK economy. The Treasury Committee recommends that the OBR consider a wider range of risks and associated scenarios in subsequent forecasts. Such examination might include ranking the risks by both likelihood and significance to the UK economy. The examination should also include an explanation of the extent to which the fan charts provided by the OBR reflect this information.**

Composition of GDP growth

Table 2: Expenditure contributions to GDP growth

	Percentage points, unless otherwise stated						
	Outturn	Forecast					
	2010	2011	2012	2013	2014	2015	2016
GDP growth, per cent	2.1 (1.8)	0.8 (0.9)	0.8 (0.7)	2.0 (2.1)	2.7 (2.7)	3.0 (3.0)	3.0 (3.0)
Main contributions							
Private consumption	0.8 *(0.7)*	-0.5 *(-0.7)*	0.3 *(0.1)*	0.8 *(0.7)*	1.5 *(1.4)*	1.9 *(1.7)*	1.9 *(1.8)*
Business investment[2]	-0.2 *(0.1)*	0.0 *(-0.1)*	0.1 *(0.6)*	0.5 *(0.8)*	0.8 *(0.9)*	0.9 *(1.3)*	1 *(1.4)*
Dwellings investment[3]	0.4 *(0.3)*	0.1 *(-0.1)*	0.0 *(0.1)*	0.5 *(0.4)*	0.6 *(0.5)*	0.5 *(0.4)*	0.5 *(0.4)*
Government	0.5 *(0.4)*	-0.3 *(0.3)*	0.0 *(-0.3)*	-0.3 *(-0.5)*	-0.5 *(-0.5)*	-0.6 *(-0.7)*	-0.6 *(-0.7)*
Change in inventories	1.3 *(1.3)*	-0.1 *(0.0)*	-0.1 *(-0.3)*	0.0 *(0.0)*	0.0 *(0.1)*	0.0 *(0.0)*	0.0 *(0.0)*
Net trade	-0.5 *(-0.8)*	1.2 *(1.2)*	0.4 *(0.3)*	0.5 *(0.6)*	0.3 *(0.3)*	0.2 *(0.2)*	0.1 *(0.1)*

Source: OBR, Economic and fiscal outlook, March 2012, p 56, Table 3.4; OBR, Economic and fiscal outlook, November 2011, p 73, Table 3.4

1. *Figures in italics are from November 2011 forecast. Components may not sum to total due to rounding and statistical discrepancy.*
2. *The sum of public corporations and private sector investment in new dwellings and improvements to dwellings*
3. *The sum of government consumption and general government investment*

17. While the OBR's overall GDP growth forecast has not changed significantly since November 2011, the forecast for the underlying expenditure components of GDP growth has changed. As Table 2 shows, the OBR now forecasts that GDP growth will be driven less by business investment, and more by consumption, with the expenditure contribution from government now forecast to be less of a drag on GDP growth going forward. However, business investment remains significant for the overall GDP growth forecast, as by 2016 business investment is forecast to make up 29 per cent of the positive

contributions to GDP growth in that year.[26] The OBR, in its March 2012 *Economic and fiscal outlook*, noted that:

> Private consumption growth forecast implies that consumer spending will continue to fall as a share of GDP, before stabilising in later years. Business investment and net trade are expected to contribute a large proportion of forecast GDP growth. These trends are driven by the sustained depreciation of the real exchange rate and the ongoing fiscal consolidation, which releases resources for private sector investment.[27]

Business investment

18. The OBR has reduced its forecast for the growth of business investment. The OBR now forecasts that real business investment growth will be 0.7 per cent in 2012, a reduction of 6.9 percentage points since the November forecast. While business investment is then expected to grow strongly from 2013 to the end of the forecast horizon in 2016, the forecast for each year's growth in business investment has been reduced since the November 2011 forecast.[28]

19. Mr Chote, Chairman of the OBR, provided us with several arguments for the weakened forecasts for business investment. He noted that in the short term the OBR had forecast a "significant downward revision to the forecast for investment growth in 2012, which is largely a reflection of the big decline in the fourth quarter of 2011".[29] He explained that the forecast for business investment for the later years in the forecast period had been reduced for two reasons. First, the OBR had looked again at the health of the corporate sector's balance sheet, and its sense was "that official statistics may be overstating the support that the amount of cash that appears to be on corporate balance sheets might provide to investment in the longer term".[30] Secondly, Mr Chote stated that the OBR had compared the current recovery with that in the 1990s. This had led it to forecast:

> Investment picking up by about 40 per cent over the five-year forecast horizon, which compares with about 50 per cent in the equivalent period of the recovery in the 1990s. Given what is going on with fiscal consolidation, credit conditions, et cetera, a robust recovery in investment that is somewhat weaker than in the 1990s seems to us to be a reasonable balance.[31]

20. During our inquiry, we have heard criticism of the OBR's proposition that the proportion of the current corporate cash surplus that would be available for investment was a key restraint on investment. Mr Chote referred to work by the OBR which suggested that not all of the cash surpluses available to UK-based corporates are necessarily available

26 OBR, *Economic and fiscal outlook,* March 2012, Cm 8303, p 56, Table 3.4; Business investment is forecast to make up a third of the GDP growth figure that year.

27 OBR, *Economic and fiscal outlook*, March 2012, Cm 8303, p 55, para 3.56

28 OBR, *Economic and fiscal outlook*, March 2012, Cm 8303, p 11, Table 1.1

29 Q 8

30 Q 8

31 Q 8

for business investment. From previous work by the OBR it is known that UK corporates in 2010 held the majority of their cash in bank accounts at foreign banks.[32] The ONS only knows in aggregate corporates' cash holdings in foreign banks. It does not have a breakdown between financial and non-financial corporates. This may be important, as non-financial corporates' cash holdings might be used for business investment, but financial corporates, such as hedge funds, are unlikely to use the bulk of their cash holdings for that purpose. In the past the OBR has fallen back on a rough estimate of the breakdown of the split between financial and non-financial corporate. At the moment, the ONS estimates that roughly 80 per cent of UK corporate cash in foreign banks is held by non-financial corporates. However, the OBR has now done some work of its own on this. It has concluded that the 80/20 split may be an overestimation of the amount held by non-financial corporates. Mr Chote explained that:

> The ONS is using a Bank for International Settlements survey, which records the claims of UK bodies on those foreign financial institutions. It attributes about 80 per cent of those to the UK corporate sector that you might anticipate would be likely to invest them. Our concern is that a smaller proportion of that than 80 per cent may be with the sorts of companies that are likely to invest this in capital. More of it, for example, might be held in by hedge funds and therefore it is less likely to be used for capital investment. That 80:20 split was come up with quite some time ago, since when the growth of non-bank financial institutions has been rather great. That concern is what primarily underlies the view that the apparent cash piles that lots of companies are sitting on may not be, as it were, just waiting to go out and be invested in capital investments, as the official statistics might suggest.[33]

Dr Jens Larsen, RBC Capital Markets, said on the other hand that he did not think "that cash is the key constraint on corporates; the key constraint on investment now is the demand outlook".[34] This view was expanded upon by Mr Bootle, Capital Economics, who told us that:

> I doubt very much whether cash will be the constraint. After all, if we are talking about large companies that find they do not have enough retained earnings and that they have got access to bond markets or equity markets—indeed, better access to the banks than SMEs have—I would be surprised whether that is really a substantive issue. When you look at their cash balances, they are very high by historical standards. The question simply is: do they want to invest? That is primarily about the overall environment of aggregate demand and the confidence that they have in the future.[35]

32 OBR, *Economic and fiscal outlook,* November 2011, Cm 8218, p 78, Box 3.5

33 Q 61

34 Q 141

35 Q 142

21. There was also some concern expressed to us about the OBR's overall forecast for business investment. Dr Hilliard, when asked about the OBR's assessment for business investment, told us that he was:

> [...] shocked by how weak its forecast is for this year. It could possibly be a little bit higher. Then, when we move to the medium term, it is relying on business investment to drive growth. Maybe I am just a good old English pragmatist. I think it will be somewhere between the two. My worry in the medium term about the growth outlook is that we will be disappointed in several demand components and that the investment one looks too weak at the moment, and a little bit too strong in the medium term.[36]

Dr Larsen also outlined his reservations about the OBR's forecast. He noted that looking further out, the whole forecast was one about a "beautiful rebalancing with much stronger business investment and much stronger net exports" and that "one can get a little worried that that will actually happen".[37] However, he stated that "The OBR has moved in the right direction [...]. The reliance on this business investment recovery is less than it was in November [2011], and November was less than it was before, so the forecast makes more sense to me".[38] When we challenged Mr Chote on the strength of the OBR's business investment forecast in later years, he replied:

> What we have is a relatively robust recovery. It is something that is increasing as a share of GDP, which we would expect during the recovery phase, but we have a less dramatic increase than we did in the 1990s, which seems appropriate given the headwinds that the economy faces at the moment. However, I would be the first person to say that if we look at this chart in nine months, the numbers may look different again. We have to address the evidence as it comes in.[39]

22. **The OBR now forecasts that the growth in business investment will be slower than it thought in November 2011. One of the OBR's explanations for this weakening was the results of further research undertaken by the OBR into the official ONS figures on the availability of cash for investment by firms which suggested that ONS figures over-estimated the amount of cash held by companies that are likely to invest in capital. We have heard conflicting evidence on this argument. In view of the importance of business investment in the GDP forecast, we therefore recommend that the OBR, in conjunction with the ONS, examine its work in this area with particular care.**

36 Q 140

37 Q 141

38 Q 141

39 Q 17

Lending

Bank lending

23. Credit conditions for businesses continue to appear strained. The OBR's *Economic and fiscal outlook* sets out the extent to which bank lending continues to be weak:

> Bank lending to private non-financial companies (PNFCs), especially small and medium-sized enterprises (SMEs), continue to be weak with the annual growth rate in November at -2.1 per cent for all businesses and -6.1 per cent for SMEs. Lenders reported especially weak demand from SMEs at the end of 2011, citing reduced business confidence.[40]

24. We questioned witnesses about the extent to which a continued lack of bank lending was constraining economic growth. Mr Chote stated that the amount of time it would take for credit conditions to normalise "is one of the key factors that explains why you have a relatively slow recovery, but it is also one thing that we have factored into deciding when the growth rate of potential GDP is likely to get back to its long-term growth rate."[41]

25. Dr Hilliard, however, argued that a lack of bank lending was not constraining growth in aggregate a great deal.[42] He suggested that, for larger firms at least, the supply of credit from banks was unlikely to be the primary factor suppressing investment, noting:

> The corporate sector is flush with money. [...] Lending is obviously important for SMEs—vital in the medium term—but in terms of the dynamic of a recovery, the larger companies are well able to power the recovery if they want to. I think the issue is much more one of confidence—trying to dispel uncertainty—in two ways. One is the uncertainty of demand, which is pervasive and may be reduced if the eurozone crisis continues to stabilise. The other is the uncertainty of funding. It is puzzling that we have such a large cash pile. It is not just a UK phenomenon; it is in all the major western economies. During the deepest part of the recession, companies felt they had to go to the bond markets to get funds, because banks were at their most cautious at that point. Even though banks subsequently reopened their lending to large companies, I think large companies learned that lesson, and continue to do so. So, there is uncertainty both on the liquidity side of funding and on the demand side.[43]

26. Mr Bootle largely supported Dr Hilliard's point of view with respect to large corporates, agreeing that they "have got substantial cash piles and are not heavily dependent on the banks, and they could step up investment even if there were not any renewed willingness of banks to lend."[44] He went on to argue however, that the conditions faced by SMEs were rather different, and that both supply and demand issues were relevant:

40 Office for Budget Responsibility, *Economic and fiscal outlook,* 23 March 2011, p 54, para 3.52

41 Q 33

42 Q 123

43 Q 123

44 Q 124

> As far as the SMEs are concerned, it is a question of both demand and supply, and it is very difficult to disentangle them. There is considerable survey evidence to the effect that the terms facing small companies that wish to borrow from banks are substantially worse—tighter—than they were some years ago. [...] Although it is often difficult to disentangle demand and supply, the key indicator is what is happening to margins. If you think the problem is lack of demand, you should find banking margins under downward pressure. You do not see that, actually. You see banking margins under upward pressure. I think that is an indication that the banks feel that lending to SMEs is a pretty risky business, and they are not as keen on it as they might be.[45]

Mr Steve Hughes of the British Chambers of Commerce (BCC) agreed that SMEs were finding it particularly difficult to gain access to bank finance:

> We now have evidence through something called the SME Finance Monitor, which was the first independent, big survey of bank lending conditions conducted post-financial crisis. It shows quite clearly that younger, high-growth, smaller businesses find it much more difficult to access finance.[46]

The National Loans Guarantee Scheme

27. On 19 March 2012 the Government announced details of the National Loans Guarantee Scheme (NLGS), under which it will guarantee loans to participating banks, which will allow them to borrow at a cheaper rate. The scheme will be limited to businesses with turnover of less than £50 million. Participating businesses will receive the entire benefit of this cheaper funding for banks through a reduction of 1 percentage point in the cost of bank loans. The Government has put in place the following measures to try to ensure that participating banks pass on the full benefit of their lower funding costs to SMEs:

> As a condition of participating in the scheme, the banks have agreed a monitoring framework with the Government. All banks will have to submit quarterly reports containing data on the loans they have made under the scheme, and demonstrate that they are passing on all the benefit of the guarantees to businesses. The scheme will also be independently audited.

Participating banks will pay a fee to the Government. The first tranche of NLGS funding will be £5 billion, with the timing and size of subsequent tranches being determined by demand up to a total of £20 billion.[47]

28. We asked witnesses whether they felt that the NLGS would be successful in addressing some of the structural problems within the SME funding market, and whether it would increase net lending overall. Mr Chote stated that the OBR's expectation was that the first

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45 Qq 124–125

46 Q 202

47 "Chancellor launches scheme to boost small business lending", HM Treasury press release 24/12, 19 March 2012

£5 billion tranche of the scheme "would lead to some rebalancing in lending towards SMEs from other borrowers," but that the OBR was "less convinced that it would have a significant impact on overall lending and therefore on the economic forecast."[48]

In response to the question of whether a larger initial tranche would have had an impact on the economic forecast, Professor Nickell stated that if the Government had proposed guaranteeing £20 billion of bank funding up front, the OBR would have had to "think seriously" about what impact that would have, but "with £5 billion, you do not have to think very hard about the additionality, because £5 billion is just not very big." He argued that with the scheme as currently designed, "the actual increase in lending you get—the bang for your buck—is not very great."[49]

29. Mr Chote, however, noted that it was not necessarily the Government's intention to increase aggregate investment through the NLGS.

> The Government are in part trying to do this, presumably, to help SMEs specifically, and then as a contribution maybe as well to aggregate levels of business investment. There is the broader question of whether that also substitutes for lending to non-businesses. It is for them to decide what their success criteria are for this policy. They might be happy if it is showing up as an SME effect, because they are particularly interested in helping SMEs, and there is an offsetting effect elsewhere. We would argue that the likelihood of that is greater than the likelihood of its making a significant boost to aggregate lending and therefore to aggregate activity in the economy.[50]

The Government has stated that "The aim of the NLGS is to help smaller businesses obtain lower cost finance."[51] In his evidence to us, the Chancellor said that having "an impact on small business lending" is "exactly what it [the NLGS] is designed to do".[52]

30. A number of witnesses, however, argued that the scheme might not prove to be particularly effective. Mr Hughes thought that the scheme would have "little impact" and not be of "material benefit":

> It will make loans cheaper for some businesses, but those businesses are more than likely to be the businesses that would have been viable or deemed viable by credit scoring systems and allowed to have finance anyway. Ultimately, it is just giving them a bit of a bonus on the pricing of their loan. There are wider problems with the system that need to be addressed.[53]

48 Q 50

49 Q 55

50 Q 56

51 HM Treasury, National Loan Guarantee Scheme, Frequently asked questions, 20 March 2012

52 Q 288

53 Q 204

Professor Nickell of the OBR also cast some doubt on the impact of reducing loans to businesses by 1 percentage point, saying: “An SME line from a bank is often 8 per cent, 9 per cent or 10 per cent, and one percentage point is not huge”.[54]

Mr Hughes raised the issue of whether the rapid launch of the scheme might hamper its effectiveness:

> State aid sign-off for the national loan guarantee scheme occurred on the Thursday; the banks signed up over the weekend and it was launched on the Tuesday. Somehow, all the bank relationship managers are meant to know and understand a scheme, so that when a business walks in after seeing it on the TV, they are able to explain to them.[55]

31. In his evidence to us, the Chancellor said: “I have made it clear that if the scheme is working and if the money is coming out of the door, I am prepared to look at increasing that £20 billion.”[56] While this might address the issue of the scheme having an impact on aggregate lending, Mr Portes, Director of the National Institute for Economic and Social Research (NIESR), argued that it was “more a design issue than a quantity issue” that would prevent it from being particularly useful: “I would not say that they should have done 40 billion rather than 20 [billion] and that that would have had a wonderful effect. I do not think that that is particularly plausible.”[57]

32. Dr Larsen said that a problem was that no one wanted to assume the additional credit risk of SMEs: “The banks are not keen to do it. The Treasury is obviously not keen, either. As you have explored on many occasions, the Bank of England does not think it belongs there. So it is very difficult to find someone who will do it.”[58] Mr Bootle noted that there was also a distinction between those SMEs who should be receiving credit and were not and those that should probably not receive credit in any case, but he argued that that there was now a shortfall of credit from banks to SMEs that should be receiving loans:

> It is certainly not the case that all SMEs that want access to bank credit should be granted it. Sometimes you listen to groups lobbying on behalf of SMEs and you get the impression that the banks must be completely off their heads—that there is not really a risk. Of course, we all know from the evidence that lending to SMEs is extremely risky, but equally, that does not mean that the banks have not overreacted, too. That is to say, in being overly generous with credit overall in the run-up to the crisis, the banks have now been under-generous with particular sorts of credit as a direct reaction to the earlier behaviour.[59]

54 Q 60

55 Q 203

56 Q 288

57 Q 127

58 Q 128

59 Q 130

33. In evidence to us, the Chancellor noted the complexity of trying to establish a scheme like the NLGS:

> It is a very complex operation to try to guarantee lending to banks, which is then passed on from the banks to small businesses. When I launched the scheme in Parliament, I said that I did not expect that we would get it 100 per cent right when we started and that we would have to improve it as we went along. I am really pleased with the way it has been launched, and we have not found any problems yet, but I am certainly prepared to increase its capacity if we can show that it is getting to those small and medium-sized businesses.[60]

34. **We welcome the Chancellor's commitment to increase the capacity of the National Loans Guarantee Scheme if it proves to be successful. We note that oversight of the Scheme through monitoring and reporting by participating banks, and also an independent audit, has been put in place to ensure that banks will pass on the full benefit of lower funding costs to SMEs. We expect there to be full transparency about the monitoring of the Scheme and the results of the audit. We will require detailed evidence from the Treasury to show that these guarantees have had the effect intended, and that the scheme is operating in such a way that banks do not retain any benefit, as the Treasury intended.**

35. The stated aim of the NLGS is to decrease the price of loans to SMEs, and evidence we received suggested that most respondents did not expect the scheme to have a material effect on net lending. However, if the interest rate on a loan to a given SME is reduced by one percentage point this, other things being equal, will make that SME less risky. Therefore, if banks maintain their existing risk appetite towards lending to SMEs, the reduction in risk brought about by the NLGS will encourage them to increase lending.

36. **We remain concerned that while the Scheme should reduce the price of loans to some SMEs, and at the margin may increase the quantity of loans available to them, it was not designed to solve the problem that many SMEs who may be reasonable credit risks are unable to access bank funding at all in the current unusual market conditions. Access to finance for SMEs remains a significant problem. Whilst these exceptional market conditions continue, the Government should regularly publish its own estimate of the degree of dysfunctionality of the market, with proposals for remedy.**

37. The flow of credit to SMEs would be significantly increased by greater competition in the banking sector. **We urge the Government to give greater consideration to the promotion of competition in banking.**

60 Q 288

Non-bank lending

38. The Budget announced £200 million additional funding for the Business Finance Partnership (BFP) and a commitment to review and implement the recommendations of the industry review of non-bank lending chaired by Tim Breedon.[61]

The BFP aims to increase the supply of capital through non-bank lending channels and to help diversify the sources of finance available to businesses. The Government initially made available £1 billion to invest through these channels, which was increased to £1.2 billion in Budget 2012. The initial focus of the BFP is on co-investment with the private sector through loan funds that can lend to mid-sized businesses in the UK.[62]

The report *Boosting Finance Options for Business* was published on 16 March 2012 and contains a set of proposals put forward by a taskforce, chaired by Tim Breedon, CEO of Legal & General plc, to widen access to new and alternative sources of finance, particularly for SMEs.[63] The key recommendation of the report were:

- The creation of an alternative point of contact to the banks for information about raising finance. Industry to establish a kitemarked Business Finance Advice network;
- A single brand and delivery agency to increase awareness and enhance delivery of the government's range of SME finance programmes drawing on international examples;
- Opening up access to capital markets funding for smaller companies through the creation of a new aggregation agency to bundle SME loans. An in-depth feasibility study led by AFME [Association for Financial Markets in Europe] is the first step in this process. Programmes also to standardise and promote private placements, mezzanine and export finance, and encourage retail investment;
- Stimulation of the retail investor base for public bonds;
- Markets for innovative products including mezzanine finance and peer-to-peer lending to be considered for investment by the Government's Business Finance Partnership;
- Reinforcement of prompt payment, led by companies in the Government's supply chain. Support for greater use of invoice discounting to fund payment gaps, including use of electronic trading platforms;
- Encouragement for large businesses to utilise supply chain financing to invest in smaller suppliers, and
- Government and industry to review impact of international prudential regulation such as bank and insurance capital rules on the supply of SME finance.[64]

61 HM Treasury, *Budget 2012,* HC 1853 (Red Book), p 44

62 http://www.hm-treasury.gov.uk/bfp.htm

63 http://www.bis.gov.uk/businessfinance

64 http://www.bis.gov.uk/businessfinance

39. We asked witnesses for their views on some of these initiatives. Dr Larsen welcomed the BFP, saying:

> That is a worthwhile initiative. It is difficult to get scale in that, but enabling a system of financing that does not rely entirely on the banking system seems a very good idea. It will eventually enable a broader set of investors, including pension funds and insurance companies, to invest not just in SMEs, but in a broader range of assets on the infrastructure side rather than in Government bonds.[65]

He also noted the difficulty in increasing the size of these schemes so that they could become an alternative funding mechanism on any meaningful scale:

> The point is that the market does not exist. I think you could achieve scale eventually, but you have to have a group of investors that wants that kind of product and a group of corporates that is willing to go through the discipline that comes with the process. There is no doubt that market finance for businesses will be more expensive than bank finance was before the crisis. There is a chicken and egg problem: you need to establish a market—establish both demand and supply—and that is not easily done, certainly not in the current environment.[66]

40. In his evidence to us, the Chancellor highlighted the difficulty in trying to restart the market for securitised small business loans as suggested by the Breedon review, stating:

> Trying to restart the securitised market for small business lending is something that we are considering, but let's be clear: it completely shut because of the financial crisis. Securitised products were one of the main causes of the loss of confidence—people's lack of certainty about what was in them. Restarting it is not easy and I am not aware of any country that has successfully done this on a large scale since the crash. With small business lending, there is the particular challenge of people having enough information about the small businesses that are part of the package. Mortgages, at least, can be a bit more standardised. I am trying to crack that nut; it is a big challenge, but we are actively looking at it.[67]

41. **SMEs face serious and often insurmountable problems in obtaining bank lending at reasonable rates. Non-bank lending could be a solution for some SMEs, although the market for such loans seems relatively unresponsive to apparent demand. The Breedon review suggests that there are problems both with supply and demand for non-bank financing, including a lack of knowledge amongst SMEs about available sources of such financing. The Government's efforts to examine non-bank channels for funding businesses are very welcome, but we note there is much work still to be done to establish large scale alternatives to bank lending for most SMEs. We recommend that the Government continues to pursue creative solutions, including those suggested by**

65 Q 131

66 Q 132

67 Q 300

the Breedon review, to increase the level and availability of non-bank funding, and set out the results in detail in the Autumn Statement.

Export target

42. In his Budget statement, the Chancellor announced a new export target. He noted that "over the last decade our share of world exports shrank as Germany's grew. We sold more to Ireland than we did to Brazil, Russia, India and China put together". He argued that the UK's export performance "was the road to Britain's economic irrelevance" and said that the Government wanted "to double our nation's exports to £1 trillion this decade".[68] The Chancellor told us that the export target had been recommended by Lord Green, the Minister of State for Trade and Investment, who thought that it "would help lift the eyes of Government Departments to what more they could do to promote exports".[69]

43. Given that it is the balance of exports and imports (net trade), rather than exports alone, that contributes to economic growth, we asked the Chancellor why he had not chosen a net trade target. He replied "Because in the end we can have a more direct impact on the promotion of British exports. I think the net trade figure is more difficult for the Government to target."[70] He also confirmed that the export target was a nominal one.[71] **While a nominal export target may be of some use in concentrating minds within Government, GDP growth will only benefit if the UK's net trade position improves as well, and that will require imports to grow less quickly than exports. We are therefore sceptical about the value of an export target without examining the overall current balance and will further examine this issue in our inquiry into global imbalances.**

Forecasting the impact of the macroprudential tools

44. On 22 March 2012 the Governor of the Bank of England wrote to the Chancellor with the advice of the Bank's interim Financial Policy Committee (FPC) that the future statutory FPC should be given powers of direction over the following macroprudential tools:

- The countercyclical capital buffer;
- Sectoral capital requirements, and
- A leverage ratio.

45. Given the potential impact on the economy of the use of these tools, we asked the OBR how they intended to forecast the impact of the use of the tools. Professor Nickell outlined how the OBR might react to arrival of the FPC by providing the following example:

68 HC Deb, 21 March 2012, Col 797 [Commons Chamber]

69 Q 326

70 Q 327

71 Q 329

> I suppose that the way one might think about doing it is that if you constructed a forecast—this is ignoring the new committee—and you discovered in the context of that forecast that you had very rapid rises in house prices and rapid expansions in credit, we would probably say, “Ah, but that will not be allowed to happen”, because we suspect that the committee will intervene to restrict the rate of credit expansion, either by using capital requirements and/or direct regulation of things such as loan-to-value ratios. I can see that that would be how we might proceed on that score.[72]

He did note, however, that rapid credit growth was not a concern for the OBR at the moment. He stated that “In our current forecast, we do not have such a growth in credit that we feel that the new committee [FPC] will be intervening any time soon”.[73] Both Professor Nickell and Robert Chote emphasised that information from the FPC about how they would use the tools would be helpful in determining how the OBR’s forecasts would change.[74]

46. **The powers of direction to be granted to the statutory Financial Policy Committee of the Bank of England are likely to have a significant impact on the economy when used, and the possibility of their use will have to be taken into account in the forecasts of the Office for Budget Responsibility. We recommend that the FPC and the OBR work together as the macroprudential tools are developed to ensure that they are adequately reflected in the OBR’s forecasts. We will inquire into the new macroprudential tools. Among issues we will examine is whether they will be as effective in ameliorating downturns, as well as limiting upswings, in credit cycles.**

Monetary Policy

47. Monetary policy in the United Kingdom is currently exceptionally loose. The Bank of England’s Monetary Policy Committee (MPC) lowered the official Bank rate to 0.5 per cent in March 2009, and it has not been raised since.[75] In that same month, the MPC agreed to begin quantitative easing,[76] which by the time of the Budget 2012 had increased to £325 billion, an increase of £50 billion since the November 2011 forecast.[77] In his Budget statement, the Chancellor announced that:

> Inflation is expected to fall throughout the period, from 2.8 per cent this year to 1.9 per cent next year, and then 2 per cent by the end of the forecast period. I am today writing to the Governor of the Bank of England to reaffirm the consumer prices index inflation target of 2 per cent. The Government’s credible and responsible fiscal policy allows the independent central Bank to pursue an activist monetary policy

72 Q 40

73 Q 40

74 Qq 40, 42

75 Bank of England, http://www.bankofengland.co.uk/monetarypolicy/Documents/mpcvoting.xls

76 In the main, quantitative easing has been pursued by the purchase of gilts using newly created central bank reserves

77 Bank of England, http://www.bankofengland.co.uk/monetarypolicy/Documents/mpcvoting.xls

> consistent with targeting low inflation. I confirm that the asset purchase facility will remain in place for the coming year.[78]

The OBR's March 2012 *Economic and fiscal outlook* highlighted the importance of inflation falling, and the role of monetary policy in closing the output gap:

> An important anchoring assumption in our forecast is that monetary policy succeeds in bringing inflation back to target over the forecast horizon. Coupled with a view that domestic price pressures (well-represented by the output gap) are the most important driver of inflation in the medium term, this implies that monetary policy will act to close the output gap over time by stimulating or softening aggregate demand.[79]

Mr Chote emphasised to us that:

> The main policy driver remains the accommodative stance of monetary policy. You have had some change in market expectations of where interest rates would go and, implicitly within that, what will happen to QE, but the foot clearly remains firmly on the accelerator on that score. In terms of the policy support, that will be a key one.[80]

However, the OBR also noted in its *Economic and fiscal outlook* that there were limitations as to what monetary policy could achieve. It explained that its forecast of the size of the output gap meant "Economic activity remains around 0.5 per cent below potential in the final year of the forecast", and that this partly reflected "the limitations of what monetary policy can do to encourage the uptake of spare capacity".[81] It also said that "Whether the second and third rounds of quantitative easing will provide as much support to the real economy as the first remains a risk to our central forecast".[82]

48. In our hearing on the February 2012 Inflation Report, we explored with MPC members how effective the second and third rounds of quantitative easing (QE) would be. Dr Adam Posen, an external member of the MPC, told us that that "except for that additional fillip from panic response, which thankfully is not part of our programme now, I expect QE to be just as effective as it was."[83] He explained that the additional fillip was that "there is one major difference in QE now versus, say, in 2009, which is that we do not have the outright lock up and panic in the markets, and there is an added benefit, in the sense of being in a bad situation, that QE alleviates that problem and adds confidence".[84] The Governor of the Bank of England told us that what was needed now was "patience":

78 HC Deb (2010–12), 21 March 2012, Col 794

79 OBR, *Economic and fiscal outlook*, March 2012, Cm 8303, p 50, para 3.43

80 Q 15

81 OBR, *Economic and fiscal outlook*, March 2012, Cm 8303, p 8, para 1.21

82 OBR, *Economic and fiscal outlook*, March 2012, Cm 8303, p 50, para 3.44

83 Oral evidence to the Treasury select committee, Bank of England February 2012 Inflation Report, HC (2010–12) 1867, Q 1

84 Oral evidence to the Treasury select committee, Bank of England February 2012 Inflation Report, HC (2010–12) 1867, Q 1

> We have done the things that are necessary. We have to keep our eye on policy. We will adjust asset purchases in either direction as seems appropriate. Gradually I hope we will be able to raise interest rates back to a more normal level, as the economy recovers. But after a financial crisis of this kind, the main lesson of history is that, yes, you need to take quick action; you need to get hold of the banks and restructure them so that they can once again start to perform their normal function, but a large element of all of this is patience. It does take time to recover from a crisis of this kind.[85]

49. Dr Larsen told us that he thought "the strategy that is in place—the fiscal strategy, but also the monetary complement—overall makes a lot of sense, and it's certainly a strategy that has been understood in the market".[86] He also noted that "if you look at the OBR's forecast, it takes the full horizon to close the output gap; that would mean expansionary monetary policy for a very sustained period of time. So I think the notion that expansionary policy, monetary policy alone, can do this, is probably flawed".[87] Dr Hilliard seemed dubious about whether the further rounds of quantitative easing would be as effective as the first. He argued that:

> What I distinguish between QE1 and QE2 is that, when QE1 was launched, the world was a very, very dangerous and frightening place. The Bank of England embarked on QE not knowing what its impact would be, but having run out of conventional policy tools. What is a little troubling now is that we are seeing the Bank of England describe its continuing use of QE as a conventional tool, and that makes it rather too relaxed in using it. I do not think that the impact of QE2 will be as powerful as QE1. I know that that is not what the Bank of England believes. I do not see immediate inflation risks or anything like that, but there are distortions in the gilt market from doing that which should not be ignored.[88]

50. Mr Portes was clear regarding the consequences of the fiscal and monetary stance of the Government:

> When we talk about the output gap here, the OBR is basically talking about unemployment. So what we are saying is that we are allowing unemployment to remain much higher than the NAIRU and structural level for a very long period. We know that that does long-term social and economic damage and damages potential growth and output going forward. That is the case for doing something.[89]

51. **While the Government maintains the current tight fiscal profile, monetary policy will remain the main tool for stimulating demand in the economy. The Bank of England appears confident of the efficacy of continued quantitative easing, and the**

85 Oral evidence to the Treasury select committee, Bank of England February 2012 Inflation Report, HC (2010–12) 1867, Q 47

86 Q 113

87 Q 112

88 Q 138

89 Q 147

Governor urged patience. We note from the OBR forecasts that despite its current extremely accommodative stance, monetary policy alone will be unable to close the output gap over the forecast horizon, with long term consequences for the recovery. Bearing in mind the risks of unwinding, we will continue to monitor the impact of loose monetary policy and the effectiveness of quantitative easing in our hearings with the Monetary Policy Committee and the Financial Policy Committee. We will also continue to explore the effectiveness of loose monetary policy on the economic recovery.

The redistributive effects of monetary policy

52. The policy of extremely lax monetary policy has not been without criticism. Under this policy, savers receive a far lower return on their savings than under more normal conditions. Meanwhile the returns that new pensioners will receive on their annuities have also been badly affected. When the latest round of quantitative easing was announced in February 2012, the National Association of Pension Funds, while understanding the reasoning for further quantitative easing, stated that:

> People who are retiring now are finding that annuity rates have been squashed by QE, and that they will get a smaller pension than they expected. Retirees who get locked into a weak annuity will find that the Bank's money printing leaves them out of pocket for the rest of their lives.[90]

Saga Group has explained that even those that don't buy annuities, but rather enter into income draw-down pensions, would be affected by quantitative easing. They noted that if those retiring:

> decide not to buy the annuity but go into income drawdown instead, they will also be hit by QE because the amount of income they are allowed to take out of their pension fund is determined by the Government Actuary Department's (GAD) rates, which are themselves based on gilt yields. The more the Bank of England buys gilts, the lower gilt yields go which in turn means GAD rates fall and pension income has to be cut. Indeed, many people in income drawdown are now facing falls in their pension income due to the drawdown rules.[91]

53. We received several responses from MPC members when we raised these concerns with them. Mr Charlie Bean, Deputy Governor of the Bank of England (Monetary Policy), noted that:

> it might be useful to say a few words about the effect of asset purchase on pension funds, because a lot of the discussion tends to focus on one side of the story, the impact on annuity rates, and forgets the other side of the balance sheet, which is that, by design, asset purchases are supposed to drive up asset prices. That is why yields

90 National Association of Pension Funds, Pension funds react to latest bout of QE, Press release, 9 February 2012

91 Saga, SAGA IMPLORES BANK OF ENGLAND TO CONSIDER DAMAGING SIDE-EFFECTS OF ITS QE POLICY, Press release, Wednesday 8 February 2012

> fall. There is a tight mathematical link between the two. While annuity rates might have been driven down by our asset purchases, at the same time the value of holdings in pension funds, in gilts, equities and corporate bonds, will have been driven up. So that compensates for the decline in annuity values—at least if a pension fund is in rough balance; if a pension fund has a significant deficit then that deficit is obviously widened.[92]

Mr Paul Tucker, Deputy Governor of the Bank of England (Financial Stability), acknowledged that there were redistributive effects from the current position of monetary policy, but strongly argued that despite these redistributive effects, the MPC's decisions had been correct. He explained the consequences, as he saw them, of not running a lax monetary policy in the following stark terms:

> I want to lean against this "savers get hurt". [...] If we were not, and had not been, running an easing monetary policy for the last three years or so now, this economy would have been destroyed. Savers are investors in the future. Savers would be hugely worse off had we not been supporting demand in the economy. I know, of course, that we have pulled down the discount rate and the rate of interest paid on deposit accounts is low. I understand and have great sympathy for the effect of that on savers, because many of them did nothing to bring about this dreadful crisis, but I promise you they would be even worse off had we not supported demand to the extent that we have. So the distributional effects are important, but given the gravity of this crisis—excuse me if this is an unfortunate expression—they are second order to where we could have been. We could be in ruination and we are not there, because of the measures that have been taken, not only by our own central bank but other central banks around the world, and they dominate the distributional effects, I would say.[93]

These arguments were also echoed by the Chancellor when we asked him what the Government was doing to protect pensioners, and especially those on income drawdown.[94] Referring to the Governor of the Bank and Mr Bean, he stated that:

> Policies like quantitative easing have increased asset prices, including the value of pension pots. So there is a benefit, even to savers with pension pots, of asset price increases and it cannot be in the interests of anyone in this country that we have very high interest rates that throttle off any recovery and lead to higher unemployment.[95]

54. **Loose monetary policy, achieved through quantitative easing and low interest rates, has redistributional effects, particularly penalising savers, those with 'drawdown pensions' and those retiring now. The Bank of England has argued that some of those**

92 Oral evidence to the Treasury select committee, Bank of England February 2012 Inflation Report, HC (2010–12) 1867, Q 13

93 Oral evidence to the Treasury select committee, Bank of England February 2012 Inflation Report, HC (2010–12) 1867, Q 84

94 Qq 305–314

95 Q 308

effects may be mitigated by the increase in asset prices stimulated by quantitative easing. While the aggregate of savers and pensioners may have received some benefit from higher asset prices, there will be many individuals who will not have benefited. The Bank of England, after, where appropriate, consultation with the Treasury, should provide its estimate of the overall benefit and loss to pensioners and savers from quantitative easing. It should, in addition, estimate how that balance changes depending on when an annuity was purchased, using the following three dates: immediately before the start of the crisis five years ago; immediately after the introduction of quantitative easing; and now. We further recommend that the Bank of England, and particularly MPC members, improve upon their efforts to explain the benefits of the current position of monetary policy to those affected by the redistributive effects of quantitative easing.

55. **We recommend that the Government consider whether there are any measures that should be taken to mitigate the redistributional effects of quantitative easing, and if appropriate consult on them at the time of the Autumn Statement.**

Fiscal discipline and monetary policy activism

56. Given the Government's commitment to its current policy of fiscal discipline and monetary policy activism, we asked witnesses whether there should be changes to the mix of monetary and fiscal policy. A variety of views were expressed to us. Dr Larsen noted that:

> So the strength of fiscal consolidation, the commitment to that, combined with the fact that the Monetary Policy Committee can respond to a slowing economy by expanding monetary policy, is very well understood in the gilt market, and very widely appreciated among the people I meet in the international investor community. So I think that's absolutely essential.[96]

He warned that while "There is a very real question of whether you could have chosen a different path, where you had perhaps a little bit less fiscal tightening and perhaps a little bit less expansion of monetary policy", to his mind "that discussion was very relevant a year or two ago when that strategy was set out". At present, Dr Larsen concluded, "you wouldn't want to deviate from the current strategy".[97] Mr Portes disagreed with this position. He told us of Dr Larsen's position: "I call that the Macbeth argument for carrying on. You know the quote from Macbeth: we are so stepped in blood, we must carry on to reach the other side. My view is that you do not enhance credibility by sticking with a strategy that does not appear to be working."[98] However, Mr Bootle noted that:

> I have written, right from the beginning of this Government, that I thought that their plans were fiscally too tight. However, the idea that having set those plans out, you

96 Q 113

97 Q 113

98 Q 117; William Shakespeare, *Macbeth*, Act 3 Scene 4, "I am in blood / Stepped in so far that, should I wade no more, / Returning were as tedious as go o'er"

can now announce some massive splurge in public spending or tax reductions that would not have consequences in the market, I find really rather bizarre.[99]

57. Dr Hilliard provided us with the following description of how he viewed the current policy position, emphasising the importance of fiscal credibility, and the role of quantitative easing:

> I think, really, the lines between monetary and fiscal policy in this kind of world are very blurred, and in fact the credibility of fiscal policy is actually delivering a monetary policy impact. [...] we are getting very low gilt yields, which I think are a direct result not only of QE but also of the fiscal credibility, so that is giving us a low yield curve. That is lowering financing costs for all entities in the UK, so to that extent I think the two are a marriage; and I don't think any fine tuning of fiscal policy would make a great deal of difference. I think actually we have to become reconciled to a fairly slow growth path.[100]

However, Mr Portes strongly disagreed with this conclusion. While he acknowledged that quantitative easing was having "some depressive effect" on gilt yields, he argued that it was wrong to suggest that the extremely low level of gilt yields were due to fiscal credibility.[101] He argued:

> We have fiscal credibility. We have always had fiscal credibility in the sense that nobody thinks that the UK is not going to pay its debts over the medium to long term. Our analysis, which is pretty simple and which can be easily replicated by the Treasury or by Mr Hilliard, shows that the fall in gilt yields is primarily driven by economic weakness. It has tracked what has happened in the US. It mirrors movements in equity markets and the pound. The analytical evidence is pretty strong.[102]

Dr Hilliard, responding to Mr Portes' comments, told us that he agreed "in the general sense that expectation theories of the yield curve do drive it. If we saw high yields come through because of a general improvement in the economic background, the Bank of England would not react to that. It would applaud it".[103]

58. When we asked the Chancellor whether he was committed to closing the output gap, he replied:

> I am the first person who wants to reduce unemployment and youth unemployment. Of course, I want to close the output gap as well. I suspect—you can ask the Governor of the Bank—that he would not be running such a loose monetary policy if he thought that the output gap was closed. He is interesting on the challenges of

99 Q 117

100 Q 116

101 Q 117

102 Q 117

103 Q 138

> trying to calculate the output gap. Of course, we are in the recovery phase and what the OBR said this year and last autumn is that the impact of the financial crisis or financial crash, which, let's be clear, is on some measures the worst in British history, has had a real effect on the pace of recovery. Chuck in the external factors, such as the euro crisis at the back end of last year and the oil price, and those are additional headwinds. I can tell you that I am doing everything that I possibly can to speed up the recovery and ensure that the accomodative monetary policy can work for as long as possible. The idea that I am tolerating this is not true; I am doing everything I can to speed up the recovery.[104]

59. **Witnesses have expressed reasonable differences about the current mix of fiscal and monetary policy. There is also some concern that monetary policy is reaching the end of its effectiveness in accommodating the present tightness of fiscal policy. We will continue to monitor the Government's and the Bank of England's approach in this area.**

The output gap

60. The output gap is defined as the difference between the potential output of the economy and the actual level of activity within the economy. When the output gap is negative, there is less activity than potential. The output gap is unobservable since the potential output of the economy is unmeasurable. Yet the output gap is used as a primary tool in assessing the success of the fiscal policy. It is simply an estimate based on the judgement of economists and is inherently extremely imprecise. The size of the output gap determines how much of the fiscal deficit at any given time is cyclical and how much structural: in other words, how much will disappear automatically, as the recovery boosts revenues and reduces spending, and how much will be left when economic activity has returned to its full potential. The narrower the output gap, the larger the proportion of the deficit that is structural and the less room for manoeuvre the Government will have against its fiscal mandate, which is set in structural terms (see paragraph 75). The output gap can also be used to assist with the assessment of the potential for inflationary pressure on prices if demand cannot be met at a given level of capacity.

61. In its March 2012 *Economic and fiscal outlook*, the OBR estimated that the output gap was not as deep as it had thought in November 2011 (-2.5 per cent vs. -2.8 per cent of potential GDP). This followed a revision in November 2011 from -3.1 per cent to -2.6 per cent of GDP which was based on an assessment that there has been a persistent and significant slowdown in potential output growth following the financial crisis.[105] The OBR says that it reduced its estimate of potential output growth as a result of data released since November 2011.[106]

104 Q 287

105 Office for Budget Responsibility, *Economic and fiscal outlook*, March 2012, p 40,para 3.23

106 Office for Budget Responsibility, *Economic and fiscal outlook*, March 2012, p 40, para 3.24

62. Given that the fiscal mandate is based on a cyclically adjusted balance, the estimate of the output gap will be a source of uncertainty in measuring whether the fiscal mandate will be met. In its March 2012 *Economic and fiscal outlook* the OBR highlighted the implications of this uncertainty in measuring the output gap:

> The biggest risk to the achievement of the mandate is that we again need to revise down our estimates of future potential output. If the output gap was around ¾ per cent of potential GDP narrower or rather the level of potential output ¾ per cent lower, then in our central forecast the Government would no longer be on course to balance the cyclically adjusted current budget in 2016–17.[107]

Mr Chote also emphasised to us the difficulties in measuring the output gap and the range of alternative estimates that existed:

> It is an extremely hard thing to measure. There is enormous uncertainty about it. We take great care to report the range of views on the size of the output gap and the range of views on the evolution of potential.[...]we would be the first to say that it is an extremely difficult task, and it involves elements of art as well as science.[108] [...]

> The big difficulty with the output gap is that there is never a final correct answer to compare it to because it is not a directly measured variable. [...]If you look at the range of alternative estimates that we cite here, we are in line with the average at about 2.7 per cent for 2011. The range varies from -½ to -4 so that gives you some sense of the variability. [109]

63. Given the risk to the fiscal mandate from a change in the size of the output gap, we asked the panel of experts whether they believed the OBR's estimates of spare capacity. Dr Larsen responded:

> I think the OBR's estimate of the output gap is reasonable. I thought the change they made in November when they reduced the level of potential output – the rate at which the economy can grow substantially in the near term – was the right judgement. I am a little bit more sceptical than them about the return to a normal growth rate.[110]

Mr Portes, however, disagreed, stating:

> I think the OBR is being too pessimistic. It is relying too much on survey-based indicators of capacity utilisation. I do not think it is credible to say that firms have only less than half a per cent of spare capacity, within firms, I mean, given the current levels of employment, which is what the OBR's estimates are. It is essentially

107 Office for Budget Responsibility, *Economic and fiscal outlook*, March 2012, p15, para 1.41

108 Q1

109 Q2

110 Q112

> saying that firms, given their current levels of employment, are running pretty much at full capacity, and I find that quite difficult to believe.[111]

Mr Bootle, while also recognising the difficulties of estimating the output gap, considered where one should allow the margin of error to lie:

> I suspect that the OBR is seriously underestimating the size of the output gap. However, given that this is very uncertain, we need to ask ourselves what attitude should we take to uncertainty; where should we allow the margin of error to lie? That is to say, is there a sense in being too optimistic about the output gap? From the point of view of fiscal conservatism, it is probably the right thing to do—to run with an estimate of the output gap which is on the low side. I suspect that it is on the low side. If it is, the result will be that we will find that the economy can grow much further, much. faster and the fiscal position will come better earlier and more than we actually expected. [112]

64. In our Budget Report of 2011, we recognised the importance of the estimates of the output gap for assessments of the size of the structural deficit.[113] However, the OBR told us "that it was hard not to take some view implicitly or explicitly about the amount of spare capacity that there is at the moment and the growth rate of potential over that five year period".[114]

65. **The OBR relies heavily on the output gap in order to assess whether the Government is on course to meet its fiscal mandate. However, as an unobservable measure, the output gap is prone to great uncertainty and frequent revision. There is therefore a risk that there will be unwarranted changes in fiscal policy as a result of reliance on it. We recommend that the Treasury ask the OBR to evaluate other, supplementary, approaches.**

111 Q117

112 Q117

113 Tenth Report of Session 2010–12, para 32

114 Q 1

3 The Public Finances

Changes within the Budget

66. The overall fiscal impact of the policy decisions announced in the Budget was small. In the Red Book the Government stated:

> Budget 2012 policy decisions have a neutral impact on the public finances over the forecast period, with the costs of policy decisions offset by measures to reduce borrowing. As a result, all of the decrease in the OBR's forecast for public sector net borrowing will contribute towards deficit reduction.[115]

Taking into account the forestalling impact of the reduction in the additional rate of income tax and the cap on unlimited tax reliefs, the Government has estimated the impact of the policy measures in the Budget to be a £1.9 billion increase in spending compared to receipts in 2012–13. However, as the estimated impact of forestalling is then reversed, the Government forecasts an increase in receipts compared to spending from 2014–15 onwards.

Table 3: Summary of Budget policy decisions[116]

	£ million				
	2012–13	2013–14	2014–15	2015–16	2016–17
Total tax policy decisions	+560	-1,550	-520	-500	-30
Total spending policy decisions	-90	-160	+755	+960	+1,170
TOTAL POLICY DECISIONS	**+470**	**-1,710**	**+235**	**+460**	**+1,140**
Forestalling impact of additional rate reduction and cap on unlimited tax reliefs	-2,400	+760	+1,750	-370	0
TOTAL FISCAL IMPACT OF POLICY DECISIONS	**-1,930**	**-950**	**+1,985**	**+90**	**+1,140**

Costings represent the OBR's latest economic and fiscal determinants

67. Although the net revenue effect of the individual policy decisions in the Budget was limited, there were 56 new Budget policy decisions. The only two whose effect is more than £1 billion in 2016–17, the end of the five year period, are as follows:

- The increase in the personal allowance by £1,100 in 2013–14, with a proportion passed to higher rate tax payers (which costs £3.58 billion in 2016–17); and
- The freeze and restriction to existing recipients of the age-related allowance, from 6 April 2013 (which raises £1.25 billion in 2016–17).[117]

115 HM Treasury, *Budget 2012,* 21 March 2012, p 17

116 HM Treasury, *Budget 2012,* 21 March 2012, Table 1, p 7 and Table 2.1, p 50–51

These changes are discussed later in this Report (see pages 42 to 46).

Fiscal consolidation

68. By the end of 2011–12, approximately two-thirds of the fiscal consolidation to be achieved through tax will be in place, but only about 30 per cent of the reductions in spending planned for the Spending Review 2010 period.[118] Mr Carl Emmerson, Deputy Director of the IFS, made the point that the planned spending cuts represented "the longest sustained cuts to public service spending since the second world war—if they are delivered. [...] It is almost twice as big as the seven-year period of cuts delivered between 1975 and 1982 after economy-wide inflation".[119]

69. When asked whether the forecast spending totals would be met, Mr Paul Johnson, Director of the IFS, responded:

> They are going to be extremely tough to hit and it will take a significant amount of political capital to hit them. What was interesting about what we saw this year is that there have been some underspends in departmental budgets, despite the scale of the cuts intended through this year. In one sense, that is perhaps not that surprising given the political capital that would be lost if there were overspends. [...] In some sense, we have seen the slightly easier wins happening, but I certainly do not think that the public have got their head round the fact that the large majority of the cuts are still to come. The numbers that you quote—the 30 per cent already done—are off a baseline of assuming that real freezes is a reasonable baseline. It will feel tighter than that, because the normal baseline is to move up in line with the economy.[120]

Additionally, in the IFS post-Budget briefing, Mr Johnson noted that the Chancellor is:

> [...] only meeting his borrowing forecast this year because a £5 billion undershoot in tax receipts is, despite the scale of the planned cuts, slightly more than offset by a £6 billion underspend—£5 billion of that by government departments.[121]

On the Government's underspend the OBR explained:

> We expect £6.2 billion less expenditure than we forecast in November, thanks largely to central government departments under-spending against plans by more than expected[122].

70. **The Government has made progress in its fiscal consolidation. However, it has only met its forecast for this year owing to a £6 billion underspend, and the main challenges of the public sector spending consolidation still lie ahead.**

117 HM Treasury, *Budget 2012,* 21 March 2012, Table 2.1, p 50

118 HM Treasury, *Budget 2012,* 21 March 2012, p 19

119 Q 166

120 Q 163

121 Institute for Fiscal Studies, *Post-budget briefing 2012,* March 2012

122 Office for Budget Responsibility, *Economic and fiscal outlook*, March 2012, p 151

71. The Treasury will be responsible for achieving the Government's fiscal policy and the required spending consolidation. We note the findings of the recent review of the Treasury's response to the financial crisis regarding the organisational challenges it faces.[123] We will monitor how the Treasury addresses the concerns raised about staff turnover, pay and cultural barriers within the organisation.

Additional reductions in spending on welfare

72. As part of the Budget the Government published an analysis showing that if the reductions in departmental expenditure carry on at the same rate in the next spending review period there will need to be an extra £10 billion reduction in welfare expenditure by 2016–17.[124] Mr Emmerson told us that:

> The most significant number in the Budget was the £10 billion welfare cut. It is not a new policy, but it is the Chancellor now starting to point out the trade-offs between public service spending and welfare spending in the next Parliament if he is to get his public spending plans kept to.[125]

He also explained that:

> To give some figures on that, the £10 billion is in 2016–17 prices, so in today's terms, it will feel more like £8 billion. If you do not want to cut departmental spending or central Government spending on public services in the next Parliament, it is not £8 billion that you need; you would need £20 billion from welfare. If you do not want to cut welfare, then instead of cutting departmental spending at 2.3 per cent a year—the current rate of cut after economy-wide inflation—you would have to cut it by 3.8 per cent a year on average. To keep to Mr Osborne's total spending limits, those are the kind of constraints that we will be operating within the first two years of the next Parliament.[126]

73. The Chancellor made clear that these savings would come from annually managed expenditure in the next spending review period and that the Government has just started working on this. He stated:

> I hope to provide an update on this at the autumn statement. This is the work for the next spending review. We need to start the big thinking on future welfare reform, having undertaken very significant welfare reform with the Welfare Reform Act that has just become law, and the introduction of universal credit. I am saying that the job is not done. It is right that Parliament and the public, and not just Whitehall, focus on this issue.[127]

123 HM Treasury, *Review of HM Treasury's management response to the financial crisis*, March 2012

124 HM Treasury, *Budget 2012,* 21 March 2012, Annex A

125 Q 190

126 Q 164

127 Q 325

74. **In the next spending review period the Government will need, on current forecasts, to find significant further reductions in expenditure. We look forward to the Chancellor's update in the Autumn Statement.**

Performance against the Government's fiscal targets

75. The OBR's *Economic and fiscal outlook* sets out the Government's medium term fiscal mandate and supplementary target as:

- To balance the cyclically-adjusted current budget by the end of a rolling, five-year period, which is now 2016–17, and
- To see public sector net debt falling as a share of GDP in 2015–16.[128]

76. The Office for Budget Responsibility is currently forecasting that the Government will meet both of these targets:

> Our latest forecasts suggest that the Government has a greater than 50 per cent chance of hitting both targets. The margin for error against the fiscal mandate would have been very slightly smaller than in November in the absence of any Budget measures, but is unchanged when they are included. The margin for error against the supplementary target is unchanged, both including and excluding the impact of Budget measures.[129]

77. We asked whether the Chancellor could claim he has met his target if we experience a sluggish and long-term recovery. Mr Parker, from the OBR, responded that "He could say that he has met the fiscal mandate. Whether he meets the secondary target of debt falling is another matter."[130]

78. **The OBR suggests that the Government is on course to meet its fiscal mandate and supplementary target. There is little margin for error. The achievement of the fiscal mandate is dependent on measurement of the output gap. We have already expressed our concerns about the output gap as a measure (See para 65).**

128 Office for Budget Responsibility, *Economic and fiscal outlook*, March 2012, p 163

129 Office for Budget Responsibility, *Economic and fiscal outlook*, March 2012, p 163

130 Q 20

4 Principles of Tax Policy

Introduction

79. In March 2011, we published a Report *Principles of Tax Policy* in which we set out six principles with which tax policy should comply. These are:

- Basic fairness;
- Supporting growth and encouraging competition;
- Certainty, including simplicity;
- Stability;
- Practicality, and
- Coherence. [131]

In his Budget speech, the Chancellor said:

> Two hundred years ago, Adam Smith set out the four principles of good taxation– and they remain good principles today. Taxes should be simple, predictable, support work, and they should be fair.[132]

We note the similarity between these principles and those set out in our Report.

80. We have asked professional bodies to assess how far the main tax principles contained in the Finance Bill comply with these principles, and these are contained in Appendices 1, 2 and 3. We therefore do not carry out this exercise in the body of this Report, but make some general observations below.

Simplification

81. Good tax policy should provide certainty, one element of which is that it is simple.[133] The Red Book states that "The Government will [...] make the tax system simpler and more sustainable overall".[134] The assessment by Mr John Whiting, Director of Tax Policy at the Chartered Institute of Taxation (CIOT), of the simplification of the tax system in the last two years was that:

> It is good in parts. It has got simpler where there has been good consultation and things have evolved carefully. Even if we end up with extensive legislation, it has been

131 Treasury Committee, Eighth Report of Session 2010–12, Principles of Tax Policy, HC 753

132 HC Deb, 21 March 2012, col 806 [Commons Chamber]

133 Treasury Committee, Eighth Report of Session 2010–12, Principles of Tax Policy, HC 753, p 28

134 HM Treasury, Budget 2012, HC 1853, March 2012, p 27

knocked into shape and well thought through both in terms of policy and the exact wording. It is less good where consultation is not followed.[135]

On the overall task of simplification, he said:

I can only quote a figure that I suspect I quoted to you last year, which was 100 versus 382, which is 100 pages of legislation chopped out by the OTS last year and 382 pages of new legislation brought in, so we are probably losing, but not by so much.[136]

82. Despite the Government's commitment to simplification, the Budget contained some measures that add to the complexity of the tax system. For example, Paul Johnson told us that "The way that child benefit is now going to be taxed back, ... creates quite a lot of complexity in the system".[137] The method of clawback proposed is similar to the method previously used to claw back age related allowances, which the Chancellor stated were abolished as a simplification measure.[138] Mr Johnson also told us that another way in which the system was becoming more complex was:

That we now have a hotch-potch of different ways of indexing bits of the tax system. The allowances and so on are, by default, increased in line with prices, but the £150,000 [threshold for becoming an additional rate taxpayer] is not increased at all. Within the [National Insurance] system, we even have this odd situation in which employer NI thresholds are increased by the RPI, but employee ones by the CPI. The combination of different ways of indexing is becoming less rather than more sensible.[139]

83. One of the measures the Government states will create a "simpler and more sustainable tax system"[140] is:

A new Personal Tax Statement for around 20 million taxpayers. This will detail the income tax and National Insurance contributions (NICs) they have paid, their average tax rates, and how this contributes to public spending.[141]

Mr Whiting welcomed this announcement, and said it:

Will encourage people to engage more in the tax system. I think that it is an admirable idea and an admirable aim, because [...] people do not engage enough with the tax system. They are just automatically put off. If a brown envelope arrives, the tendency is to put it behind the clock or whatever, or just bin it and hope it goes

135 Q 197

136 Q 198

137 Q 160

138 HC Deb, 21 March 2012, col 801 [Commons Chamber]

139 Q194

140 HM Treasury, Budget 2012, HC 1853, March 2012, p 27

141 HM Treasury, Budget 2012, HC 1853, March 2012, p 4

> away. [...] There is a lot of design work to be done on these statements, but I think that the objective is to be wholly supported.[142]

84. **We note the welcome given by the Director of the Office of Tax Simplification. Personal tax statements have the potential to provide some additional transparency for taxpayers. They should explain what they pay in tax and how it is spent. They will need fairly to describe Government spending. We recommend that the Treasury consult the OBR on their design.**

Retrospective tax measures

85. We note that the Budget contains a number of measures which apply retrospectively. Amongst four[143] measures that can or will apply retrospectively is an anti-avoidance scheme which "amend[s] the corporation tax rules on loan relationships held between connected companies".[144] This measure was introduced in response to a specific avoidance scheme being carried out by a particular taxpayer.[145] The Chancellor also announced a consultation on a general anti-avoidance rule and said that this would be "legislated for in next year's Finance Bill".[146]

86. The Chancellor said in his Budget Statement regarding new stamp duty measures:

> Let me make this absolutely clear to people. If you buy a property in Britain that is used for residential purposes, we will expect stamp duty to be paid. This is the clear intention of Parliament. I will not hesitate to move swiftly, without notice and retrospectively if inappropriate ways around these new rules are found".[147]

We recommend that the Government clarify what retrospection is proposed with regard to stamp duty.

87. Speaking more generally, John Whiting told us that:

> I do worry about retrospection. It has great potential to do damage to the image and reputation of the UK's tax system. It damages it because it takes away some of the reputation for stability, certainty and fairness, which in many ways are the cornerstones of our system.[148]

He added that:

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142 Q 234

143 HM Treasury, Budget 2012, paras 2.78, 2.156, 2.170, 2.201

144 HM Treasury, Budget 2012, HC 1853, March 2012, page 76

145 HC Deb, 27 February 2012, col 5WS [Commons written ministerial statement]

146 HC Deb, 21 March 2012, col 804 [Commons Chamber]

147 HC Deb, 21 March 2012, col 804 [Commons Chamber]

148 Q199

> It is possibly a solution for some lazy drafting of legislation, because you could in extremis get to the stage of, "Well, it doesn't really matter what the legislation is, because we can always correct it later, and correct it retrospectively."[149]

He further said that:

> You can never rule out retrospection completely, but it really is not something that you want to waive regularly. We at the Chartered Institute of Taxation put up a paper about 18 months ago as part of the tax policy-making discussion, suggesting it was time to really tackle this issue of retrospection and when, if at all, it would be used. It would be good to take that forward and bottom out why it is thought to be necessary, and when, because it really ought to be in a very tightly controlled box to avoid scaring things.[150]

88. Retrospective tax legislation conflicts with the principles of tax policy recommended by this Committee and with those laid down by the Chancellor. We therefore have serious reservations about retrospection in the tax system. It may make the task of improving the quality of legislation even more difficult.

89. **We recommend that the Government restrict its use of retrospective legislation to wholly exceptional circumstances, which should be narrow and clearly-defined. The Treasury should set these out as soon as possible for consultation, along with an explanation of how gradual further extension of retrospection can be prevented. Any future retrospective tax measure must be justified against the agreed criteria: such justification must include clear explanatory statements to Parliament by the responsible Minister and should invite views from relevant professional bodies.**

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[149] Q200

[150] Q199

5 Taxation

Additional rate of income tax

Introduction

90. The introduction of a temporary additional rate of tax of 50 per cent for earnings above £150,000 was announced by the previous government in 2009[151] and implemented by the current Government the following year.[152] HMRC estimates that in 2011 the number of people subject to the additional rate was around 250,000.[153] The 2012 Budget states that "To improve competitiveness, encourage entrepreneurship and support growth, the Government will reduce the top rate of tax from 50 per cent to 45 per cent from April 2013".[154] The Chancellor told us in evidence that this rate did not have the same temporary status that the 50p rate had had, saying "The 50p rate was assigned a special status by my predecessor, and by me, of being temporary. I do not assign a special status to the 45p rate".[155] He added that all tax rates were kept "under review".[156]

Exchequer effect of the 50 per cent tax rate

91. HMRC produced a study published alongside the Budget entitled *The Exchequer effect of the 50 per cent additional rate of income tax.*[157] HMRC states that the study "provides the first comprehensive ex-post assessment of the additional rate yield using a range of evidence including the 2010–11 Self Assessment returns".[158] The study finds that "the underlying yield from the additional rate is much lower than originally forecast (yielding around £1 billion or less)",[159] whereas it "was expected to yield around £2.5 billion".[160]

92. The HMRC study considers the impact of two separate types of response to the rate change: forestalling, meaning that income was moved into the 2009–10 tax year from future years to avoid paying the 50p rate, and other underlying behavioural responses (for example working fewer hours, migration and tax avoidance).[161] The study concludes that

151 HC Deb 22 April 2009 c244

152 HC 61 June 2010 p 32 (para 1.97)

153 HMRC, The Exchequer effect of the 50 per cent additional rate of income tax, p 30, table 5.3

154 HM Treasury, Budget 2012, HC 1853, p 32

155 Q 339

156 Q 339

157 HMRC, *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012

158 HMRC, *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012, p 2

159 HMRC, *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012, p 46

160 HMRC, *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012, p 2

161 HMRC, *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012, p 38; [ref] for the three e.g.s of underlying responses.

both forestalling and other behavioural responses reduced the incomes subject to income tax of those taxpayers subject to the additional rate.[162]

93. While expressing caution over the uncertainty surrounding HMRC's work on the behavioural response to the change in the top rate of tax, the IFS supported HMRC's findings. Mr Johnson said that more weight could be placed on the findings than it might at first appear because "they are actually pretty much in line with what previous studies here and elsewhere have got."[163]

Cost of reducing the additional rate

94. Using the conclusions drawn by HMRC about the behavioural response of taxpayers to the 50p rate, the Treasury produced an estimate that reducing the rate to 45p would cost the Exchequer £50 million in 2013–14, £100 million in 2014–15 and 2015–16, and £110m in 2016–17.[164] Work on this costing is in Annex A of HMRC's report.[165] The Chancellor told us that:

> The HMRC report is the HMRC's report, and Annex A is the Treasury's—not the HMRC's—costing. I did not ask the HMRC to tell me what the cost of cutting is. The report is not about the cost of cutting from 50p to 45p. This is the Exchequer effect of the 50 per cent additional rate of income tax. From this work, I then derived a costing of a Budget policy measure, which was to cut from 50p to 45p.[166]

95. The Chancellor placed considerable emphasis on the OBR's approval of the Treasury's costing of the reduction in the additional rate. He told us that:

> The OBR described it as a reasonable and central estimate. First, this was work done by the HMRC, and the OBR looked at it and came up with this being the central and reasonable estimate, which is what you would ascribe to any of the costings in this document. There is no special status ascribed to the costing of the 50p measure compared with any other measure in the Budget.[167]

This emphasis is not entirely borne out by the OBR. Mr Chote said that it was a "heroic exercise to try to disentangle" the forestalling effects and other behavioural responses to tax rate changes.[168] The OBR also listed the costing of this policy as one of six it highlighted as "areas of particular uncertainty".[169] The OBR states that:

162 HMRC, *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012, p 39 (table 5.2)

163 Q 171

164 HM Treasury, Budget 2012, HC 1853, p 50

165 HMRC, *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012, p 48

166 Q 366

167 Q 342; See also Q 335, Q 363 and Q 367.

168 Q 88

169 HM Treasury, Budget 2012 policy costings, March 2012

> The estimate of the impact of this policy is based on the evaluation by HMRC of the revenue raised by the 50 per cent additional rate. As the HMRC report emphasises, the results of this evaluation are highly uncertain.

96. The IFS also highlighted some uncertainty surrounding the costing of this policy.[170] Mr Johnson told us that:

> The real issue is: does it look from what it has done that [the Treasury's] central estimate is broadly sensible? Probably, yes, but [...] it is incredibly uncertain, to the extent that we think that its estimate suggests there is only a two-thirds probability that a revenue-maximising rate lies between 30 per cent and 75 per cent. Those numbers are absurd in some sense, but that gives you a sense of the level of numbers of assumption and uncertainty that underlie what [the Treasury] has done.[171]

A particular area of uncertainty highlighted was:

> That there may be some significant asymmetry, in the sense that if you have, because of the 50p tax rate, invested in avoidance schemes, it is not clear you will just unwind them as soon as it goes.[172]

97. **The cost and benefits of reducing the additional tax rate to 45p are both highly uncertain, and could be significantly more or less than the cost included in the Budget. We recommend that HMRC publish in due course a comprehensive assessment of the effect on the Exchequer of the new 45p rate.**

98. We note with interest that the Chancellor has initiated a process to "start undertaking some real research into dynamic scoring and what the broader-economy effects are of changes to taxation."[173] Dynamic scoring takes account of the wider economic effects of a tax change and how those effects affect tax revenues. **The introduction of dynamic scoring could have a significant impact on tax policy decisions and we will monitor its progress.**

Age-related allowances

99. In the Red Book the Government announced that it will:

> Move towards a simpler, single personal allowance regardless of age by freezing existing age-related allowances (ARAs) from 6 April 2013 at their 2012–13 levels (£10,500 for those born between 6 April 1938 and 5 April 1948, and £10,660 for those born before 6 April 1938) until they align with the personal allowance. From April 2013, ARAs will no longer be available, except to those born on or before 5 April 1948. The higher ARA will only be available to those born on or before 5 April

170 Q 195

171 Q 171

172 Q 174

173 Q 338

1938. These changes will simplify the system and reduce the number of pensioners in Self Assessment.[174]

100. Although described as a simplification, the phasing out of age related allowances also represents a revenue increase to the Government of £360 million in 2013–14, rising to £1,250m in 2016–17.[175] The Chancellor argued:

> That is a significant saving. We are doing this in a way that will simplify the tax system. The National Audit Office and the Office for Tax Simplification both pointed to the complexity of the system. We are doing it in a way in which there are no cash losers—people have their allowances frozen—and we are also not handing out new allowances next year. But we are also doing it at a time, and this was very much part of our thinking, when we are rapidly increasing the personal allowance so that, in a few years, everyone can be on a single personal allowance. When you have a bit of the tax system that is identified as complex and there is an approach that you can take that deals with that, it is worth looking at.[176]

Mr Whiting, who is also Tax Director of the Office of Tax Simplification (OTS), acknowledged that the removal of age-related allowances was something that the OTS was looking at, but stated that it had not yet made a recommendation:

> I was surprised that it was taken forward so quickly, yes. The context is that we undertook to do a two-stage review of pensioner taxation. The first would document the problems and codify all the problems. Hardly surprisingly, the complexities around age allowances were raised by some people in virtually every group that we talked to the length and breadth of the land—difficulties in making sure that the right amounts were given, coding problems and all those sorts of issues. Hardly surprisingly, it comes through as a source of complexity. Having logged it, we listed a number of ways in which it might be worth considering how you might tackle the complexity. Unsurprisingly, getting rid of age allowances is in the list. Stage two was to go ahead and look at them and try to work out what might be the best way forward. We would have to do that within our remit of being broadly revenue-neutral.[177]

101. Mr Johnson criticised the lack of time between the announcement and the implementation of the policy. He pointed out that if it had delayed implementation by a year, the Government would have given people more time to plan for the changes, and, owing to the fact that the personal allowance was due to increase again in the following year, the financial impact on those just retiring would be reduced:

> I think there are problems in the way that this was announced, particularly coming in so quickly without giving people much of a chance to plan. To get a sense of the

174 HM Treasury, *Budget 2012,* 21 March 2012, p 4

175 HM Treasury, *Budget 2012*, 21 March 2012, Table 2.1, p 50

176 Q 346

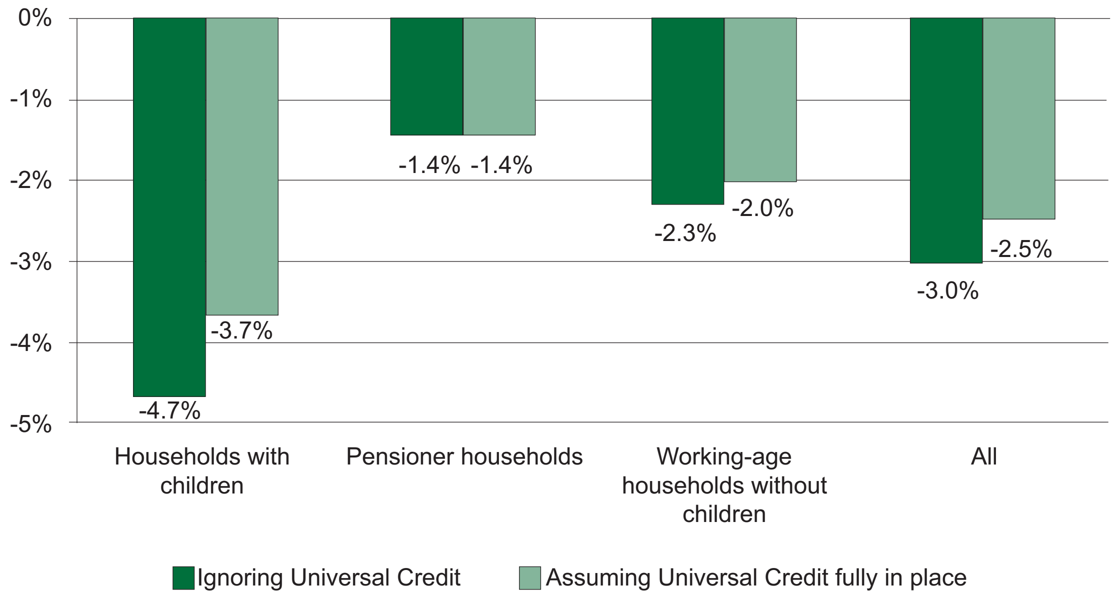
177 Q 232

> scale here, the group most affected will be those who are retiring next year because they will not gain the expected benefit of it immediately. We think the maximum loss, which is quite significant for that group, might be up to £300 a year. If you are on a relatively modest income, that is quite significant. For all the other groups the loss is only the loss relative to what would have been indexation and the losses there are much smaller.[178]

102. The IFS submitted written evidence to the Committee estimating what difference delaying the implementation of this policy would have had on the group of people turning 65 and retiring in the following year. This showed that, based on the assumption that the Government will increase the personal allowance to £10,000 in 2014–15, the loss to those retiring in that year would reduce from £323 to £214.[179]

103. The IFS's overall view of the measure in its post-Budget briefing was that "despite this morning's headlines, this looks like a relatively modest tax increase on a group hitherto well sheltered from tax and benefit changes".[180] The IFS submitted evidence to the Committee showing that, of the main types of households it identified, pensioners had been the least affected by the tax and benefit changes implemented by the current Government (Chart 1), that pensioners had benefited the most from the distributional impact of tax and benefit changes since 1997–98 (Chart 2) and how median pensioner incomes have risen since 1961 (Chart 3).

Chart 1: Distributional impact of tax and benefit changes implemented by current government up to and including April 2014, by household type[181]



Notes: Income measured at household level before housing costs have been deducted.

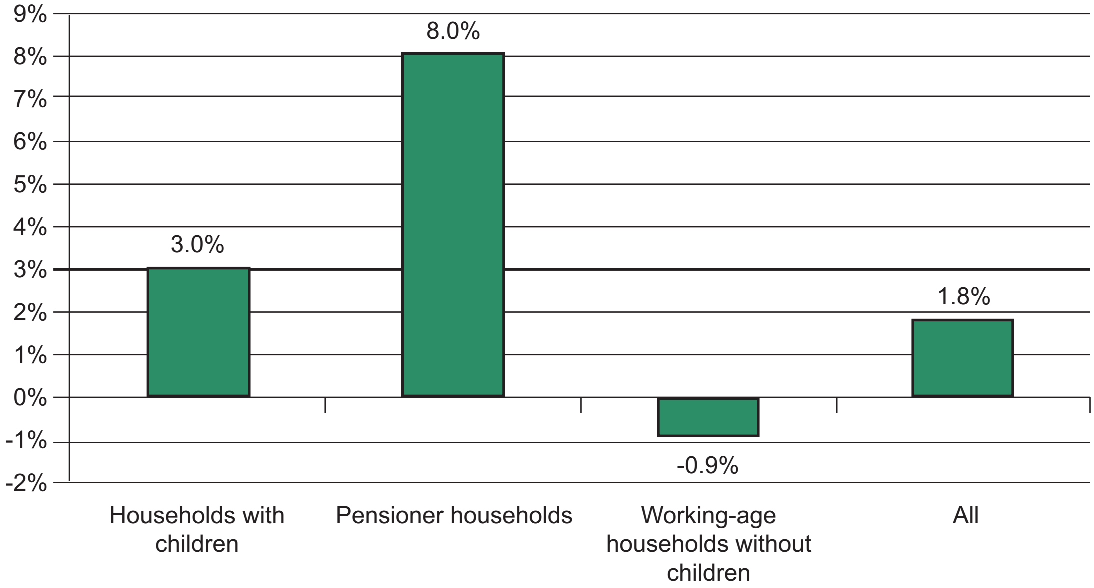
178 Q 180

179 Ev 65–66

180 Institute for Fiscal Studies, *Post-budget briefing 2012,* March 2012

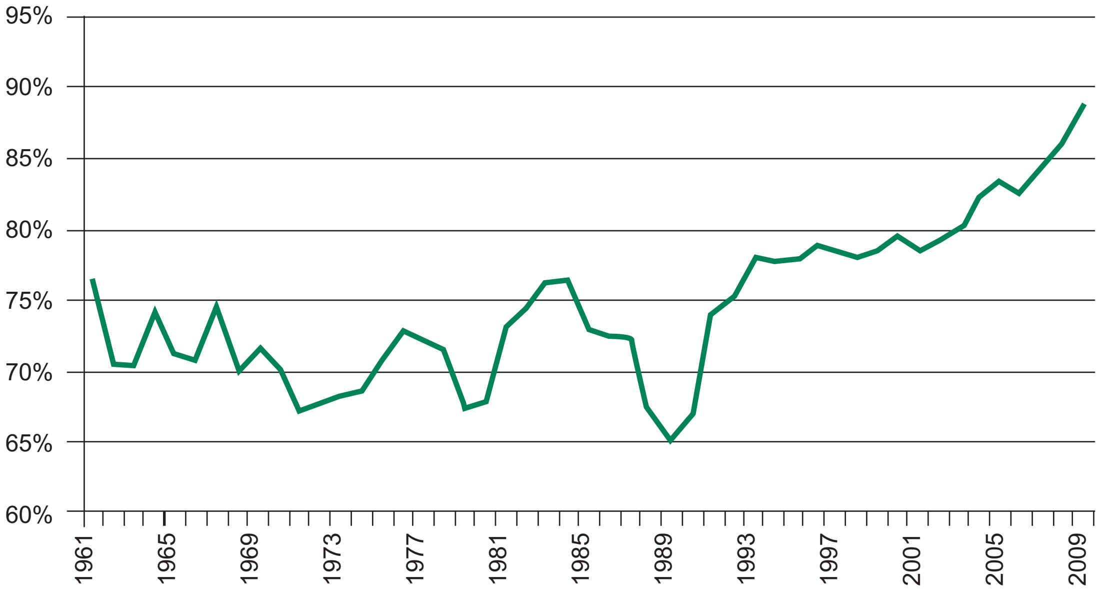
181 Ev 66

Chart 2: Distributional impact of tax and benefit changes introduced between 1997–98 and 2010–11, by household type[182]



Notes: Income measured at household level before housing costs have been deducted.
Source: J.browne and D.Phillips, 'Tax and benefit reforms under labour', IFS Briefing Note 88 (http://www.ifs.org.uk/publications/4807).

Chart 3: Median pensioner income % of overall median income since 1961[183]



Notes: Income measured at household level before housing costs have been deducted, adjusted for household size using modified-OECD equivalence scale. Years are calendar years until 1993 and financial years thereafter.
Source: Family Expenditure Survey and Family Resources Survey, various years.

104. Ms Gillian Guy, Chief Executive of Citizens Advice, however, emphasised the need to look at the cumulative impact of all increases in costs of living on pensioners. She highlighted that:

182 Ev 67

183 Ev 67

> Fuel prices continue to rise, and that is a key worry; 43 per cent of the people who come to us are worried that they will not be able to meet their fuel bills. We have examples of people coming into our bureaux who do not heat their homes because they are worried about not being able to afford it.[184]

105. We note that having taken the exemplary step of setting up the Office of Tax Simplification the Government took the decision to phase out age related allowances whilst aware that the matter was receiving detailed examination by that body. We hope that in future the Government will take proper recognition of the work of the OTS.

Higher-rate threshold and personal allowance

106. The Government has a clearly stated objective to move towards a system where the first £10,000 of income is free from income tax.[185] In the Red Book the Government announced that:

> The Government will increase the personal allowance by a further £1,100 in April 2013, taking it to £9,205 in total. The basic rate limit will be reduced, from £34,370 to £32,245 in 2013–14, so most higher rate taxpayers will get one quarter of the benefit a typical basic rate taxpayer will receive. This will affect those earning more than £41,450. Rather than pass on the full benefit of the personal allowance to higher rate taxpayers, an equivalent amount of funding will be provided to assist in the fair implementation of Child Benefit reform. The personal allowance increase will provide a real terms gain of £170 to most basic rate taxpayers and £42.50 to most higher rate taxpayers in 2013–14. It will benefit an estimated 23.6 million individuals and lift an additional 840,000 people out of income tax altogether.[186]

107. The net effect of these measures is to reduce government revenue by £3,320 million in 2013–14, rising to £3,580 million in 2016–17.[187] However, the Government has not disaggregated the total cost of the increase in the personal allowance from the increased tax take from lowering the higher rate threshold. Moreover, the Government has not made an estimate of the number of people who will be brought into the higher rate tax rate by this change, which the IFS has estimated to be 325,000.[188]

108. **The Red Book conflates the revenue impact of the increased personal allowance and the reduction in the higher rate threshold. We recommend that, as a matter of principle, the Government set out separately in future Red Books the revenue effect of each tax decision.**

184 Q 229

185 HM Government, *The Coalition: our programme for government*, June 2010, p 30

186 HM Treasury, *Budget 2012,* 21 March 2012, p 29

187 HM Treasury, *Budget 2012*, 21 March 2012, Table 2.1, p 50

188 Institute for Fiscal Studies, *Post-budget briefing 2012,* March 2012

Child Benefit Policy

109. In the 2010 Spending Review, the Government announced that it would withdraw Child Benefit through the tax system for households with a higher rate taxpayer from January 2013.[189] This proposal attracted criticism owing to the fact that it:

- presented a cliff-edge at the higher rate threshold where an increase in salary could lead to a decrease in income as the benefit was withdrawn, and
- meant that Child Benefit entitlement would depend only on the income of the higher-income person in the family. This led to the situation where a family with two incomes of £40,000 and therefore a joint income of £80,000 would receive the full benefit but a family with one income earning £45,000 would not receive the benefit at all.[190]

110. When announcing the changes to Child Benefit the Chancellor acknowledged that they were "tough". The Government defended the measures: "Is this going to cause some people some pain? Yes, it is, but what alternative is there for the United Kingdom to rescue itself?"[191]

111. In the Red Book the Government amended its proposal so that:

- Child Benefit will be withdrawn through an income tax charge, and that the charge will only apply to households where someone has an income over £50,000 a year, and
- for households where someone has an income between £50,000 and £60,000 the charge will apply gradually, preventing a cliff edge effect. Only households where someone has an income in excess of £60,000 a year will no longer gain from Child Benefit.[192]

112. Witnesses welcomed the amendments but stated that the policy still had problems.[193] The Government has amended its policy to remove the cliff-edge problem but has not removed the bias against single-earner households being punished relative to two-earner households. Mr Emmerson said:

> In terms of how individuals lose their child benefit as their incomes rise there is now no cliff edge. It is not the case that people will find themselves worse off after getting a pay rise, which would have been true for some individuals under the original system. It is now the case, as long as you have fewer than eight children, that you will not face an effective withdrawal rate of over 100 per cent. So they have dealt with that problem. The other problem that people identified with the initial proposal was that one-earner households could be punished relative to two-earner households. You

189 HM Treasury, *Spending Review 2010,* October 2010, p 8

190 Institute for Fiscal Studies, *Post-budget briefing 2012,* March 2012

191 Daily Telegraph, *George Osborne to take another bite out of Child Benefit,* 7 October 2010, www.telegraph.co.uk

192 HM Treasury, *Budget 2012,* 21 March 2012, p 30

193 Q 176, 221

> might not think that that is fair. Clearly there is still an issue, and people who were concerned about that before may well still be concerned about it.[194]

113. The policy, and the amendments made in the Red Book, have also added to the administrative burden of Child Benefit. HMRC has estimated that 500,000 more people will have to do self-assessment forms because of the child benefit changes, and that it will cost £100 million in staff over five years and £8 million in IT spending.[195] Mr Whiting made the point that:

> The administrative load must not be underestimated. There is a big need for proper and careful communication, and for making sure that people do not get the wrong message about things such as having to give it up, or not staying on the register in case they lose their job. It is all an extra problem.[196]

The Chancellor confirmed that the HMRC would not receive extra funding to cope with these administrative costs, or other measures set out in the Budget such as the extra costs associated with the changes to age-related allowances.[197] HMRC will in fact be reducing the number of staff it employs from 64,000 now to 54,000 in 2015.[198] The Chancellor defended the extra administrative costs associated with the changes to Child Benefit, saying that:

> Once you accept the premise—of course, there are some people who don't accept the premise—and take the decision to remove child benefit payments from better-off families, and we are talking here about the top 10 per cent of families by income, you then have to consider how best to do it. The alternative implied by your question would put 7 million or 8 million people into some form of household means test requiring a complicated form.[199]

114. Another issue with the changes to Child Benefit is that one person's income, in the form of a benefit, may need to be declared on their partner's tax return. We asked whether this represented "a step backwards for women's financial emancipation". Mr Whiting responded that "the point is very well made". [200] He also noted that:

> We have a very uneasy meeting of benefits, which tend to be on a family unit because tax credits are like that, with a tax system that is independent taxation. I do not think that division has ever really been tackled since tax credits were in force. The moves on child benefit erode that independent taxation even more.[201]

194 Q 176

195 HMRC, *Child Benefit: Income Tax Charge for Those on Higher Incomes,* 21 March 2012

196 Q 226

197 Q 374-5

198 HMRC Delivering Our Vision: Business Plan 2012-15

199 Q 331

200 Q 227

201 Q 227

115. **We recognise that the Government needs to take difficult decisions to tackle the budget deficit. Nonetheless, the Government's latest proposals for reform of Child Benefit solve only one of the two main problems identified with its original policy. They add further complexity. We will review the effect of the changes on HMRC, where further staff reductions are being implemented, in our regular hearings with it.**

VAT

116. Amongst a range of proposed amendments to indirect tax law is that "VAT will also apply, to the extent that it does not already do so, to the sale of hot food".[202] The specific change proposed is that:

> The current test for "hot takeaway food" which is based on the purposes for which food is heated becomes a simpler and more objective test based on whether the food is above ambient air temperature at the time it is provided to the customer.[203]

It is proposed that this will be introduced through secondary legislation.[204] The Chancellor explained the background to the measure:

> In 1984, 30 years ago, there was an intention to make sure that hot takeaway food was vatable [sic]. Since then, under all Governments, there has been a load of legal action to try and get around that. Lots of reasons have been given for why some hot products are not designed to be hot when they are eaten. I am seeking to [...] just stick with the position that hot takeaway food has VAT on it.[205]

The Chancellor also explained that the method of assessing proportion of food sold by a retailer which is subject to VAT is that there is "a sensible arrangement between Inland Revenue and the company—about what proportion of its products are sold hot."[206] This issue has attracted significant attention from the public and the media.[207] **We recommend that, where changes to complex areas of taxation are proposed, the greatest possible supporting material be published to allow for greater scrutiny of the possibility of unintended consequences.**

Cap on available reliefs

117. Legislation will be introduced in Finance Bill 2013 to apply a cap on income tax reliefs claimed by individuals from 6 April 2013.[208] The cap will apply only to reliefs which are currently unlimited. For anyone seeking to claim more than £50,000 in reliefs, a cap will be

202 HM Treasury, Budget 2012, p 73

203 HM Revenue and Customs, Overview and Tax Legislation and Rates, March 2012, A85

204 HM Revenue and Customs, Overview and Tax Legislation and Rates, March 2012, A85

205 Q 317

206 Q 318

207 For example, BBC, "'Pasty lover' David Cameron defends VAT hike", www.bbc.co.uk; The Sun, "Pied Paupers: pasty VAT leaves workers worse off", www.thesun.co.uk; The Mirror, "Half-baked Tory tax a mistake-and-bake from Osborne and co", www.mirror.co.uk.

208 HM Treasury, Budget 2012, p 59

set at 25 per cent of income.[209] The Chancellor gave stylised examples of people who had income of £10m but had paid no income tax through use of reliefs.[210] He commented that "I think it is very difficult to justify people having 0 per cent tax rates when they have very high incomes."[211]

118. CIOT was generally critical of the cap:

> We can understand the desire to tackle what is seen as excessive reliefs offsetting. We do think the route chosen is the wrong one. If, as we understand it, the mischief being targeted revolves around 'sideways loss relief' (loss relief from business investments), it would be better to adjust the already manifold controls on loss offsets. Although that would add more complexity to an already involved area, it is likely that the new rules will be complex anyway.[212]

119. As CIOT notes, this change appears to be aimed at tax avoidance. However the proposals as published may also have a detrimental impact on relief for genuine business losses and charitable giving. The Budget states that "the Government will explore with philanthropists ways to ensure this new limit of uncapped reliefs will not impact significantly on charities that depend on large donations",[213] but CIOT told us that "there is real concern in the charitable sector about wealthy philanthropists being put off giving because of the reliefs capping".[214]

120. **We recommend that the Treasury soon ask HMRC to make an assessment and publish the impact of the cap on income tax reliefs, both on business investment and charities. A more detailed explanation of the problem the cap seeks to address is needed, along with consideration of other possible means of dealing with it as the Red Book proposes.**

Corporation tax

121. The Budget announced that the main rate of corporation tax would be reduced from 26 per cent to 24 per cent from April 2012, rather than to 25 per cent as had been announced at Budget 2011. The rate will then be reduced by 1 per cent per year, so as to reach 22 per cent from April 2014.[215]

122. The OBR estimated that the additional reduction in corporation tax would:

> Reduce the cost of capital faced by firms and increase the level of business investment by 1 per cent over the forecast period. [...] Given that output is below

209 *Ibid.*

210 Q 348

211 *Ibid.*

212 Ev 55

213 HM Treasury, Budget 2012, p 59

214 Ev 55

215 HM Treasury, *Budget 2012,* HC 1853 (Red Book), p 65 para 2.96

> potential across the forecast period, we assume no offset from monetary policy, leading to a very small increase in the level of GDP of 0.1 per cent by the end of the forecast period.[216]

Mr Chote noted that the reduction "has a modest offsetting effect on the downward revision in the business investment forecast [...] but it is small in comparison with the overall reduction in the business investment forecast since last time."[217]

123. Mr Bootle cited the reduction in corporation tax as being "quite favourable [...] for the medium-term growth outlook."[218] He further stated that he thought:

> The corporation tax changes were pretty favourable because not only did they immediately produce the tax impact on business, but they were a signal to business of what the Government's intentions were. So that is something that might well help to boost the animal spirits of business and therefore get investment going.[219]

Mr Whiting supported the view that the reduction in corporation tax acts as a signal to business and "is part of the shop-window advert for businesses."[220] But in response to our question of whether the reduction in corporation tax signalled the return of the United Kingdom to a more competitive position he noted that:

> There are an awful lot of nuances in this. [...] The capital allowance rate has been coming down at the same time as the headline corporation tax rate. [...] Let us not forget that the vast majority of businesses gain no benefit from the headline corporation tax rate cut, because they are paying at the small profits rate or, of course, are unincorporated and are losing on capital allowances and gaining no benefit on rate cuts.[221]

124. **The reduction in the headline rate of corporation tax is intended to send a positive signal about the United Kingdom as a place to do business and is forecast somewhat to encourage investment. We note, however, that other measures, such as the reduction in the capital allowance rate, may mean that the immediate benefit of the corporation tax cut is only felt by a subset of businesses in the United Kingdom. We recommend that the Government monitor, and report on, the impact of the reduction in corporation tax on businesses of all sizes.**

216 Office for Budget Responsibility, *Economic and fiscal outlook*, March 2012, Box 3.1, p 46

217 Q 69

218 Q 154

219 Q 154

220 Q 215

221 Q 220

6 The supply side

Plan for growth

125. As noted above, the Government has put forward a number of measures intended to support macroeconomic recovery. These supplement the current stance of monetary policy.

126. Distinct from these measures are a series of longer-term microeconomic supply-side reforms which have been put in train since 2010. Last year's Budget was accompanied by the publication of *The Plan for Growth* which set out a series of ambitions and benchmarks for the United Kingdom economy. This year's Budget reaffirmed those ambitions as being:

- encouraging investment and exports as a route to a more balanced economy;
- making the UK the best place in Europe to start, finance and grow a business;
- creating a more educated workforce that is the most flexible in Europe, and
- creating the most competitive tax system in the G20.

It also set out progress already achieved against the Government's ambitions, some detail on implementation of previously announced measures and new measures being announced in Budget 2012.[222]

127. Mr Bootle cast doubt on the achievements of the plan, and the Government's commitment to it, saying that the Government's Plan for Growth:

> Seems to have died a bit of a death. My own experience in talking to officials in both BIS and the Treasury is I don't think they are seriously interested in it; they haven't been all along. They thought that the objective is to give George Osborne something to put into a document or a speech, rather than genuinely believing that there are things that can be done.[223]

He argued that more could be done to reform labour laws, and that little had been achieved in this arena so far:

> If you are looking at the SME sector—we talk about finance—what is it that gets animal spirits going? What is going to give them the confidence to invest? I think a profound change in the labour laws would have a big impact. I know that there is room for disagreement on this across the political spectrum, but my point is, that would not cost any money, and the Government have not done anything, or done

222 HM Treasury, *Budget 2012*, HC 1853 (Red Book), pp 37–38

223 Q 146

next to nothing. It is in that sort of area that I think there is significant room for advance.[224]

128. However external MPC Member Adam Posen told us in February 2012 that:

> It would be a mischaracterisation of the UK labour market to suggest that we are hamstrung by labour market regulation at this point. If you look at the way our labour market behaved throughout the crisis, our dysfunction has been doing a very bad job of putting non-university educated young people into work. In all other aspects, the British labour market worked quite well in international comparison, and so to me it is not like Germany, circa 2003, when they had to do major changes to the employment protection and the generosity of unemployment benefits because they were so askew that there was a very high natural rate of unemployment. I do not want to comment on that specifically, but it would strike me as odd if you were going to do a labour market reform in the UK right now, just on basic economic principles.[225]

129. The Chancellor denied the accusation that the Plan for Growth had been forgotten and outlined the measures included in this Budget and other documents that he saw as key components of the plan:

> When I launched the growth strategy last year, I said that planning reform was a critical part of it and one of the absolutely central measures. A year later we have, with all the challenges of ensuring that it is properly consulted on and so on, implemented a policy that comes into effect today. No one, to my knowledge, has changed planning rules in this country in a generation as quickly as we have. If you look at the corporate tax rate, it is now aggressively lower than our main competitors [...] Larger companies are getting a clearer signal that they need to invest in the UK, because we have the lowest tax rates of any major economy. If you look at the components of the growth strategy, which were things such as planning reform and other supply-side changes to regulation and the like, and if you look at tax reform, those things are taking effect. When it comes to investment in infrastructure, we have had the Chinese sovereign wealth fund confirming that it is investing and taking a stake in Thames Water. That is the first major western infrastructure investment, and I am very keen to get British pension funds investing as well.[226]

Infrastructure

130. Following on from measures announced in the Plan for Growth, the Autumn Statement, and the National Infrastructure Plan 2011, Budget 2012 outlined a number of further infrastructure measures as well as proposals to promote private investment in infrastructure. Additional measures announced included development of a national roads

224 Q 146

225 Oral evidence taken before the Treasury Select Committee on 29 February 2012, HC 2010–12 1867 ,Q 76

226 Q 289

strategy, support for Network Rail's investment in the Northern Hub rail scheme to improve transport links between a number of cities in the North of England, support for the establishment of a new platform to facilitate private pension fund investment in UK infrastructure, and expansion of the super-connected cities programme aimed at increasing the provision of ultrafast broadband.[227] The Government has also previously announced commitments to a number of large-scale infrastructure projects, most notably High Speed 2, the cost of which will have to be agreed by the next Parliament.

131. Nonetheless, a number of witnesses cited further infrastructure spending as something that could be undertaken to increase economic growth, without necessarily risking the Government's fiscal credibility.[228] Dr Hilliard stated:

> A little more infrastructure investment would be useful. I think perhaps we have become a little too hung up on the precision of fiscal neutrality. When the Chancellor presents his Budget, does he have to balance it to the nearest £100 million to say that he has spent some money and he is going to pay for it with other things? The markets would be forgiving of £2 billion or £3 billion here or there—without being flippant—if it were seen to be driving the medium-term sustainability of the economy.[229]

Mr Portes strongly agreed, arguing:

> On infrastructure spending, public sector net investment has fallen, according to the ONS figures that came out on Budget day, from about £47 billion to somewhere in the low 30s—by more than a third in a couple of years. We are cutting public sector net investment very substantially at a time when we can borrow at the cheapest rates in generations, when there is lots of spare labour capacity and when we are in a very slow recovery. That cannot possibly make economic sense.[230]

132. On the question of how important the Budget 2012's infrastructure measures are, and whether they have gone far enough, Professor Dieter Helm, of Oxford University, echoed Mr Portes, asserting that there was a considerable shortfall in infrastructure spending:

> On the one hand, it is extremely welcome that infrastructure has become part of a Budget, and significant enough for the Prime Minister to make a speech about it. But the scale of the shortfall on infrastructure investment against the policy still leaves a pretty big gap. [...] So the gap between what needs to be done and what is being done remains very large. It is a good news story that it is finally being taken seriously, but we are not anywhere near closing up those gaps.[231]

227 HM Treasury, *Budget 2012,* HC 1853 (Red Book), p 5

228 Qq 145, 159

229 Q 145

230 Q 147

231 Q 207

Energy

133. Budget 2012 set out a package of oil and gas measures to secure investment in the Continental Shelf, and announced that the Government will publish a strategy for gas generation in Autumn 2012.[232] In his Budget Statement the Chancellor said that:

> Gas is cheap, has much less carbon than coal and will be the largest single source of electricity in the coming years, so my right hon. Friend the Energy Secretary will set out our new gas generation strategy in the autumn to secure investment. I want to ensure that we extract the greatest possible amount of oil and gas from our reserves in the North sea. We are today introducing a major package of tax changes to achieve this. We will end the uncertainty over decommissioning tax relief that has hung over the industry for years by entering into a contractual approach. We are also introducing new allowances, including a £3 billion new field allowance for large and deep fields to open up West of Shetland, the last area of the basin left to be developed—a huge boost for investment in the North sea.[233]

134. In evidence to us the Chancellor confirmed that the rationale for a new gas policy was driven by an understanding that gas will play a much greater role in the United Kingdom's energy strategy in the near-to medium-term:

> Part of the Budget was a commitment to produce by the autumn a gas strategy on the understanding that gas-generated electricity is going to be the major source of electricity generation for many years to come. The plethora of environmental policies that were put in place by the previous Government and that exist under this Government do not, we think, provide adequate support for investment in the gas industry. The Energy Secretary is going to produce that strategy, and the key thing is that it is going to provide some grandfathering for the emission permits. In other words, it will allow people to build a gas power station with some certainty that we are not suddenly going to change in five, 10 or 15 years' time the emission requirements of that station. That was deterring investment.[234]

135. We questioned Professor Helm on whether, in his view, the Government had done enough to ensure energy security for the future. His view was:

> Are we addressing the provision of an investment framework to ensure that we have security of supply? By that, I do not just mean the lights going out, but sufficient security so that we do not see price spikes all over the place to achieve that security. Not yet—it's a mess. We have been reviewing energy policy for years. There have been 12 years of reviews of energy policy after each election, and White Papers, etc. Do I have any confidence that we have a framework yet that will provide sufficient

232 HM Treasury, *Budget 2012,* HC 1853 (Red Book), p 30 para 1.218

233 Official Report, 21 March 2012, col 798

234 Q 383

> incentives to build the power stations, to provide one of the basics of an economic system going forward? No.[235]

He also argued that the recent crisis had probably forestalled an energy crisis because demand for energy has been much less than might have been expected in the absence of the economic downturn. He stated that "if economic growth is 3 per cent to 4 per cent per annum from now onwards to the end of this decade, we will have a serious problem. If it's nought, we probably won't."[236] Professor Helm further argued that energy market reforms have:

> Created an immensely complicated system. [...] You have individual contracts for feed-in tariffs, for different kinds of technologies, plant by plant negotiations, separate capacity market, and separate energy market. That is a recipe for confusion and expense and I think it is going to be costly on the cost of capital for investment.[237]

136. With respect to the Chancellor's gas strategy, Professor Helm highlighted that because of an increase in investment in renewable energy, which had brought more intermittent power onto the system, it was no longer possible to guarantee to investors in, for example, a gas power station that they would be able to rely on that station running at base load in order for them to recover the cost of their investment. As a result, "anyone now wanting to build those kinds of stations needs some kind of contract to do it. [...] The problem we have at the moment is that there is not any incentive to build any of it."[238]

137. Professor Helm argued that the current regime for reducing carbon emissions was ineffective. He argued that most economists would propose a carbon tax scheme that had a price of carbon and a carbon tax that was set low originally but had a rising trend.[239] He contrasted this with the carbon reduction scheme that was currently in place:

> Instead, what we have is the European Union Emissions Trading System, which is short term, volatile and very low. We now put a carbon floor price in because the EU ETS cannot deliver the price we want. Then we extend these commitments on a company by company, case by case basis. Again, what you create is, by definition, an enormous bureaucracy and lots and lots of costs.[240]

He welcomed the Chancellor's plans to review the Carbon Reduction Commitment Scheme, and noted limited success so far in reducing the UK's carbon footprint. With respect to energy policy generally, he would propose:

235 Q 235

236 Q 236

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238 Q 237

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240 Q 239

> A more radical discussion about what we are really trying to do here and how that fits with our security and competitiveness, as well as our commitment to addressing global climate change. [...] Between 1990 and 2005, carbon production in this country under Kyoto fell 15.4 per cent. If you add back the imports and the carbon we actually consume, which is our genuine carbon footprint, our emissions went up 19 per cent. That is why at the global level, emissions keep going up, the coal burn keeps going up in the developing countries [...] We ought to clarify what we are trying to do and address what is a really urgent global environmental problem as best we can, without incurring costs without benefits.[241]

138. **The Committee welcomes the Government's inclusion of supply-side measures in the Budget and recommends a greater focus on supply-side reform. As a priority the Government should set out in the Autumn Statement areas of progress in implementing its agenda and more detailed benchmarks for further reform than we have hitherto seen.**

241 Q 239

7 Leaks and advance briefing

139. Last year in our Budget Report we deprecated both leaks and advance briefing of Budget announcements:

> It has been noticeable over many years under successive Governments that measures appear to have been trailed, sometimes accurately, sometimes in a way designed to place them in the most favourable light. Whether particular press reports are leaks or briefings or merely press speculation, we have no view, but we deprecate both leaks, and any advance briefing. Such activities are corrosive of good government. We will return to this issue at future autumn statements and budgets.[242]

Regrettably, the Treasury chose not to address this conclusion in its response to our Report.

140. This year a considerable number of the announcements in the Budget speech appeared in the press in advance of the Budget on 21 March. For example, on 14 March press reports appeared that the Government would in the Budget announce that the Debt Management Office (DMO) would be consulting on issuing 100 year and perpetual government bonds.[243] On 17 March the Herald reported that the Government would in the Budget announce a guarantee on the future of tax relief on North Sea decommissioning costs.[244] Both these stories were attributed to a Treasury source. On 19 March the cut in the additional rate of income tax from 50p to 45p was reported.[245] On the morning of the Budget itself, the Financial Times reported that the rate of stamp duty on homes over £2 million would increase from 5 per cent to 7 per cent.[246]

141. We asked the Chancellor whether any of the measures in the Budget were briefed to the press. He responded:

> In terms of the contents of the Budget, clearly some parts of the Budget were in the newspapers before I delivered the Budget. I think every single Budget that I've seen in the 20 or so years that I've been involved in politics has involved a lot of speculation beforehand. Sometimes entire Budgets have leaked and sometimes that speculation has been very well informed. What I can confirm to the Committee is

242 Tenth Report of Session 2010–12, *Budget 2011*, HC 897, paragraph 4

243 See: *Osborne budget plan could mean never having to pay his debts*, The Guardian, 14 March 2012 (http://www.guardian.co.uk/uk/2012/mar/13/budget-government-bonds-debt-osborne); *Government mulls issuing perpetual gilts, Reuters*, 14 March 2012 (http://uk.reuters.com/article/2012/03/14/uk-britain-bonds-idUKLNE82D00920120314)

244 *Osborne will throw lifeline to North Sea oil industry*, The Herald, 17 March 2012 (http://www.heraldscotland.com/mobile/politics/political-news/osborne-will-throw-lifeline-to-north-sea-oil-industry.17044925?_=e72a32b81af08da32dc6250f14ff025ff99ee615)

245 *George Osborne to reduce top rate of tax to 45p*, The Daily Telegraph, 19 March 2012 (http://www.telegraph.co.uk/finance/budget/9152102/Budget-2012-George-Osborne-to-reduce-top-rate-of-tax-to-45p.html)

246 *Tax grab on London's top homes*, Financial Times, 21 March 2012 (http://www.ft.com/cms/s/0/8846f682-72c1-11e1-ae73-00144feab49a.html#axzz1qPHcCmxs)

> that no Treasury official, no Treasury Minister and no Treasury special adviser briefed before the Budget any specific information on tax rates or tax allowances.[247]

The Chancellor also confirmed, however, that the Treasury "did engage with the press" on the North Sea decommissioning relief and that he had authorised the Treasury press office to brief the press about the DMO consultation on 100-year and perpetual bonds.[248]

142. With particular reference to the DMO consultation, the Chancellor said that:

> I draw a distinction. You have a perfectly legitimate concern, and I have a concern, about things like rates of income tax and personal tax allowances, some of which did appear in the press beforehand, but the fact that the Debt Management Office is going to consult in the future on gilt maturities is the sort of thing that, frankly, the Treasury and every other Government Department engages with the press on every day—I would not regard that as Budget purdah, it is not on the score card. I am talking about, and I suspect your Committee is concerned about, what pertains to things in the classic definition of a Budget and what is on the score card.[249]

143. Paragraph 9.1 of the Ministerial Code, under the heading 'Ministers and Parliament', reads:

> General principle
>
> 9.1 When Parliament is in session, the most important announcements of Government policy should be made in the first instance, in Parliament.

We asked the Chancellor whether briefing the press on the DMO consultation on gilts conflicted with the Ministerial Code. He replied that:

> I certainly agree that important announcements of Government policy should be made to Parliament but, in the case you are citing, this is talking about the fact that the Government might, at a future date, bring forward a consultation on their gilt policy. That is not—I would hazard to argue in front of you, Chair—something that has to be done in an oral statement to Parliament; it could easily be in the kind of material in a speech that I would give, whether at the Mansion House or anywhere else.[250]

144. As we have seen above, the Chancellor assured us that no Treasury minister, official or special adviser briefed before the Budget any specific information on tax rates or allowances. He noted that there had been leaks of Budget measures in previous years. He assured us that "I completely agree that it would be much better if the announcements that I referred to—on stamp duty, personal allowances and the like—had been made on Budget

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247 Q 241

248 Qq 242–4; Qq 246–53

249 Q 247

250 Q 250

day".[251] He claimed, however, that the Budget process he had to deal with was materially different from that experienced by his predecessors for two reasons:

> Two things have changed [...]. First, I must agree my major Budget measures well over a week in advance. On the Monday before the Budget—not the Monday of the Budget week, but 10 days in advance—I must give the Office for Budget Responsibility the major Budget measures, and by Friday I have to have confirmed absolutely everything. No Chancellor has had to do that before. [...] Because of the OBR process, which I think is a good process, the Budget exists 10 days before it is given.
>
> The second thing is that I must negotiate in a coalition. Inevitably, a process whereby the Chancellor came up with a Budget in secret with the Treasury, occasionally consulted the Prime Minister, and perhaps intensely engaged the Prime Minister in the last couple of days before the Budget was given was very different from a process in which I must engage two political parties to make sure that I have their consent to proceed [...]. This is genuinely not pointing the finger at any individual, but many more people know in a coalition what will be in a Budget because I need to get the consent of both political parties.[252]

145. The Permanent Secretary, Sir Nicholas Macpherson, told us that the culture of Budget secrecy had changed in the time since he had first been involved in Budgets in the 1980s:

> I think it fair to say that that culture has changed over time. [...] The Budget process of the 1980s was different from how it has evolved over the past 15 years. The convention in those days was that there was extraordinary secrecy about nearly every aspect of the Budget. [...] The culture of politics has changed. If I were stuck in 1980s-think, I would probably be utterly appalled by what goes on now, but the reality is that through the 1990s and 2000s, the way in which the Government of the day engaged with the media changed. I do not think that is a bad thing. Exposing policy, ventilating ideas and encouraging debate is all to the good.[253]

146. Sir Nicholas told us that he had not initiated a leak inquiry within the Treasury as he did not have the prima facie evidence to warrant one.[254] He told us that:

> There are usually tell-tale signs about where things come from. Having looked at the stories and the relevant facts around them, I am confident that they didn't come from Treasury sources.[255]

When asked, the Chancellor endorsed the decision of his Permanent Secretary.[256]

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251 Q 264

252 Q 258

253 Qq 272–4

254 Q 281

255 Q 280

256 Q283

Conclusions

147. In his discussion of leaks and advance briefing the Chancellor attempted to draw a distinction between announcements upon which he thought it was normal for the Treasury to brief the press in advance, but not formally announce for consultation, and Budget announcements, involving tax rates or allowances, which he maintained should not be revealed in advance. He and the Permanent Secretary pointed to the occurrence of leaks in the past and to the change in recent years in the culture of Budget secrecy. Although the Chancellor expressed regret at the leak of information on Budget tax changes, he appeared to be resigned to a greater risk of such information leaking because the Budget is completed earlier than in the past and because there is coalition government. We find all these arguments unconvincing.

148. We reject the suggestion that it is acceptable for Budget measures to be briefed to the press in advance. Public trust in politics is low, and is further eroded if people have grounds to think that announcements about important things affecting them are simply part of a Government media operation. Such an approach would appear to breach the long standing convention, supported by the Ministerial Code, that major announcements should first be made to Parliament. The Government might also incorrectly assess the market sensitivity of information it decides to release.

149. **Appropriate pre-Budget consultation on specific measures, especially in the tax field, is to be welcomed. It is possible that there may also be cases where the Treasury judges it necessary to canvass views about a measure intended for the Budget which has not been out put out for consultation. Information about such measures should be publicly released by the Treasury in the normal way and, as appropriate, accompanied by a written or oral parliamentary Statement.**

150. While there was no golden age when Budget measures never leaked, that is not an reason for accepting their occurrence. Budget leaks in the past have, rightly, provoked measures to prevent them happening. The Chancellor claims to be operating under circumstances that make leaks more of a risk: the need to complete his Budget some days in advance so that the OBR can study it, and the existence of coalition government. The first of these is no reason on its own for leaks to be more likely, and there is no suggestion that the OBR has been the cause of any leak of information. As for the coalition being a factor, that is also a weak argument. While more people may be aware of the contents of the Budget, this is a risk that can be managed. The Treasury has Ministers of both parties within the coalition and is clearly capable of discussing Budget measures internally without leaking them, since the Chancellor and Permanent Secretary are both confident that no leak occurred from any Treasury minister, special adviser or official. The Government as a whole should similarly be capable of devising ways of discussing what may be in the Budget without leaking it. The Committee repeats the condemnation of leaks of Budget measures stated in our Report last year; such leaks are corrosive of good government.

151. **Coalition government is not a justification for Budget leaks. We recommend that the Government review its practices, based on the experience of this Budget, for preserving Budget confidentiality in a coalition context.**

Conclusions and recommendations

Introduction

1. The timings of the Second Reading of the Finance (No. 4) Bill and the Committee of the Whole House stage are highly unsatisfactory. While we recognise that there are exceptional circumstances this year, the new pattern of Prorogation and State Opening risks making the timing of the stages of future Finance Bills tighter than in the recent past. We therefore recommend that the Treasury and the Business Managers work together to plan the timings of future Budgets and Finance Bills so that the House has longer between publication of the Bill and Second Reading and, particularly, between Second Reading and Committee of the Whole House. This may require the Budget to be somewhat earlier in future. (Paragraph 2)

Macroeconomy

2. We welcome the OBR's use of scenario analysis to further its understanding of the major risks to the UK economy. The Treasury Committee recommends that the OBR consider a wider range of risks and associated scenarios in subsequent forecasts. Such examination might include ranking the risks by both likelihood and significance to the UK economy. The examination should also include an explanation of the extent to which the fan charts provided by the OBR reflect this information. (Paragraph 16)

3. The OBR now forecasts that the growth in business investment will be slower than it thought in November 2011. One of the OBR's explanations for this weakening was the results of further research undertaken by the OBR into the official ONS figures on the availability of cash for investment by firms which suggested that ONS figures over-estimated the amount of cash held by companies that are likely to invest in capital. We have heard conflicting evidence on this argument. In view of the importance of business investment in the GDP forecast, we therefore recommend that the OBR, in conjunction with the ONS, examine its work in this area with particular care. (Paragraph 22)

4. We welcome the Chancellor's commitment to increase the capacity of the National Loans Guarantee Scheme if it proves to be successful. We note that oversight of the Scheme through monitoring and reporting by participating banks, and also an independent audit, has been put in place to ensure that banks will pass on the full benefit of lower funding costs to SMEs. We expect there to be full transparency about the monitoring of the Scheme and the results of the audit. We will require detailed evidence from the Treasury to show that these guarantees have had the effect intended, and that the scheme is operating in such a way that banks do not retain any benefit, as the Treasury intended. (Paragraph 34)

5. We remain concerned that while the Scheme should reduce the price of loans to some SMEs, and at the margin may increase the quantity of loans available to them, it was not designed to solve the problem that many SMEs who may be reasonable credit risks are unable to access bank funding at all in the current unusual market conditions. Access to finance for SMEs remains a significant problem. Whilst these exceptional market conditions continue, the Government should regularly publish its own estimate of the degree of dysfunctionality of the market, with proposals for remedy. (Paragraph 36)

6. We urge the Government to give greater consideration to the promotion of competition in banking. (Paragraph 37)

7. SMEs face serious and often insurmountable problems in obtaining bank lending at reasonable rates. Non-bank lending could be a solution for some SMEs, although the market for such loans seems relatively unresponsive to apparent demand. The Breedon review suggests that there are problems both with supply and demand for non-bank financing, including a lack of knowledge amongst SMEs about available sources of such financing. The Government's efforts to examine non-bank channels for funding businesses are very welcome, but we note there is much work still to be done to establish large scale alternatives to bank lending for most SMEs. . We recommend that the Government continues to pursue creative solutions, including those suggested by the Breedon review, to increase the level and availability of non-bank funding, and set out the results in detail in the Autumn **Statement.** (Paragraph 41)

8. While a nominal export target may be of some use in concentrating minds within Government, GDP growth will only benefit if the UK's net trade position improves as well, and that will require imports to grow less quickly than exports. We are therefore sceptical about the value of an export target without examining the overall current balance and will further examine this issue in our inquiry into global imbalances. (Paragraph 43)

9. The powers of direction to be granted to the statutory Financial Policy Committee of the Bank of England are likely to have a significant impact on the economy when used, and the possibility of their use will have to be taken into account in the forecasts of the Office for Budget Responsibility. We recommend that the FPC and the OBR work together as the macroprudential tools are developed to ensure that they are adequately reflected in the OBR's forecasts. We will inquire into the new macroprudential tools. Among issues we will examine is whether they will be as effective in ameliorating downturns, as well as limiting upswings, in credit cycles. (Paragraph 46)

10. While the Government maintains the current tight fiscal profile, monetary policy will remain the main tool for stimulating demand in the economy. The Bank of England appears confident of the efficacy of continued quantitative easing, and the Governor urged patience. We note from the OBR forecasts that despite its current extremely accommodative stance, monetary policy alone will be unable to close the output gap over the forecast horizon, with long term consequences for the recovery. Bearing in mind the risks of unwinding, we will continue to monitor the impact of loose monetary policy and the effectiveness of quantitative easing in our hearings with the Monetary Policy Committee and the Financial Policy Committee. We will also continue to explore the effectiveness of loose monetary policy on the economic recovery. (Paragraph 51)

11. Loose monetary policy, achieved through quantitative easing and low interest rates, has redistributional effects, particularly penalising savers, those with 'drawdown pensions' and those retiring now. The Bank of England has argued that some of those effects may be mitigated by the increase in asset prices stimulated by quantitative easing. While the aggregate of savers and pensioners may have received some benefit from higher asset prices, there will be many individuals who will not have benefited. The Bank of England, after, where appropriate, consultation with the Treasury, should provide its estimate of the overall benefit and loss to pensioners and savers from quantitative easing. It should, in addition, estimate how that balance changes depending on when an annuity was purchased, using the following three dates: immediately before the start of the crisis five years ago; immediately after the introduction of quantitative easing; and now. We further recommend that the Bank of England, and particularly MPC members, improve upon their efforts to explain the benefits of the current position of monetary policy to those affected by the redistributive effects of quantitative easing. (Paragraph 54)

12. We recommend that the Government consider whether there are any measures that should be taken to mitigate the redistributional effects of quantitative easing, and if appropriate consult on them at the time of the Autumn Statement. (Paragraph 55)

13. Witnesses have expressed reasonable differences about the current mix of fiscal and monetary policy. There is also some concern that monetary policy is reaching the end of its effectiveness in accommodating the present tightness of fiscal policy. We will continue to monitor the Government's and the Bank of England's approach in this area. (Paragraph 59)

14. The OBR relies heavily on the output gap in order to assess whether the Government is on course to meet its fiscal mandate. However, as an unobservable measure, the output gap is prone to great uncertainty and frequent revision. There is therefore a risk that there will be unwarranted changes in fiscal policy as a result of reliance on it. We recommend that the Treasury ask the OBR to evaluate other, supplementary, approaches. (Paragraph 65)

The public finances

15. In the next spending review period the Government will need, on current forecasts, to find significant further reductions in expenditure. We look forward to the Chancellor's update in the Autumn Statement. (Paragraph 74)

16. The OBR suggests that the Government is on course to meet its fiscal mandate and supplementary target. There is little margin for error. The achievement of the fiscal mandate is dependent on measurement of the output gap. We have already expressed our concerns about the output gap as a measure (See para 65). (Paragraph 78)

Principles of tax policy

17. We note the welcome given by the Director of the Office of Tax Simplification. Personal tax statements have the potential to provide some additional transparency for taxpayers. They should explain what they pay in tax and how it is spent. They will

need fairly to describe Government spending. We recommend that the Treasury consult the OBR on their design. (Paragraph 84)

18. We recommend that the Government clarify what retrospection is proposed with regard to stamp duty. (Paragraph 86)

19. We recommend that the Government restrict its use of retrospective legislation to wholly exceptional circumstances, which should be narrow and clearly-defined. The Treasury should set these out as soon as possible for consultation, along with an explanation of how gradual further extension of retrospection can be prevented. Any future retrospective tax measure must be justified against the agreed criteria: such justification must include clear explanatory statements to Parliament by the responsible Minister and should invite views from relevant professional bodies. (Paragraph 89)

Taxation

20. The cost and benefits of reducing the additional tax rate to 45p are both highly uncertain, and could be significantly more or less than the cost included in the Budget. We recommend that HMRC publish in due course a comprehensive assessment of the effect on the Exchequer of the new 45p rate. (Paragraph 97)

21. The introduction of dynamic scoring could have a significant impact on tax policy decisions and we will monitor its progress. (Paragraph 98)

22. The Red Book conflates the revenue impact of the increased personal allowance and the reduction in the higher rate threshold. We recommend that, as a matter of principle, the Government set out separately in future Red Books the revenue effect of each tax decision. (Paragraph 108)

23. We recognise that the Government needs to take difficult decisions to tackle the budget deficit. Nonetheless, the Government's latest proposals for reform of Child Benefit solve only one of the two main problems identified with its original policy. They add further complexity. We will review the effect of the changes on HMRC, where further staff reductions are being implemented, in our regular hearings with it. (Paragraph 115)

24. We recommend that, where changes to complex areas of taxation are proposed, the greatest possible supporting material be published to allow for greater scrutiny of the possibility of unintended consequences. (Paragraph 116)

25. We recommend that the Treasury soon ask HMRC to make an assessment and publish the impact of the cap on income tax reliefs, both on business investment and charities. A more detailed explanation of the problem the cap seeks to address is needed, along with consideration of other possible means of dealing with it as the Red Book proposes. (Paragraph 120)

26. The reduction in the headline rate of corporation tax is intended to send a positive signal about the United Kingdom as a place to do business and is forecast somewhat to encourage investment. We note, however, that other measures, such as the reduction in the capital allowance rate, may mean that the immediate benefit of the corporation tax cut is only felt by a subset of businesses in the United Kingdom. We recommend that the Government monitor, and report on, the impact of the reduction in corporation tax on businesses of all sizes. (Paragraph 124)

The supply side

27. The Committee welcomes the Government's inclusion of supply-side measures in the Budget and recommends a greater focus on supply-side reform. As a priority the Government should set out in the Autumn Statement areas of progress in implementing its agenda and more detailed benchmarks for further reform than we have hitherto seen. (Paragraph 138)

Leaks and advance briefing

28. Appropriate pre-Budget consultation on specific measures, especially in the tax field, is to be welcomed. It is possible that there may also be cases where the Treasury judges it necessary to canvass views about a measure intended for the Budget which has not been out put out for consultation. Information about such measures should be publicly released by the Treasury in the normal way and, as appropriate, accompanied by a written or oral parliamentary Statement. (Paragraph 149)

29. Coalition government is not a justification for Budget leaks. We recommend that the Government review its practices, based on the experience of this Budget, for preserving Budget confidentiality in a coalition context. (Paragraph 151)

Appendix 1: Institute of Chartered Accountants in England and Wales

1. Last year, the Treasury Select Committee (TSC) identified six principles for tax policy: it should be fair, support growth and competitiveness, be certain (i.e. legally clear, targeted and simple), stable, practical and coherent. Following the Budget and the publication of the Finance Bill 2012, ICAEW has assessed how this year's new tax proposals match up to the committee's six principles for tax policy.

FINANCE BILL AND BUDGET MEASURES		VERDICT
Accelerated corporation tax cut *Down to 24% this year, down to 20% by April 2014*		**PASS** Will make the UK more competitive, provides certainty and is practical and coherent.
'Patent box' *A reduced level of corporation tax on profits attributed to patents and similar types of intellectual property*		**PASS** Will drive growth and encourage innovation.
R&D tax credits *These will be moved 'above-the-line', meaning that loss-making companies as well as profitable ones can benefit from them. The credit will be a minimum rate of 9.1% of qualifying expenditure before tax.*		**PASS** Generally positive, but represents yet another change in frequently shifting R&D tax rules.
Repeals of miscellaneous reliefs *For example certain stamp duty reliefs.*		**PASS** Tidies up statute that is no longer required
VAT changes *Closes loopholes and anomalies in VAT rates, including on hot food (including pasties).*		**PASS** Broadly sensible reforms improve coherence of VAT system, but will still leave plenty of anomalies.
Abolishing 50p income tax rate *Reduced to 45% from 2013, to encourage investment and cut avoidance.*		**NEUTRAL** Will attract business and investment, but unclear why it isn't being introduced straight away, especially if HMRC expect much income to be deferred until 2013.

Seed enterprise investment scheme *Tax break for people investing in early-stage businesses will be introduced from April 2012, offering combined tax relief of up to 78% in the year of investment.*		**NEUTRAL** An excellent policy to increase funding for new businesses, but currently cumbersome because of poor drafting.
Controlled Foreign Companies reforms *A simpler tax regime for big companies with foreign subsidiaries, should result in a simpler way of taxing foreign profits with a less complicated 'gateway' to identify avoidance.*		**NEUTRAL** Another excellent policy to increase funding for new businesses, but currently hampered by poor drafting.
New 7% stamp duty rate *Applies to residential property over £2 million.*		**NEUTRAL** Will take some time for the market to adjust to this, and it will create distortions at the margin of the new rate because of the 'cliff-edge' impact of the tax.
General anti-tax avoidance rule *A GAAR will be introduced in the next Finance Bill.*		**NEUTRAL** Good in principle, but depends on final draft. Targeted measures and simpler tax also needed to curb avoidance.
Child benefit withdrawn from higher rate taxpayers *Benefits will be tapered down between incomes of £50-60,000.*		**FAIL** The phased withdrawal between £50-60,000 will be complex and costly to implement and comply with.
Limits on tax reliefs *'Tycoon tax' caps how much you can claim back, including on charity donations.*		**FAIL** Will tackle the problem of avoidance schemes using charities to avoid tax bills, but must be more targeted to avoid hitting genuine charitable donations.

Overall Verdict

2. We are happy that the Budget and the Finance Bill were broadly fiscally neutral. The UK is still in a difficult position, and the government has a tough task, tackling the deficit while trying to kick-start the economy.

3. The Chancellor's measures are likely to make the UK more internationally competitive, as he intended. The key measures for this were a further reduction in the planned headline

rate of corporation tax (down to 24% from April 2012 and dropping a further 1% for the following two years, reaching 20% from April 2014), reforms to the Controlled Foreign Companies regime, and a new patent box regime to encourage and protect UK innovation, and the reduction in the income tax additional rate from 50% to 45%.

4. Large companies will benefit much more than small companies. The pro-competitive measures listed above will help bigger organisations, which do have great potential to drive growth. But small businesses account for 99% of all enterprise in the UK, and 58.8% of private sector employment[257]. Smaller businesses will not be helped by the reduction in the main rate of corporation tax, as they already pay at a rate of 20% - or at a marginal rate which is still lower than the main rate).

5. The Budget did little to encourage growth in the important SME sector. SMEs will also be hit by the forthcoming reduction in the annual investment allowance from £100,000 to £25,000, and the lowering of capital allowance rates (legislated for last year). Even a measure targeted at new small enterprise investment, the seed enterprise investment scheme (SEIS), will attract few new investors if the legislation remains as complex as it is currently drafted.

6. Top income tax rates are still high. We are surprised that the government is delaying scrapping the 50p rate until next year, as the Government's own figures suggest that £2.4bn of income will be deferred until 2013 to take advantage of the lower rate. The Government should also recognise that the UK tax system has a higher effective tax rate than 50%. Because personal allowances are withdrawn for individuals with income over £100,000, those earning between £100,000 and (currently) about £115,000 suffer an effective tax rate of 60%. The large increases in the personal allowance will increase the band of income subject to the effective 60% rate, so by 2013 the 60% rate band will apply to income between £100,000 and £118,410. The result is that tax rates fluctuate as income rises rather than simply increasing in line with the amount you earn. This distorts incentives, increases the complexity of the tax system, and encourages more avoidance. This does not appear to be a particularly fair or efficient approach for a tax system that is designed to be progressive. Further, the income tax system will now be complicated further by the phased withdrawal of child benefit for those with income of more than £50,000 – see further below.

7. This year's changes make the tax system more complex, despite the government's pledge to simplify the system. It's true that the government has simplified some rates, particularly around income tax, and the Bill does provide for the removal of various reliefs and VAT anomalies. But the system itself remains far too complicated, and this Bill does little to help. One example is the new phased withdrawal of child benefit for those with income of more than £50,000- see further below. This 'sliding scale' approach to phasing down a benefit is being removed for personal tax allowances for the elderly, yet it is being reintroduced for child benefit.

8. This will probably be the longest ever Finance Bill and that limits scrutiny. Complexity is more problematic than volume in tax law – but long Bills like this are harder for

257 Federation of Small Businesses http://www.fsb.org.uk/stats

Parliament to scrutinise effectively. Last year, the 2011 Finance Bill was just over 400 pages long and the Office of Tax Simplification had removed about 100 pages, leaving a net increase of 300 pages. This year, the net increase is 670 (so far). When it is enacted the Finance Act 2012 will probably be the longest ever. It's important to note that about 20% of the Bill it is taken up with necessary changes to the rules for the taxation of life insurance companies, and that the Bill provides for the removal of various reliefs, but in spite of this, the Bill nevertheless will bring a major increase to the volume of UK tax legislation. The longer and more complex the Bill, the more likely it is that there will be inadequate time and resources for proper Parliamentary scrutiny. It's vital that the Bill committee and the House as a whole is given sufficient parliamentary time and resources to properly scrutinise the legislation.

9. The Office of Tax Simplification is doing good work, but we are concerned that there is a danger that support for the important work of the OTS will be undermined if it appears that the Government is cherry picking parts of its work without developing the proposals in the round. For example, in its review of the taxation of pensioners, the OTS noted that the higher age related personal allowances caused considerable additional complexity (we would agree) and needed review. However, the announcement that age related allowances would be frozen and no longer available for those turning 65 was a surprise. In its review of reliefs, the OTS recommended the retention of mineral royalty treatment but the Government nevertheless decided to abolish it in 2013 albeit with some transitional reliefs.

10. Poor drafting of tax law turns good policy into bad legislation. The improved drafting techniques developed in the Tax Law Rewrite Project appear to have been forgotten, so that much of the drafting is unnecessarily complicated and difficult to understand. There are two major examples in this Finance Bill - the Seed Enterprise Investment Scheme and the Controlled Foreign Companies rules. Both are great policy ideas, but unfortunately the legislation for the SEIS in particular, is so lengthy, complex and badly drafted that it's likely to be unworkable and inaccessible to the businesses and investors the measures are aimed at.

11. We're happy with improvements in the tax policy consultation process, such as the early publication of draft Finance Bill clauses. However a number of key policy changes in the Budget, such as to Child Benefit, appear to have been made without proper scrutiny.

12. The government is not keeping its word on tax stability. Despite being fiscally neutral, this Finance Bill makes many tiny changes and tweaks – 'piecemeal changes'. The Treasury's consultation document of June 2010 *Tax Policy Making: a New Approach*, stated (paragraph 2.5):

> The Government wants to restore the tax system's reputation for stability. It is committed to making fewer piecemeal changes to the tax code and to slowing down the rate of change. When the Government does introduce changes, it will do so in a more considered way.

13. To tackle tax avoidance, we need clear, targeted anti-avoidance measures and simpler tax law. The Finance Bill contains a number of detailed anti avoidance measures. In the Budget, the Chancellor announced the introduction of a general anti abuse rule (GAAR) from 2013. We fully support the Government's strategy to prevent abuse of the tax system.

We have stated consistently that the proper approach to addressing avoidance should be through properly targeted anti avoidance legislation. We also believe that the scope for egregious tax planning would be reduced if the UK tax system was simplified and that the number of changes made year on year was reduced.

14. We are concerned to ensure that any GAAR is effective in tackling abusive tax avoidance but does not impose unreasonable burdens and costs on businesses undertaking ordinary commercial activity and engaging in reasonable tax planning. The draft GAAR produced by Graham Aaronson was a reasonable approach and given our comments above about drafting, we believe it is important that any GAAR produced follows the principles and approach set out by Graham Aaronson. In tandem with that, we believe it is important that HMRC works with business and the professions to produce guidance that helps to identify the boundary between when the GAAR will and will not apply. We appreciate that the Government is committed to this, but stress the importance of seeking to identify areas of common ground on the application of a GAAR so that uncertainty is reduced.

Particular areas of concern

Withdrawal of child benefit

15. The Government stated its intention at the time of the 2010 Spending Review to withdraw, with effect from January 2013, child benefit for households where there was a higher rate taxpayer. The details of this have now been announced: there will be an income tax charge where a taxpayer earns more than £50,000 which will be tapered where income is between £50,000 and £60,000. We believe that such a mechanism will be difficult to implement, open to error and potentially costly for HMRC to administer and for taxpayers to comply with. The trouble is that an income tax system based on taxation of individuals, does not work properly if it has to cope with benefits that apply to a household (tax credits) or potentially to another person (such as child benefit).

16. Particular problems with the proposal include:

- The start date (January 2013) does not align with the start of the income tax year (6 April);
- The phased withdrawal between £50,000 and £60,000 will use the complex phased approach, which the government is withdrawing for age-related personal allowances for those reaching the age of 65 next year (dubbed 'the granny tax'). This will increase complexity and uncertainty, and won't work well with the PAYE system;
- Many more taxpayers will be brought into self-assessment and may face unexpected tax bills at the end of the tax year, and
- The system is unlikely to cope efficiently household relationships change.

Restriction of tax reliefs – e.g. for charitable giving – 'Tycoon tax'

17. One major concern arising from the Budget statement is the proposal to restrict the availability of uncapped tax reliefs to the greater of £50,000 or 25% of adjusted net income. In effect, this proposal (dubbed by some a 'tycoon tax') has the effect of imposing a minimum tax level. Thus for someone with an income of £200,000 a year, the maximum tax reliefs that can be claimed will be £50,000, leaving £150,000 in charge to tax.

18. We appreciate that tax reliefs will be a target for avoidance schemes and it is right for the Government to try to counter such schemes. Last year the Government consulted on possible approaches to counter high risk areas of the tax code and one such identified was the use of income tax losses. Three options were put forward, one of which was to cap the amount of loss which could be relieved against other income at £25,000. Although we understood that the Government was still consulting on the loss relief measure, it appears that it has now been overtaken by this new proposal. The scope of the 2011 idea has been broadened considerably to become a general restriction on the availability of all uncapped tax reliefs, albeit the proposed £50,000 level is twice as high as the limit of £25,000 mentioned in the 2011 consultation.

19. In our response to the 2011 consultation (published as TAXREP 62/11), we considered that sideways loss relief for commercial losses should continue to be allowed without restriction, and that a limit of, say, £25,000, would penalise genuine businesses where commercial losses had been incurred. We remain of that view and are very concerned to see that this earlier work appears to have been overtaken by a general restriction on tax reliefs.

20. We are aware already of serious concerns in the charitable sector about the impact of this restriction on charitable donations, although we appreciate that paragraph 1. 193 of the Red Book states that the 'Government will explore with philanthropists ways to ensure that this measure will not impact significantly on charities that depend upon large donations. Clearly, this measure could have a considerable impact on the charitable sector, potentially at a time when the UK is looking to rely on the third sector to a greater extent than in the past. It is also likely to have wider commercial implications.

21. While we welcome the announcement that the rule will not be introduced until 2013, given the importance of this measure we would have expected it to be subject to a full consultation in accordance with the Government's consultation framework. Instead, it appears that draft legislation will be published for consultation later this year – in other words the policy decision and approach have already been taken.

Stamp duty land tax: New 7% rate for £2 million properties

22. Each additional rate of SDLT creates a 'cliff edge' problem for tax. A 1p increase in the value of a property value which takes its cost over the £2m threshold could result in an additional stamp duty charge of £40,000. This is because SDLT is not a progressive tax but works by applying a single rate of tax which is determined by the value of the property and is then applied to the whole amount of that value. While no doubt the market will adjust, nevertheless it introduces distortions and does not appear to support the Government's desire for a fairer and simpler tax system. Moreover, the definition of a developer as

someone who has been undertaking their property development business for a minimum of 2 years appears unduly restrictive.

23. The Government has also announced that it will consult on the introduction of a new tax on properties of more than £2m owned by non-natural persons and that a CGT charge will also be introduced on disposals of UK property owned by an overseas non-natural person. We are concerned that these proposals may introduce distortions depending on how properties are held. We urge the Government to clarify its proposals in this area as soon as possible and ensure that any regime operates fairly and equitably.

Detailed Assessment

Clause/ Schedule	Provision	Treasury Committee Principles						Overall rating	Comments
		Fair	Support growth	Certain	Stable	Practicable	Coherent		
Cl 1	Charge for 2012-13 and rates for 2012-13 and subsequent tax years	Partly	Yes	Yes	Partly	Yes	Partly	Neutral	Reducing the 50% additional rate to 45% from 2013. If this is intended to increase growth and therefore overall tax revenues, why not simply introduce this now in 2012? HMRC expect large sums of income to be deferred from 2012/13 to 2013/14.
Cl 5	CT rate for 2012	Partly	Yes	Yes	Partly	Yes	Yes	Positive	Corporation tax will fall by 1% more than expected this year, which will be welcomed by larger businesses. Last year, businesses were hindered by not being able to submit CT 600s for periods ending after 31 March 2011 until October 2011. HMRC has a work-around this year so that returns will be able to be submitted from July 2012.
Cl 8 Scd 1	High income child benefit charge	Partly	No	Partly	Partly	No	No	Negative	Higher rate taxpayers will lose child benefit, with a taper for those earning between £50-60,000 pa. We do not believe that this proposal is very practical and will result in a considerable increase in admin burdens for HMRC and for the taxpayers affected.
Cl 19 Sch 2	Profits arising from the exploitation of patents	Partly	Yes	Yes	Yes	Yes	Yes	Positive	The patent box proposals are a growth positive measure and the Finance Bill measures appear to achieve the policy objective.
Cl 20 Sch 3	Relief for expenditure on R&D	Partly	Yes	Partly	No – R & D measures keep changing	Partly	Yes	Positive	

Cl 38 Sch 6	Seed enterprise investment scheme	Partly	Yes	No	Partly	No	Partly	Neutral	A growth positive measure let down by the long and complicated drafting.
Cl 180 Sch 20	Controlled Foreign Companies and foreign permanent establishments	Partly	Yes	No	Partly	No	Partly	Neutral	A growth positive measure let down by the long and complicated drafting.
Cl 211	Rate in respect of residential property where consideration over £2m	Partly	No	Partly	Partly	Partly	Partly	Neutral	This tax leads to problems at the margin and identifying the boundary between residential and commercial property in mixed developments. Slab – once you go over a certain value you pay on the whole lot so it's a cliff edge rate rather than gradual
Cl 225 Sch 38	Repeals of miscellaneous reliefs	Partly	Partly	Yes	Yes	Yes	Partly	Broadly positive	
Other	General anti-abuse rule	Yes, in principle	Yes, if designed properly	Too early to say	Too early to say	Too early to say	Yes as part of wider avoidance strategy	Neutral	Difficult to assess without seeing proposed legislation
Other	Restriction on loss reliefs	Partly	Partly	Too early to say	Too early to say	Too early to say	Measure appears far to widely targeted	Negative	See comments above. Leg needs to be targeted specifically at the avoidance schemes. Chancellor's onto something. Needs to be better drafted tho. You get these big donations when you get a windfall. Won't be often or many charities affected
Other	VAT changes	Yes in principle	Partly	Partly	Partly	Partly	Yes	Positive	Reasonable policy aim but still likely to leave a considerable number of anomalies in the UK VAT system.

Appendix 2: Chartered Institute of Taxation

1. The Treasury Committee has invited comments on how Budget 2012 (and succeeding Finance Bill) meets the Committee's tax policy principles, as expressed in its 2011 report on *Principles of Tax Policy.* The Chartered Institute of Taxation (CIOT) is pleased to submit some comments, which incorporate points relating to the unrepresented from our Low Incomes Tax Reform Group (LITRG).

2. The Committee's report identified six principles:

- Basic fairness;
- Supporting growth and encouraging competition;
- Certainty, including simplicity;
- Stability;
- Practicality, and
- Coherence.

3. We comment briefly under each of the principles but would stress that we are not giving a full analysis on the Budget/Finance Bill measure. Inevitably, some of our comments will be similar to those made in the wake of the Budget in our submission for the Committee's Budget inquiry.

Basic fairness

4. The CIOT's motto translates as 'Justice between the citizen and the state' so fairness in the tax system is always an important issue for us and especially for our LITRG. One key issue under the fairness heading this year is the personal allowance increase. This is clearly positive; though we do have to note that some of the poorest taxpayers will only see some 15p in the £ of the supposed benefit due to the impact on benefits (Council tax and Housing) calculated on post-tax incomes.

5. We are less sure about the fairness of the changes to the age allowance. The freezing of the allowance and its potential phasing out is in many ways sensible, especially from a simplification point of view. It is, though, a measure that would have been better announced and planned when the objective of achieving a £10,000 personal allowance was first stated. The restriction to those reaching 65 by 5 April 2013 seems unfair to those approaching 65 who have built up what might be termed a legitimate expectation. Finally on this issue, we would suggest that the presentation of the change was poor: too many people thought that it meant a further tax bill would be arriving.

6. The child benefit changes naturally raise fairness issues. We understand the government's arguments about restricting benefits for those on higher incomes. Introducing a higher threshold and (especially) making the withdrawal a taper rather than

a cliff's edge help fairness. But there is residual unfairness with the single earner (with, say, a £60,000 income) vs. a dual earner household (with, say two £45,000 incomes). Is it fair that the latter household, with a 50% higher income, retains the benefit whereas the lower income household loses it?

7. As we noted in our equivalent paper last year, there is clearly a significant fairness issue over the increased tax burdens imposed as the Chancellor attempts to 'balance the books'. As a body, we are more concerned with the workability of taxes and tax changes than their impact but we do have to note a considerable increase in the effective tax burden of those on incomes in the £35-60,000 bracket. The reduction in the higher rate threshold, tax credit changes and child benefit charge all have an impact. We trust this is something being monitored carefully by the Treasury.

Supporting growth and encouraging competition

8. There are some very positive measures here for large businesses, with the reduction in the headline rate of corporation tax, continuation of the CFC reforms, the patent box and the 'above the line' R&D credit all significant. The reduction in the 50% top rate of income tax also sends a positive signal about encouraging enterprise and UK competitiveness, as does the plan to introduce a modern statutory residence test.

9. Smaller businesses, especially the unincorporated, have regularly highlighted the fact that they do not benefit from reductions in the main rate of corporation tax but have had to help pay for it with reductions in capital allowances. The reduction in the Annual Investment Allowance to £25,000 was passed in a previous Finance Act but comes into effect this month so it is fair to note its impact in this section. Whilst the reduced allowance will indeed cover the plant and machinery purchases of many small businesses, it does not go far for a farmer or manufacturer trying to buy new equipment.

10. Small businesses will, though, welcome the measures coming out of the reports by the Office of Tax Simplification. Fully carried through, they have the potential to make a useful contribution to growth and competition.

11. The changes in Enterprise Investment Scheme and Venture Capital Trusts are useful; the Seed Investment Scheme (SEIS) is a positive idea. We have some concerns about the complexity of SEIS and would hope that there will be a proper evaluation of its effectiveness after a couple of years.

12. The stamp duty land tax (SDLT) anti-avoidance measures are only surprising to the extent that action has not happened before now. We do have concerns about their targeting: corporate ownership of property does not only happen for avoidance purposes. Care needs to be taken to make sure that there is no impact on enterprise, particularly REITs and genuine investment from outside the UK, not least because of the penal nature of the charges being planned.

Certainty, including simplicity & Stability

13. Our comments on these two principles overlap so it seems easiest to set them out under one combined heading.

14. It is difficult to get away from the sheer size of this year's Finance Bill. Some 670 pages of new legislation implies a lot of change – thus affecting stability – and must add complexity, detracting from simplicity. We have to ask, for example, whether a provision such as SEIS could have been set out in somewhat fewer than 50 pages.

15. This volume of change – and there is little sign of it abating – makes full adherence to the government's own 'Tax Policy Making – a new approach' principles critical. Much of the Bill (e.g. CFCs, Patent Box, Insurance Company taxation) is the result of proper consultation. Some (e.g. the new IHT 10% relief for 10% of estates left to charities) missed the important step of permitting consultation on the direction but did at least allow consultation on the draft law.

16. However, what detracts from In general good progress on consultation are measures such as the child benefits withdrawal charge where the principles were not consulted on. Nor was draft legislation exposed for comment, which seems unforgiveable for such an important and complex measure that has been under consideration for some time.

17. We do note some useful small measures, such as simplification of the IHT periodic and exit charges.

18. Looking forward, the certainty/simplicity picture is decidedly mixed. Moving ahead with Income Tax and NIC operational merging scores well. The restrictions to age allowances will add complexity, as will the reliefs capping measures.

19. The impact of a GAAR will potentially add complexity and detract from certainty. As we have said in our various papers on a possible GAAR[258], we can see merit in a GAAR that focuses squarely on highly artificial schemes. The challenge is to design it in a way that does not introduce more uncertainty: businesses in particular need to know whether their planning with be subject to any GAAR. If the perception is that uncertainty is increased by the GAAR, that will detract from the UK's competitive position.

20. One issue that is of major concern under the headings of Certainty and Stability is retrospection. This Budget and Finance Bill brings in a retrospective measure (around loan buy-backs) and threatens more (over SDLT avoidance). As we have said in papers[259] and in previous submissions to the Committee, we have serious concerns about the use of retrospection in the tax system. It is the antithesis of certainty and damages the image of stability. We have long called for a proper debate and, in due course, clear statement of when, if at all, retrospection will be appropriate.

21. The various changes to personal tax – ranging from child benefit clawback through reliefs capping to the reduction in the 50% rate – emphasise the need for a strategy framework for personal tax, including interactions with tax credits and benefits. Having a framework for corporation tax makes a useful contribution to the development of the tax system and has added to the image of stability. The UK now needs one for personal tax, which might help slow the pace of change – or at least make it more likely changes are in a consistent direction.

258 See http://www.tax.org.uk/tax-policy/public-submissions/2012/GAAR_CIOT_ATT

259 See http://www.tax.org.uk/tax-policy/public-submissions/2010/RetrospectiveTaxationACIOTdiscussionpaper

22. We have also long argued that there is also a real need for a framework for ‘Green’ taxes in the UK. We repeat that call. Frameworks do not have to constrain the government but should help improve debate, consistency and direction.

Practicality

23. As alluded to above, we have concerns about the practicality of the child benefit withdrawal charge. Managing the operation of the charge in relation to the ‘family unit’ and fluctuating incomes will be difficult for HMRC and for some taxpayers, not least in terms of HMRC’s duty of confidentiality to individual taxpayers.

24. There are clear practical issue for how the SDLT anti-avoidance charges will be imposed and collected and we look forward to participating on consultations to make sure the provisions are fair and workable.

25. We note some smaller, positive moves under the practicality heading: e.g. useful moves on tackling VAT fraud on imported road vehicles (though more needs to be done on other duty fraud) and the long-needed raising of the IHT limit for transfers to a non-domiciled spouse.

26. The Budget also referred to the move to PAYE Real Time Information (RTI). We are pleased to participate in the RTI consultations and the positive manner in which HMRC are approaching the issues. However, we remain concerned about how practical RTI is for the smallest employer and especially employers who do not use e filing or have no access to quality broadband, though we acknowledge that HMRC’s Basic PAYE tools are attempting to provide a solution. It would undoubtedly be helpful is there was more time to solve these issues.

Coherence

27. We have already referred to the benefits of long term frameworks that help bring coherence to the system. The moves to integrate the operation of Income tax and NICs are very welcome under many headings, including coherence.

28. The plan to cap reliefs may appeal as an anti-avoidance measure but scores badly under coherence. On the one hand, taxpayers are encouraged through the tax system to give to charity, invest in risky areas (EIS, enterprise zones) and take risks in business (through allowing loss offsets). Now we have a provision that seems to cut directly against that encouragement. What does this say about commitments to philanthropy, the environment and regeneration? We believe it would be much better to target the specific abuses the government is concerned about (abuses of charity status, artificial loss offsets) rather than attempt a blanket measure.

29. The action on VAT anomalies does not score well under this heading. Rather than picking off some perceived anomalies it would surely be better to initiate a proper overall review of areas of concern such as food. The underlying problem here is not avoidance but that the VAT system has not kept up with developments in the marketplace.

30. As a final point under this heading, the coherence of the package of papers released on Budget day has improved but still leaves much to be desired. Surely, it must be possible

produce a single, comprehensive index of documents and announcements? And when the Finance Bill is published, why can we not have a proper listing of changes to the draft Bill published in December – ideally on a track change basis – as some recompense for the efforts the CIOT and other bodies put into the consultative process?

Conclusion

31. Overall, we have mixed views on how well this Budget and Finance Bill scores under the Committee's headings. An 8/10 rating under enterprise & competition would be fair; but all the other headings have some measures that score well and others than attract low scores. Too many measures seemed to come out of the blue as well. All of that explains the results of the poll of CIOT Technical Committee and LITRG members which resulted in a slightly disappointed 6/10 average. Perhaps this also reflects our expectations increasing.

Appendix 3: Association of Chartered Certified Accountants

Memorandum on the fundamental principles of tax policy and Finance (No.4) Bill

Comments on the Finance (No.4) Bill

1. In March 2011, the Treasury Committee set out six principles by which it recommended tax policy should be measured. This memorandum seeks to comment at a high level on the extent to which the Finance (No.4) Bill coincides with those principles.

2. The Principles are that tax policy should:

- be fair. The Committee accepts that not all commentators will agree on the detail of what constitutes a fair tax, but a tax system which is considered to be fundamentally unfair will ultimately fail to command consent;
- support growth and encourage competition;
- provide certainty. In virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs;
- provide stability. Changes to the underlying rules should be kept to a minimum and policy shocks should both be avoided. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear;
- The Committee also considers that it is important that a person's tax liability should be easy to calculate and straightforward and cheap to collect. To this end, tax policy should be practicable, and
- Finally, the tax system as a whole must be coherent. New provisions should complement the existing tax system, not conflict with it.

3. As the Committee has observed, while principles can be separate into “basic” and “procedural” types, in practice there is considerable overlap between them, and tax policy needs to follow all the principles to be “good” policy. Given constraints of time on both the authors and the readership, we have focused on a few key proposals to illustrate the principles.

4. In our commentary of March 2011 on Finance Bill (No3), we observed that the current government has committed itself to a significant change of approach to tax policy. We were able to identify a clear correlation between the measures contained within that Bill and the Principles set out by the Committee, and accordingly would expect to see further clear evidence of that approach in the current Bill.

5. A feature of the new approach to tax policy is increased consultation with stakeholders in the tax system. As a result, a significant number of major policy initiatives announced in the Budget have already been subject to detailed consultation and revisions, and appear in the Finance Bill in a form which is unlikely to see further significant change. We comment on these below.

6. There are also a number of proposed policy initiatives which either do not appear in the Finance Bill at all, or only to the extent that anti-forestalling measures are to be enacted (for example the measures relating to "VAT Anomalies"). We shall comment on these separately.

7. The final group of provisions within this budget are those which have not been subject to previous external consultation, and appear for the first time in their complete form in the Bill. Many of these are anti-avoidance provisions, while the remainder represent new policy initiatives.

8. In order to comply with the principles of stability and certainty, we would expect such measures to be relatively simple and discrete. Changes to the system which interact significantly with other areas of tax legislation or are complex within themselves are most likely to benefit from as broad a consultation base as possible.

9. We would observe in this context that a bill which runs to 686 pages is perhaps in itself an indication of a system which is struggling with the principles of stability, and is at greater risk of conflicting with the principle of coherence.

10. However, comfort can be drawn from the fact that a significant proportion of the material in the bill is the culmination of many months, and in some cases years, of consultation and drafting, most notably the November 2011 publication of over 1,100 pages of draft clauses and guidance which have formed the basis of this Bill.

11. The first of the Committee's principles is that tax policy should "be fair". ACCA agrees that those charged with designing and operating tax systems across the world must have regard to fairness, but as the Committee also observes, there is significant political divergence over what constitutes a fair tax.

12. Assessing the social and economic impact of tax policy is beyond the scope of this paper, although we note that compliance with the other principles of taxation will in itself go a long way towards meeting a generally agreeable concept of fairness.

13. Without therefore seeking to comment directly on the "fairness" or otherwise of the proposed revisions to the scheme of age related personal allowances, we can nevertheless observe that the measures proposed do highlight the point that tax does not exist in a vacuum. The underlying policy justifications for the enhanced allowance for older people are linked to general demographic considerations, for example that those benefitting from the enhanced allowance tend to have fixed income which is not subject to National Insurance.

14. The proposed revisions clearly meet principles 3 (Certainty) and 4 (Stability), and in particular 5 (practicability). We understand that there is evidence to indicate that in many cases those who would be entitled to the enhanced allowance do not claim it. This is

particularly the case among those who are still in receipt of PAYE income, as many payroll systems do not have mechanisms to ensure application of the appropriate rate.

15. The current system also involves complexity for those who are potentially eligible on age grounds but need to consider the impact of the withdrawal of the relief for those on incomes greater than around £24,000.

16. In terms of the tax system in isolation, removal of a potentially confusing and under-utilised mechanism clearly meets all the procedural requirements of a good system. A more effective delivery mechanism for the policy aims would therefore be appropriate. If however no more appropriate mechanism can be identified then, notwithstanding the impact on the tax system, there may be an argument (subject to the importance of the overall policy drivers) that the tax provisions should be retained.

17. A further measure which highlights the interaction of the tax system with wider policy objectives, and in respect of which similar considerations apply, is the High Income Child Benefit Charge. The chosen mechanism tends to potentially steep marginal tax rates. For example, a family with a single income of between £50,000 and £60,000 currently suffers a marginal rate of 41% on that income. To the extent that the family receives Child Benefit, the marginal rate in that window increases, and if the total child benefit withdrawn across the band exceeds £5,900 (i.e. 8 or more children), the marginal tax rate will be over 100%.

18. While the number of households likely to be affected by this rate is perhaps small, the fact that the chosen mechanism is able to create such anomalies highlights the issue of whether an annual charge to an individual's tax is an appropriate mechanism to restrict a household benefit which is calculated on a weekly basis.

19. Consultation is currently under way on the integration of the operation of tax and National insurance, and one of the fundamental issues identified through that work is the difficulty of reconciling weekly systems with annual ones. In the case of child benefit, that difficulty is compounded by the interaction with the concepts of "partner" and the need to cater for potentially changeable domestic circumstances.

20. Means testing is of course subject to significant complexity, but is perhaps the most effective way to implement the policy in targeted fashion.

21. As a Budget aimed at supporting growth, the content of the Bill should reflect the principle that tax policy should "support growth and encourage competition". This should be tempered by recognition that tax systems in general are cumbersome instruments of policy implementation, so use of tax as a policy instrument should be exercised with care and restraint. Growth is best supported by simplicity and removing the drain on productive time imposed by unnecessary bureaucracy and complexity.

22. There are a number of measures aimed specifically at promoting growth. These measures should by definition meet the second Principle. In order to be "good" tax policy they must also meet, or at the very least avoid conflict with, the requirements of the other Principles.

23. Tax behavioural incentives can suffer from a number of inefficiencies. Typically, behaviour is rewarded rather than intentions, so businesses which would have performed

in the desired manner anyway get a free ride, picking up the incentive as a bonus. Measuring the level of subsidy or incentive is difficult, and the value of the measure to each business will be different in any event.

24. Given the potential difficulties in enacting "direct" reward tax measures which are both effective and efficient it is perhaps encouraging that relatively few measures were announced in the budget, and the bulk of the proposed changes have either been subject to consultation (and amendment) or are to be subject to further consultation in the coming months.

25. The preconsulted business tax measures in the Finance Bill broadly meet the criteria for a good tax system. As has been observed above the new approach to tax policy, and in particular the emphasis on consultation and reaction will inevitably result in legislation which has had any significant shortcomings identified and addressed.

26. The Corporate Tax Roadmap is a further positive structural element, which, while it does not feature directly in the Finance Bill, has to provide stability and coherence to the business tax regime in the UK.

27. The provisions relating to the taxation of life Insurance operations are clearly lengthy and complex. However, the market itself is extremely specialised and heavily regulated in other ways. The complexity of tax legislation in the area is not in itself a barrier to entry.

28. We note also that much of the redrafting is in response to developments in European law, and cannot as such be avoided. This being the case, the consultation with relevant stakeholders which has preceded the publication of the final clauses is in line with the principles. While some uncertainty and complexity may remain within the provisions, this is in the context of a population of taxpayers who are relatively sophisticated and will typically employ the services of knowledgeable specialists, either internal or external, with experience of the sector.

29. The Controlled Foreign Companies provisions likewise benefit from considerable consultation and debate. Combined with the Life insurance provisions, these two areas account for over one third of the Bill. As noted above, the majority of the Bill has been laid before stakeholders for consultation at least once in the form of the draft clauses published in November 2011. The considerable further discussion of these specific measures is a welcome feature of the current process.

30. There are a number of anti-avoidance provisions in the Bill which (partly by their nature) have not been subject to consultation. The Stamp Duty land Tax provisions in particular have attracted much attention.

31. As with the majority of anti-avoidance legislation the provisions are aimed at taxpayers seeking to reduce or remove a tax liability by taking advantage of provisions which were typically not intended to benefit the current users of them. As is also often the case, the existing structures continue to serve a useful purpose in other areas.

32. Given the complexity of the legislation, and its interaction with genuine commercial and business considerations, some degree of consultation on the measures is likely to reveal

aspects of the provisions which would not be readily apparent to any but the most specialised of practitioners in the area.

33. The clauses contained in Schedule 34 to the Bill have caused much concern , as in their current form they could impose charges on taxpayers who have undertaken genuine commercial transactions at the prevailing rate of tax and in full expectation that they are complying both with the letter and the spirit of the law, e.g. a UK resident company which has purchased residential property for the use of a given office holder (as distinct from the current individual holding that office).

34. At the same time, concerns have been voiced that advisers may still be able to identify and implement transactions which would avoid the proposed charges. While such activities would not be condoned by any of the principal membership or regulatory bodies, and could be susceptible to judicial challenge by HMRC, legislation which is able to impose unintended burdens on otherwise compliant taxpayers without catching the original targets cannot be said to have clearly met the principles of certainty, stability or coherence and should be carefully considered and if needs be revised before enactment.

35. While this Bill as a whole demonstrates continuous movement towards adoption of the Principles outlined by the Committee, there are still elements of the Bill which demonstrate undue complexity or potential lack of coherence. There is further evidence from other Budget announcements that while the government is committed to many of the Principles, detailed and responsive consultation with interested parties will be fundamental to creating tax mechanisms which are capable of delivering the identified policy objectives without offending the Committee's Principles.

36. As in the last budget, the scope to introduce policy measures has been constrained by the difficult economic circumstances. The budget as a whole has been portrayed as fiscally neutral, although inevitably the majority of individual measures are not. Though there are, and always will be, aspects of the tax system which fall below the ideal, Finance (No.4) Bill 2011–2012 is a further encouraging step on the road towards a better tax system.

Formal Minutes

Tuesday 17 April 2012

Members present:

Mr Andrew Tyrie, in the Chair

Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Rt Hon Pat McFadden
Mr George Mudie
Jesse Norman
Teresa Pearce
David Ruffley
John Thurso

Draft Report (*Budget 2012*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 151 read and agreed to.

Papers were appended to the Report as Appendix 1, Appendix 2, and Appendix 3.

Resolved, That the Report be the Thirtieth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report

[Adjourned till Tuesday 24 April 2012, 9.45 am

Witnesses

List of written evidence

List of Reports from the Committee during the current Parliament

Session 2010–12

First Report	June 2010 Budget	HC 350
Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 475
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069
Twentieth Report	Retail Distribution Review: Government and FSA Responses	HC 1533
Twenty-first Report	Accountability of the Bank of England	HC 874
Twenty-second Report	Appointment of Robert Jenkins to the interim Financial Policy Committee	HC 1575
Twenty-third Report	The future of cheques: Government and Payments Council Responses	HC 1645
Twenty-fourth Report	Appointments to the Office of Tax Simplification	HC 1637
Twenty-fifth Report	Private Finance Initiative: Government, OBR and NAO Responses	HC 1725
Twenty-sixth Report	Financial Conduct Authority	HC 1574
Twenty-seventh Report	Accountability of the Bank of England: Response from the Court of the Bank	HC 1769
Twenty-eighth Report	Financial Conduct Authority: Report on the Governments Response	HC 1857
Twenty-ninth Report	Closing the tax gap: HMRC's record at ensuring tax compliance	HC 1371