The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

# FINANCE COMMITTEE

Wednesday 6 March 2013

Session 4

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## FINANCE COMMITTEE
**8th Meeting 2013, Session 4**

**CONVENER**

*Kenneth Gibson (Cunninghame North) (SNP)

**DEPUTY CONVENER**

*John Mason (Glasgow Shettleston) (SNP)

**COMMITTEE MEMBERS**

*Gavin Brown (Lothian) (Con)
*Malcolm Chisholm (Edinburgh Northern and Leith) (Lab)
*Jamie Hepburn (Cumbernauld and Kilsyth) (SNP)
*Michael McMahon (Uddingston and Bellshill) (Lab)
*Jean Urquhart (Highlands and Islands) (Ind)

*attended

**THE FOLLOWING ALSO PARTICIPATED:**

Paul Johnson (Institute for Fiscal Studies)

**CLERK TO THE COMMITTEE**

James Johnston

**LOCATION**

Committee Room 1

# Scottish Parliament

## Finance Committee

*Wednesday 6 March 2013*

[The Convener *opened the meeting at 09:30*]

## Decision on Taking Business in Private

**The Convener (Kenneth Gibson):** Good morning, and welcome to the eighth meeting in 2013 of the Scottish Parliament's Finance Committee. I remind everyone present to turn off any mobile phones, tablets or other electronic devices.

Our first item of business is to decide whether to take item 3 in private. Are members agreed?

**Members** *indicated agreement.*

## United Kingdom Budget

09:31

**The Convener:** Item 2 is the United Kingdom budget, which is due to be published on 20 March. I welcome Paul Johnson, director of the Institute for Fiscal Studies, and invite him to make a short opening statement before I open the session to questions.

**Paul Johnson (Institute for Fiscal Studies):** Good morning, and thank you. I will not make much of an opening statement, but I will say a little about what we have done in "The IFS Green Budget: February 2013".

There are two or three overwhelming issues that face the Chancellor of the Exchequer. The first is, of course, the public finances: they are looking less good this year than they were last year, which is entirely down to the lack of growth in the economy. Our guess is that borrowing this year will be greater than last year—which is slightly contrary to what was suggested in the autumn statement—because tax revenues in the past couple of months have been less than was hoped.

The options that face the chancellor are not very much changed from the options that faced him a year ago. He has responded to the worse economic outlook not by reducing spending further or increasing taxes further in the short run, but by allowing the automatic stabilisers to work. He is borrowing a great deal more than he intended to in the period up to 2015. He then has a series of options for what to do after 2015, on which I am not expecting a lot more information in the budget. We will find out something in the spending review, which as far as we know will be in July, although that is not yet certain.

The chancellor has a series of options regarding the tax system, which we can discuss further if the committee wants to look at specific issues, but I have no predictions about which of those options he may choose. It seems to us that the big issues in the short run concern the overall balance of taxes and spending, and the areas in which the chancellor makes specific choices.

**The Convener:** Thank you very much. Given the amount of time available, I will try to make the discussion as interactive as possible and give members an opportunity to come in wherever they see fit. I will not speak very much this morning, especially as I attended Mr Johnson's lecture last night, but I will open with a couple of questions before I let colleagues in.

First, we should start with the background with regard to the global economy and its impact on the United Kingdom growth forecasts. The prediction for growth in the world is 2.4 per cent, but for the UK it is only 1 per cent. How robust is that figure? Our concern is that forecasts always seem to err on the side of optimism rather than realism.

**Paul Johnson:** I should begin by saying that I am no great expert on macroeconomic forecasts, as those are not something that we do—very deliberately, because that means that we cannot get them wrong.

However, you make an important point. Most of the macro forecasts in the past two or three years—which have come from many different forecasters and show different outcomes—have been based on similar models. They have a level of trend growth built in, and a gap between the current output and the output at the balance of the economy. They are all in essence calibrated to move from where we are now to a period of trend growth at some point, which is what the bank, Office for Budget Responsibility and Treasury models and most of the independent forecasters do.

Given that we are starting at a point well below trend—although there is quite a lot of disagreement about how far below trend we are—all those models are calibrated almost to force them to say that, a couple of years down the road, we will return to 2 or 2.5 per cent growth. That is in effect what the OBR models did a couple of years ago, and—exactly as the convener described—they have ended up being rather overoptimistic.

The OBR has, rather nicely, looked back at its forecasts from 2010 and 2011 and asked why it got them wrong. It put that down mostly to the fact that a combination of things—in the euro zone in particular and in the world economy more generally—turned out less well than it had hoped, and also down to the higher inflation that was driven to some extent by commodity prices. Those are the OBR's reasons for why things turned out worse than it had forecasted, but the difference also relates to the fact that the recovery from a major financial crisis has taken longer throughout the world than anybody expected.

I do not know whether 1 per cent will be the right figure for next year, or whether 2 per cent—or whatever the forecasts are—will be right for the year after. Presumably, we will at some point return to growth; let us hope that it is next year.

**The Convener:** That is interesting. Last year the committee took evidence from Robert Chote of the OBR, which was predicting 0.8 per cent and, on the same day, I met Stephen Boyle from the Royal Bank of Scotland, which was predicting 0.2 per cent. One would have thought that the OBR's forecast would have been more accurate, as it would have greater access to facts and figures than RBS, but the opposite turned out to be true.

I want to talk about productivity, which you touched on only lightly in your lecture last night. It is interesting—and disconcerting—that output remains below pre-recession levels, but there has also been a fall in labour productivity since 2008. For the record, can you say a bit about why that should be the case?

We know that real wages have fallen and that the profitability of companies has grown considerably. Is there a lack of confidence in the business sector and an unwillingness to invest? Investment is 16 per cent below the pre-recession high. Is it, as the committee's adviser Professor Bell has said, because banks have continued to fund zombie companies—companies that are not performing well—in order to protect their balance sheet while failing to support new entrants? Perhaps you could talk about that a wee bit.

**Paul Johnson:** I am happy to talk about that. It is a big question, to which there is no single answer. You are right that what has happened in the past two years has been pretty surprising to most people. Generally speaking, during recessions and their aftermath, productivity tends to rise pretty swiftly, not least because that tends to be the flip side of increased unemployment and of less highly productive firms going out of business.

What we appear to have had this time is a very different experience to what we had in the recessions of the early 1990s and the 1980s in a number of respects. One difference—which is the silver lining—is that unemployment is much less high than one would expect, given what has happened to output. Indeed, employment levels in the private sector are now higher than they were at the beginning of 2008, and yet output is lower, which means by definition that productivity has gone down, and it has gone down quite a lot.

There seems to be a series of things going on, although it is hard to put relative weights on their importance and to decide which way causality runs. One issue involves a straightforward question about what is happening in the labour market. It appears that real wages have been much more flexible downwards than has been the case in the past. There is some evidence that that started before the recession, when there was already quite a lot of variability in real wages and some evidence of downward variability. That appears to some extent to be related to institutional changes, and to long-term changes in the way in which the benefits system works.

It is very important to examine different parts of the labour market. It is clear that there has been a much bigger shift in unemployment and wages for younger people than there has been for older people. Wages for younger people have fallen quite starkly, and the labour market for young people seems to have become particularly weak during that period in a way that the labour market for older people has not.

One would usually think of productivity being driven by, among other things, the educational skills of the workforce. Even over the past three or four years, the workforce has become significantly better educated. The proportion of graduates continues to grow, while the proportion of people with no qualifications continues to fall. The quality of the workforce has not got worse—if anything, it has moved in the other direction.

There are quite a lot of things that may be happening in the labour market. Investment by companies has—as you suggest—fallen pretty dramatically, which is, again, a different story to what we have seen in previous recessions, in the sense that investment has not yet recovered at all. That seems to be—as you suggest—at least partly to do with lack of confidence in investment and lack of access to capital, particularly for new companies.

I do not know whether one wants to refer to “zombie companies”, but it is clear that the number of companies that are going out of business has been much smaller than one would expect given the fall in output, and smaller than we have seen in previous recessions, which suggests some level of forbearance on the part of banks. That may be to do with the very low interest rates, which allow banks to keep trading, and the relatively small amount of capital that is available for new companies.

Where does productivity growth tend to come from in the economy? It tends to come from the exit of low-productivity firms and the entry of new and higher-productivity firms. If the rate of exit and entry is slowed down, that may be part of the story of reduced productivity.

It is worth saying that this appears to have happened right across the different sectors of the economy. It is not that one sector has become much less productive, and it is certainly not that one sector—for example financial services—has become much smaller. It seems to have happened pretty much right across every sector of the economy.

09:45

**The Convener:** I wonder whether you could touch on the impact that reduced investment and reduced productivity have on competitiveness. You have also talked about banks not lending to new companies, and we are all very much aware of that. The banks, however, say that 40 per cent of the money that is available to lend to existing companies is not being picked up by established companies—they have some £770 billion on their balance sheets. Given the fact that investment is required for growth and the fact that growth is required to bring the public finances back into some kind of order, what is the way to break the logjam other than by addressing the confidence issue, which we have touched on already?

**Paul Johnson:** I wish that I had a clear answer to that. The UK economy does not look very different from many of the economies in Europe in that respect. At the moment, a lot of the European economies are seeing a similar surprise on the positive side in terms of employment and a similar surprise on the negative side in terms of productivity. The reverse can be seen in the United States. In some ways, the US looks more like Europe used to look, and Europe looks more like the US used to look, in the sense that labour markets—certainly in the UK, but not just in the UK—seem to be working pretty well and productivity seems to be doing much less well. That is much more like the US experience in the 1980s recession, for example.

You are right about the lack of lending from banks to existing companies. That partly reflects the fact that the banks—particularly the big ones—are sitting on quite a lot of cash and have been for some time. That is related to their view of the opportunities for productive investment. They are clearly not yet happy to make that investment.

What will unlock that? That takes us back to your first question about growth in the rest of the world, which is terribly important. We are unusually dependent on what happens elsewhere in the world, and there is probably a limit to what we can do to unlock it in the UK independent of what is going on in the rest of the world. How can we unlock it? I do not know. There are options around short-term tax breaks for investment, which might bring investment decisions forward. I do not think that such tax breaks tend to increase the total level of investment over a period, but they can change the timing of investment and changing the timing of investment may itself help to kick-start us on to a different path. I think that most of it will be about timing.

**John Mason (Glasgow Shettleston) (SNP):** My question continues the theme of productivity, especially public sector productivity. It is suggested that that has been improving despite what you have just said about the rest of the economy and the private sector. That seems strange to me and, perhaps, to others. How robust are the figures? Are we really convinced that public sector productivity is improving?

**Paul Johnson:** The short answer is that the figures are not very robust and we are not very convinced. It is terribly hard to measure public sector productivity, although in some bits of the public sector a genuine attempt is made to measure outputs.

The number of children who are educated and the exam results that they get, and the number of patients who are treated and the number of operations that are provided, are measures of output in the education and health sectors respectively. In a large part of the public sector and public administration, outputs simply equal inputs. The number of civil servants is in effect equated to their output, so it is pretty hard—we cannot really measure their output, and the national statistics keep that at a constant level.

In the bits that it is possible to measure, there has clearly been a reduction in inputs—there have been significant reductions in the number of public sector workers. Thus far, according to how these things are measured, there does not seem to have been a reduction in outputs, be that in school results, the number of operations or what have you. That implies an increase in productivity.

Three things are worth pointing out about that. First, just because outputs are not falling in the short run does not mean that they will not fall in the long run. The snapshot of outputs at the moment might not be a good signal of productivity in the public sector if the effects of the cuts in inputs are lagged in relation to what the outputs will be. Secondly, as I said, a lot of the outputs are poorly measured. Thirdly, there is probably a flip side of what looked like falling productivity over the 2000s, when spending and inputs increased across the public sector and measured productivity fell. At least to a significant extent, that was probably to do with the way in which productivity is measured, rather than being a real fall in productivity. I would take the figures with a significant pinch of salt.

**John Mason:** That reassures me that my grasp of the situation was not too far off. This is not really a matter of measuring, for instance, the quality of people's degrees or the quality of planning applications. It is possible that the quality of those things is decreasing, although more is being churned out.

**Paul Johnson:** That is possible. We just do not have measures of those things. It is also possible that there were unproductive practices, workforces and inputs in some of those areas, and those are the first things that are being stripped out. It is possible that productivity is genuinely rising, but it is difficult to say that with confidence across the board.

**John Mason:** How much impact is public sector productivity having on the overall gross domestic product figures? Does it bring them into question?

**Paul Johnson:** I do not know quite how important it is. Public sector output is not productivity per se—it is public sector output as a whole that goes into the GDP figures. Government spending has gone down, and that will have a negative effect, but the fact that output has not gone down as much as expected is having more of a positive effect relative to expectations. Overall, the effect is relatively neutral, although it could become more negative if outputs end up being less robust than they currently appear.

**John Mason:** One of the problems in Scotland is that we are always comparing our GDP with GDP down south. One might be 0.1 per cent better or worse, and we all get very excited about that. I am beginning to feel that we should perhaps not get too excited about that, because there is a lot behind the figures.

**Paul Johnson:** You should never get excited about GDP being 0.1 per cent better or worse. In the short run, it is incredibly difficult to measure the thing. We have a £1.5 trillion economy across the UK and there has been a lot of excitement about whether we are in a double-dip or triple-dip recession, but the truth is that we had a recession and a short period of growth, and since then we have been flatlining for a couple of years. GDP might go down or up a little bit but, first, these things are very difficult to measure and, secondly, there is only one sensible way to describe what has been happening to GDP over the past two years, which is that it has been flat—not that it has been going down and up or anything else. Any measurements that show differences of 0.1 or 0.2 per cent are well within the bounds of statistical error and, exactly as you describe, within the errors that can be created conceptually in terms of how we measure this stuff. You are absolutely right not to get excited about differences of 0.1 or 0.2 per cent in GDP.

**Jamie Hepburn (Cumbernauld and Kilsyth) (SNP):** Thank you for describing the different experiences of the recession in the United States and the United Kingdom. In the summary section of your document, you point out:

> "US growth is expected to outpace growth in the other major economies over the next two years, reaching around a 3% annual rate by 2014."

The UK picture is not quite as rosy. Clearly, the Administration in America pursued a slightly different response to the economic downturn than we have seen here in the United Kingdom. That might lead to a conclusion that the US pursued the right path, whereas that was not so much the case in the UK. Will you comment on that?

**Paul Johnson:** The macro forecasts are not mine or ours. The US economy has behaved quite differently not just from the economy of the UK but from that of the rest of Europe. Once again—albeit surprisingly in this case—the UK sits between Europe and the US as far as its response is concerned. Although our fiscal consolidation is eye-wateringly extraordinary compared with anything that has happened in the past, it has been less dramatic than that of a number of European countries, because of the constraints that have been put on them by the growth and stability pact and being members of the eurozone.

In the US, at least in the short run—and over a slightly longer period, in fact—there was a more expansionary policy, and there has been a different response to the problems in the banking sector. That might have had a differential effect. There is also the fact that the US economy is a very different type of economy from those of the UK and Europe, both in its size and in its insulation, to some extent, from the rest of the world, particularly with respect to its currency and to the fact that it is a relatively closed economy in comparison with the UK. There will always be different things going on in the US relative to the UK and the rest of Europe.

Oxford Economics, which did the macro forecasting work with us for “The IFS Green Budget”, takes the view that some of the differential growth was down to a looser fiscal policy in the US in comparison with Europe and the UK. It also takes the view that a somewhat looser fiscal policy in the UK would have led to more growth. It takes that view because it thinks in large part that there is a very big gap between where we are at the moment and the trend output.

Oxford Economics thinks that the gap is much bigger than the OBR believes. The OBR thinks that we are about 3 per cent below trend output; Oxford Economics thinks that we are about 6 per cent below. There are other macro forecasters who think that we are more like 0.5 per cent or 1 per cent below, in which case there will be extremely little space for fiscal expansion.

What drives someone’s view on the subject is their view about the level of spare capacity in the economy. In that respect, rather unusually, the macroeconomic forecasters are not clustering around a single number; they are widely dispersed. It is from the dispersion of those judgments that we get a dispersion of judgments about the likely effectiveness of fiscal policy.

**Jamie Hepburn:** Can you explain what you mean by a “looser fiscal policy”? Does that mean not removing economic stimulus at the rate at which that has taken place here by reducing capital investment, for example?

10:00

**Paul Johnson:** That question is bigger than it sounds. In a real sense, the Government is pursuing a much looser fiscal policy than it ever intended to. I do not remember the numbers for this year, but the Government’s current view is that it will borrow something like £64 billion more in 2014-15 than it planned to in 2010. That is a fiscal loosening, relative to plans, of about 4 per cent of GDP in 2014, which is a very big difference.

That is entirely driven not by changes in policy but by the fact that fiscal numbers have come in much worse because growth has been much less than hoped. In a sense, the Government is talking an austere policy, while absolutely allowing what we might think of as the automatic stabilisers to work within its original set of plans. That is one part of the answer.

**Jamie Hepburn:** Is there not a certain irony involved in pursuing this looser fiscal policy now? Perhaps if the Government had pursued it at the outset, it might not have had to borrow now. Is the Government borrowing because it failed to achieve growth then failed to achieve the requisite revenue to pay for public services? It is now having to borrow to fill a black hole that it could be argued was its own creation.

**Paul Johnson:** That is an interesting question. Do I know what would have happened had spending fallen less quickly in 2010 and 2011? No, I do not. Do I think that we would be borrowing significantly less now if we had spent more then? Probably not. We might have had higher growth, but that would have been bought, as it were, at the expense of lower taxes or higher spending. I do not think that we would be borrowing less at the moment.

I do not say that that would not have been a preferable path. It might have been preferable, because we would have had higher growth. However, I do not think that anyone really believes that spending an extra £10 billion or £20 billion would have resulted in Government revenues rising by £10 billion or £20 billion very quickly. That is not to say that that would necessarily have been the wrong policy. If we look at the explanations for the lack of growth, fiscal consolidation is certainly part of that, but a lot of it is clearly to do with what has been going on in the rest of the world. The OBR and others are better placed to take on those issues.

To go back to your original question, the reason why we are borrowing much more than the Government planned is clearly that growth has been a lot less than hoped. It can be argued that the Government is being a lot less austere than it claimed that it would be. On the other hand, the plans post-2015 are extremely tight. As those plans are set out now, I question the likelihood of their being put into practice.

**Jamie Hepburn:** You say that one of the most significant domestic risks to economic recovery "remains the high level of consumer indebtedness".

I presume that you are talking about the global, collective indebtedness of individuals. Will you quantify what that is in the United Kingdom right now?

**Paul Johnson:** The numbers may be in the document, but I do not have them in my mind. Consumer behaviour in this recession has been very different from that in previous ones. Consumption has not picked up anywhere near as quickly as it did after previous recessions.

After the 1980s recession, there was a fairly steep but short-lived reduction in consumer spending and then it started rising very quickly again. This time around, consumer spending has not done that and, indeed, I think that it is still below where it was several years ago. Part of that is down to a pick-up in savings rates, which relates to the very low levels of saving and relatively high levels of debt before the recession. That consumers appear to be continuing to pay down some of that debt is clearly acting as a drag on growth, and that drag will remain.

I am afraid that I do not have the numbers to quantify that in my head, but it all appears to relate to the kind of recession that we had, with a financial crash following a period of very low levels of saving and relatively high levels of consumer debt. That sort of thing takes a long time to wash out of the system.

**Jamie Hepburn:** Could it be argued that part of the problem was that growth was predicated entirely on people getting into more and more debt? Of course, it constituted real growth in the sense that people were going out and consuming items, but the fact is that, when push comes to shove, they will have to pay the money back at some time. Now that they seem to have realised that and are paying it back, might we have to rethink our whole approach? Perhaps the previous model was not the most appropriate one.

**Paul Johnson:** The debt was predicated on an assumption that incomes would continue to grow in real terms at a couple of per cent a year. However, that has been the key variable. People might have expected their incomes to increase by 10 or 12 per cent over the past five years but, in real terms, they have fallen by several per cent. I am sort of making these numbers up a bit, but the gap between people's expected and real income is probably about 15 to 20 per cent.

The difficulty is that, as I have suggested, borrowing was predicated on an assumption that people's income level might be 15 per cent higher than it turned out to be. In a sense, the borrowing would have been sustainable had the economy, growth and growth in people's incomes been sustainable. Because income growth has not been sustained, borrowing has not been sustainable and people's difficulty in reining in their financial exposure is building on the new reality about their incomes to make the effect on the economy worse.

**Jamie Hepburn:** It is arguable, then, that the economy was not sustainable because it was predicated on borrowing.

**Paul Johnson:** Had we continued to grow, the level of borrowing would have been sustainable on the basis of a relatively slow unwinding. The question is which comes first and which drives what, and it is very difficult to determine causation. People were borrowing on the assumption that the economy would continue to grow, but the fact that the economy has not continued to grow has made borrowing look unsustainable.

**Jamie Hepburn:** I want to explore other areas, but I will come back to them later.

**The Convener:** I think that we all have other areas to explore.

**Michael McMahon (Uddingston and Bellshill) (Lab):** I am trying to get clear in my head the benefits or otherwise of the chancellor's fiscal policy commitments. The first is his five-year rolling forecast, which appears to be based on the notion that tomorrow never comes and the accuracy of which we will know only with hindsight. The second is a fixed-point commitment to balance the budget by 2015-16. He might well have introduced this flexible fiscal policy because he has not been meeting the commitments that he has set for himself, but is it possible that, when he reaches 2015-16, he might not have met his fixed-point target but his forecast will say that he might do so in the next five years? If so, what is the value of such a position?

**Paul Johnson:** That is a very deep and interesting question.

There are two fiscal rules: first, we must have cyclically adjusted current budget balance at the end of the five-year forecasting horizon which, as you say, carries on into the future ad infinitum; and, secondly, debt must be falling as a proportion of GDP in 2015. It looks like the second rule is going to be broken; I say this with more certainty than exists at the moment but, according to most forecasts, including the OBR's, debt will be rising as a proportion of national income in 2015. In a sense, it is not a terribly good rule; after all, there is nothing special about 2015.

On the other hand, despite the fact that the forward-looking rule has the strange effect of never getting to the end of its five-year period, there is still quite a lot to be said for it. Under the previous Government's fiscal rules, which were very much backward looking, the view on borrowing depended on the view of the cycle up to 10 years previously. However, it does not make a great deal of sense to say that we can borrow X billion pounds because of what the economy was doing, say, eight years ago.

The chancellor has used the flexibility afforded by the forward-looking rule to the full in the way that I have just described. He is not dramatically cutting borrowing today simply because he has a rule that says that he must; instead, he is saying that he wants to set out a credible path to getting back into balance. There is quite a lot to be said for such an approach. If, for example, we had the same rules as the European Union in its stability pact, we would have to cut spending or raise taxes today; if we had the rules that the previous Government put in place and which were actually legislated for, we would be breaking them because they are fixed with regard to the current level of debt and the chancellor would have to introduce very dramatic additional spending cuts today in order to meet them. I do not believe that any chancellor would have done so, but the act of having to throw out those rules would have made them look pointless. It is therefore rather important that we have something that sets out a credible path looking forward.

However, the problem with the forward-looking rule is that there is no anchor to it. Indeed, the chancellor introduced the additional rule that debt should be falling in 2015 to provide some form of anchor because, as you have suggested, if such a rule is entirely forward looking, you might never reach where you are going. We need an additional anchor in the system and, at the moment, we lack one.

**Michael McMahon:** I am particularly concerned about how the welfare budget will pan out as we move forward. If we take out of the equation the ideology that is driving the cuts to the budget, we see that the targets for reducing the amount of money for welfare have been predicated on the national debt. How can the chancellor make adjustments in that respect if he cannot make the forecasts and if he is missing targets all over the place? How does all that impact on his other calculations for reducing the welfare budget?

**Paul Johnson:** There are two parts to the welfare budget: one for pensioners and the other for non-pensioners. Pensioner spending is continuing to rise quite quickly; for a start, it has not been subject to any cuts. There are also more pensioners and, indeed, we will be moving into this demographic change over the next few years. Spending is also rising because the new cohorts of pensioners are entitled to more state pension than the previous cohorts and, as a proportion of total spend, pensioner spend is going to rise relatively rapidly between 2010 and 2017. The only way of changing that is to make deliberate policy changes in order to reduce benefits.

From 1997 to 2010, pensioner and non-pensioner benefit spending rose at pretty much the same rate. For non-pensioners, that was very much down to policy changes and driven very much by tax credits, the cost of which rose from about £3 billion to about £30 billion over that time, and by increases in housing benefit, which itself is driven by things such as rents rather than by policy change.

10:15

The difference going forward between the pensioner and working-age budgets is that the pensioner budget is continuing to rise and the working-age budget is now beginning to fall slowly because of some of the changes that the Government has made.

There have already been significant cuts in the generosity of tax credits and cuts to child benefit. There will be reductions in that benefits are being indexed to 1 per cent rather than inflation. That has a slightly odd effect, which is that the real value of those benefits is unknown. If inflation turns out to be high in the future, a 1 per cent cap means that it will be a very tight policy. If, on the other hand, inflation turns out to be low in the future, the cut in benefit rates will be much smaller than intended. There will also be a series of changes to disability living allowance and housing benefit.

That will all result in a noticeably lower welfare bill in future. It is all predicated on unemployment staying at its current low level relative to the level that we might expect given what has happened to the rest of the economy. If unemployment—particularly long-term unemployment—starts to grow rapidly, we will have much more uncertainty about the scale of spending.

**Malcolm Chisholm (Edinburgh Northern and Leith) (Lab):** You questioned the likelihood of future plans being put into practice. I am trying to relate that statement to the effect that it might have on the budgets of this Parliament, under its existing powers. My general point, which follows on from Michael McMahon’s, is that I am told that, at the end of this financial year, we will already have had 79 per cent of the tax increases, 67 per cent of the cuts in investment, 32 per cent of the cuts in benefits and only 21 per cent—which is the most worrying point—of the cuts in resource spending, which would have a big effect on this Parliament.

To what extent could those figures be changed either in absolute terms or in the timescales of the cuts if your earlier statement that you do not believe that future plans will be put into practice is correct? For example, could we end up with a higher percentage of cuts to resource spending? Could we end up with those cuts being made over a longer or a shorter period? How fixed are the figures in real terms?

**Paul Johnson:** Let us put this into some context. The Government initially planned cuts through to 2014-15. Then, in the 2011 autumn statement, because the economy was doing so badly, it pushed the cuts forward two years to 2016-17 and then, in the most recent autumn statement, through to 2017-18. Each time that there has been worse economic news, the response has been to say that there will be further cuts in the next Parliament.

So far, the Government has said that it will get public service spending to bear the brunt of those cuts, will not increase taxes and will do something on social security spending in proportion to what it is doing to the rest of public service spending. If we push that out from 2010 to 2017-18, we see an overall public spending cut of about 18 per cent—so, nearly a fifth.

That is a pretty extraordinary level of cut. What makes it much more extraordinary is that, if we protect the health service—which, at £120 billion or £130 billion, is much the biggest bit of spending outside of social security—and spending on schools, the consequence is that everything else, such as policing, local government, the environment and defence, will experience cuts of one third on average over that period. An on-average cut of one third implies a cut of more than one third in some of the areas that have done badly so far, which includes local government and the police. Cuts of more than one third—with big cuts to come after 2015 following substantial cuts so far—as the only way of filling the additional hole look extraordinarily difficult to achieve.

Therefore we have to think about what options will be faced by whoever wins the next election—this is not a political point. They could decide to follow the current set of plans, which as I say involve extraordinarily tight cuts for a particular set of public services. They could decide not to protect health, which would then loosen the constraint on many other areas. They could decide to increase taxes. On average, after general elections, the first budget is a big tax-increasing budget. In general election after general election, in the first budget after the election, taxes go up. We reckon that, on average over the past 30 or so years, each budget has raised taxes by about £1 billion, but each budget after an election has raised taxes by about £6.5 billion. If I was a betting man, I would bet on taxes going up in the June 2015 budget, or whenever it will be, as part of a response to the situation.

The third possibility, or it might be the fourth—I cannot remember what number I got to—is to push out borrowing so that we borrow somewhat more in the short run than is currently planned. The final option is to do more on benefit spending and, in particular, pensioner benefit spending, which so far has been protected. My guess is that we will get a mix of all those things and that the cuts will not all be ladled on to a relatively narrow set of spending, as is currently implied. I do not know, but that is my guess.

**Malcolm Chisholm:** You made the interesting comment that, even if there had been more borrowing to create more growth, you do not think that it would have changed the overall borrowing levels. If there was a significant improvement in the growth prospects, would that have a significant effect on the scenario that you describe?

**Paul Johnson:** Yes. To go back to the basic arithmetic, as it were, of why we are in the current position, public spending at its 2008 level has turned out to look unsustainable given the tax base, because national income collapsed. If national income were quickly to return to its previous trend, spending on its previous trend would be entirely sustainable. The action that is having to be taken and the additional cuts that are pencilled in post-2015 are driven entirely by the lack of growth. If growth recovered quickly, we would not need the level of spending cuts that are being considered.

An important way to think about the issue is to consider public spending as a proportion of national income. The plans are that spending will go back to about 40 per cent of national income by 2017, which is pretty much where it has been on average over a long period and where it was in the middle of the 2000s. The reason for the severe cuts is absolutely and entirely the very big cut in national income, relative to expectation. If national income were to come back, the problem would largely go away.

**Malcolm Chisholm:** Will the approach be determined by the view that is taken of the underlying structural deficit? I was struck by the big variations that you described in views on issues such as the output gap. I presume that the view that is taken on fiscal consolidation is also relevant, and that, if that was overdone, that would also influence the view of the underlying deficit. How big a difference would it make if there were big variations there?

**Paul Johnson:** It makes a difference to the view on how much consolidation is required. If we take Oxford Economics's view of the scale of the output gap, which is twice as big as the OBR view, I think that we are looking at needing a fiscal consolidation of somewhat more than £20 billion less than is currently planned—I cannot remember the exact numbers. The Fathom Consulting view of the world, which suggests that there is a very small output gap, implies that we need an additional consolidation, of a similar order of magnitude. We are talking about quite big differences in the scale of the overall consolidation. I should say that all that takes the fiscal rule as a given.

In the OBR's forecast at the autumn statement, it was noticeable that the OBR made a judgment that a relatively small part of the loss of growth in 2012 was a permanent loss. It was quite explicit in saying that its model suggested that rather more of that loss was permanent, but it layered a judgment on top of that and said, "Well, we don't really believe so much is permanent; we believe there is still quite a big output gap, and therefore the total level of consolidation required is less than it might otherwise have been."

There is a huge amount of uncertainty around the issue—it is a necessary part of a fiscal rule, in a sense, because we want to target the cyclically adjusted deficit, but it is one of the most difficult bits of any fiscal rule, because one never knows quite where one is in terms of the cyclically adjusted deficit.

**Malcolm Chisholm:** The suggestion that we will have had only 21 per cent of cuts in resource spending by the end of the financial year is the one that is most immediately alarming for this Parliament, although of course we do slightly better because certain areas, such as health, are protected at UK level. People make predictions for budgets up to 2018 based on that kind of scenario, and some people project budgets way beyond that and into the next decade. I suppose that it is often about saying, "This is how bad things are."

I want to get a feel for how confident we should be—of course we should not be totally confident. Is there so much uncertainty that it is not particularly meaningful to project resource budgets or any other budget beyond three years or so?

**Paul Johnson:** There is a lot of uncertainty about. Whatever Government wins the 2015 election, my central bet would not be that it will keep to the plans that are currently in the budget books; my central bet would be that the Government will do something rather different. What we have done in our report is say, "Given what the chancellor has said about his plans post the next election, this is what that implies for how much has been done so far." As I said, that is the only thing that we have to go on—but it would not be my central bet.

**Jean Urquhart (Highlands and Islands) (Ind):** Growth in the economy was predicted but did not happen. You said in your report:

> "Growth should gather pace in the later part of 2013 and average 2.1% in 2014."

You also said that inflation might fall. It does not feel like that will happen; it feels like inflation in food prices is rising, and world markets show that food prices are due to rise. Given the evidence of the past couple of years, why are we still saying that there will be growth? Should forecasts be more modest?

**Paul Johnson:** I should say that those are not our predictions. We deliberately get other people to do the macro-economic forecasts, because that is not part of our expertise. I do not know what is likely to happen.

As I said, the macro economic models all work in a rather similar way. They all assume a certain gap between where we are now and where trend output is, and they all assume that at some point we will start moving from where we are towards trend. What has gone wrong in the past is that—this is the case for all the models; I do not think that anyone has this right—we have not moved towards that trend, and they have had to recalibrate their models and push forward the point at which growth returns. I hope that it will at some point, but I do not know what that point will be. As I said, a lot of that is dependent on what happens in the rest of the world—we are very exposed to what happens to growth and inflation in the rest of the world. We are also exposed on inflation by, for example, the big fall in the exchange rate over the past week or two. Falls in the exchange rate have an impact on inflation and will make us worse off—that is what falls in the exchange rate do.

10:30

It is also worth saying that the pattern of inflation is an area that has had a negative effect not only on growth but on welfare across the distribution because that pattern has been focused on necessities such as food and domestic energy and has therefore had a bigger effect on those on lower incomes than it has, relatively speaking, on those on higher incomes. We are exposed economically and, as it were, socially to higher inflation.

**Jean Urquhart:** We are the most inequitable society in Europe in terms of rich and poor. In comparison with other European countries, it seems that we are resistant to taxing people on a higher income more. In fact, the UK Government has reduced the tax for the highest paid and the income of the lowest paid. When we compare ourselves with other European societies, we talk about having a fairer society, but none of the economic policies seems to address any of the issues or look creatively at how we deal with that.

Is that an issue only for the Westminster Government? Does it not care? Is it not bothered?

**Paul Johnson:** You are right that we have relatively high income inequality in the UK. It is higher than it is in most European countries, although it is not as high as it is in the US and a lot of non-European OECD countries. That is reflected in both ends of the distribution as it were—we have a bunch of extremely high earners and a lot of people who are on very low incomes.

The big increase in inequality in the UK happened in the 1980s. In the 20 years between 1990 and 2010, an increase in inequality was driven almost entirely by increases in incomes at the top end, so there was not much increase in inequality among the bulk of the population. The incomes of the people right at the top rose more quickly than everyone else's.

Since the recession, we have seen a big reduction in inequality. That is essentially because people in work, including those on high earnings, have seen their real earnings fall quite fast while, up to now, benefit levels have carried on rising in line with inflation. In 2010-11—the last year for which we have data—we saw the biggest fall in inequality in the 50 years for which we have data.

There has been a complex set of changes in the tax and benefits policies that have been implemented since the start of the consolidation in January 2010. The group who have lost most as a proportion of their income are the top group—the top 5 per cent of the population or so—as a result of the withdrawal of the personal allowance, increases in national insurance contributions, reductions in pension tax relief, the 45p and 50p rate of income tax and the withdrawal of child benefits. All those have hit the top 5 per cent or so of the population. They are the group who have lost the most as a proportion of their income.

If we look at the rest of the population, we find that the bottom third have lost the next most as a proportion of their income—essentially, we are talking about working-age people who are dependent on benefits, particularly those with children—as a result of the reductions in tax credits and the upcoming changes to housing benefit, disability benefits, council tax benefit and so on. If we look at the bottom 90 per cent of the population, we find that the higher people's income, the less they lose.

The group who have lost the least from the tax and benefit changes are basic rate taxpayers—people who are in work who are on modest to high-ish earnings. That is significantly to do with the big increase in the income tax personal allowance, which is costing the Government £9 billion a year. That is a very big tax cut which, in effect, is helping people on middle to higher middle household incomes. Things such as cuts in petrol duty are helping with that, too. Families with children have done much less well than families without children because of the reductions in child benefit and so on. Pensioners have been hit the least—there have not been any significant benefit cuts for pensioners. The budget has had a set of very different effects across the population.

You asked specifically about taxes on the people with the highest incomes. There have been some extremely big tax increases on the very highest earners—those who earn £70,000 or £80,000 a year and above. It remains the case that the top 1 per cent of income tax payers pay about a quarter of all income tax, because they earn such a huge amount.

There are options open to the Government to get more from that group of high-income or high-wealth people. Some of them are very bad options. For example, increases in stamp duty have been a poor way of raising money. A much better way would be to reform council tax. As I said earlier, I think that council tax is the only tax that has been deliberately designed to be regressive, in that it is charged at a lower rate the higher the value of the property. Simply making council tax proportional to the value of the property would hit people with relatively high wealth and would help people with relatively low wealth.

We still have problems with the capital gains tax regime, partly because it is all forgiven at death and partly because the so-called entrepreneurs relief shields a very large amount of money for a small number of people. In addition, there are changes that could be made to pension tax relief—I do not mean income tax relief; I mean the national insurance treatment of pension contributions, which is generous to people who put lots of money into pensions. There are things that could be done to the tax system if there was a desire to raise more money.

I should say that I believe the Government figures that suggest that the 50p tax rate does not raise any money. The evidence on that is uncertain, but I would not put money on raising the higher rate of income tax to 50p again as a way of raising any significant sums.

**Jean Urquhart:** Other European nations pay higher tax. Why do we not just get everyone to pay more tax?

**Paul Johnson:** That is an option. There are countries that raise more than the 38 per cent or so of national income that we have raised, on average, from tax over quite a long period. I do not think that increasing the basic rate of income tax by even 2p or 3p would be disastrous for the economy and it would raise more money. It is clear from countries such as Denmark and

Sweden that it is possible to operate using higher rates of tax as a proportion of national income than we have. However, before we do that, it is extremely important that we get the tax system effective and efficient, and we are some way from that. The more we get from the tax system, the more important it is that we have a well-functioning tax system. How much is to be got from the tax system is as much a political decision as it is an economic one. It is not impossible to operate an economy with taxes as a percentage of GDP being 1 or 2 per cent higher than we have run with for a period.

**Jean Urquhart:** Could we be more efficient at closing the tax avoidance gap? The estimates about uncollected taxes, particularly from corporations, are a hot topic.

**Paul Johnson:** I am sure that there are ways of bringing in more money. The corporation tax issue is horribly difficult. By way of background, it is important to understand that we raise much more from corporation tax than anyone looking ahead from 30 years ago would have guessed was possible. Given globalisation and given what has happened to the complexity of companies, that we still raise as much as we do from corporation tax, and that the figures have not been on a downward trend although corporation tax rates have come down, is in some senses a triumph. We should not be too downbeat about the corporation tax system’s effectiveness. That is the first bit of context.

The forecast for the next five years or so is that corporation tax receipts will come down a bit. That is largely because the corporation tax rate is coming down.

A lot of the issues that relate to raising corporation tax concern where multinational companies record their profits. In a sense, that is a zero-sum game. If they record those profits in the Netherlands, they do not record them in the UK, and vice versa. That is why various Governments, including the UK Government, are setting lower tax rates, to attract in profits. We are introducing the patent box, which will tax corporate profits that are associated with patents at 10 per cent. That is entirely to do with international tax competition and is intended to stop companies claiming profits in the Benelux countries and elsewhere and to encourage them to claim the profits here. That is the most obvious example of tax competition, and the UK is participating in that competition with a degree of gusto.

A really big issue is how to decide where a big multinational company’s profit is earned. There is a lot of international law about that, which must be agreed between countries, largely through the Organisation for Economic Co-operation and Development. Conceptually, getting the right economic answer on where profit has been earned is close to impossible. The conceptual framework is based on looking at transfer prices. If a trade takes place in a company, the idea is that that should be valued at the market rate, but there is often no market rate, particularly for things such as intellectual property.

If we really want to sort that out, we probably need a pretty radical change to how corporations are taxed across Europe, and possibly more generally, that moves towards something like the common consolidated corporate tax base, which the European Union has discussed. In effect, that would apportion profits to different countries, rather as happens between states in the United States. Politically, that would be difficult to achieve, because there are winners and losers at national level.

While we have the current system, we will continue to have rows about where profits were genuinely earned. However, as I said, the overall context is that we should be relatively relieved that we can still raise quite a lot of money. Previously, we might have thought that we would have lost all that by now.

**Gavin Brown (Lothian) (Con):** Before I focus a few questions on chapter 2 of “The IFS Green Budget”, which is on the UK economic outlook, I will pick up on one of your answers to Jean Urquhart. If I heard correctly, you said that the figures for 2010-11, which are the most recent available, showed a fall in income inequality. Can you give us the numbers? You have given some of the background. What was the size of that fall? How does it compare with other years?

10:45

**Paul Johnson:** In that year, the official figures show that incomes fell across the board: by about 1 per cent in the bottom 10 per cent, by about 3 per cent in the middle and by about 5 per cent at the top. The further up the income distribution you were, the more your income fell in that year. On the standard measures of inequality, that is the biggest one-year fall in inequality that we have seen since 1960. Now, that is the biggest one-year fall, but it still leaves inequality massively higher than it was a number of years ago. It certainly does not even begin to undo the increases in inequality that occurred before then.

We will know the answer for 2011-12 when the stuff is put out in June or July, which will give us an additional year of data.

**Gavin Brown:** You have pre-empted my next question.

In the chapter on the economic outlook for the UK, you highlight a couple of factors that could drive inflation upwards and you also highlight factors that could drive inflation downwards. What is your central bet, as it were, for inflation? Do you think that inflation will increase or decrease over the next, say, 12 months?

**Paul Johnson:** I am sorry to keep saying this, but we do not make forecasts of inflation, so I do not really have a central bet.

Within the past few weeks, the central bet has moved up because the exchange rate has come down significantly because of what the bank has said about quantitative easing and, indeed, about the exchange rate. It seems pretty clear that the bet will have been moving in an upward direction over the past few weeks.

**Gavin Brown:** Again, this is not your decision or your bet, but you have referred to the Bank of England's monetary policy committee. After the next MPC meeting, which is fairly soon, what do you expect or anticipate will happen to quantitative easing and interest rates? Obviously, there have been a few stories about interest rates lately.

**Paul Johnson:** I would be surprised if interest rates move. I would be surprised if we end up in the negative interest rate world that has been suggested. I really do not know about the likelihood of further QE.

**Gavin Brown:** In response to an earlier question on how to break the logjam, you suggested—I do not know whether this was a suggestion or just an illustration—that one way of getting the economy moving would be to provide, if I have written this down right, a short-term tax break for investment. If the chancellor were here, would you put that to him as a suggestion, or was that just an illustration of the type of thing that might be done? I just wondered what your stance was on that.

**Paul Johnson:** I said that by way of illustration rather than firm suggestion.

My honest view is that, in the short run, there are a limited number of things that you can do to make a big difference to growth. You can make a choice about your fiscal stance, so you could choose to spend more and take a different bet, as it were, which is that spending a bit more in the short run would be good for growth. You would then take the risk, as it were, about what that does for the initial level of borrowing and Government debt.

Now, there is a trade-off there, clearly. As we illustrate, the biggest risk with that is that, if we went into another serious recession—for example, because the euro zone broke up—UK Government debt would zoom up to way over 100 per cent of national income. That is the kind of risk that the Government has in mind when it thinks about what is the sustainable level of debt. I do not think that anyone believes that borrowing an additional £10 billion this year would be the straw that breaks the camel's back immediately, but it might well put us in a more difficult position if things continue to go wrong. That is part of the bet. However, you could take a bet on the total level of spending.

As I said, you could also do things such as shift the way in which the tax system works to provide short-term incentives on investment or shift the way in which you spend money by, for example, spending more on infrastructure and even less on public services. We are fairly sure that spending less on health and more on roads would be good for the economy, but politically it would be extraordinarily difficult to do, for obvious reasons.

The truth is that it is difficult to do things that affect growth significantly in the short run. Governments can do a lot of things to affect growth in the long run, which might involve infrastructure spending, the planning system, the tax system, road pricing or the way in which the education system is structured. All those things can have effects in the long run, and Governments should be continually thinking about them. One of the lessons that I have learned from macroeconomic policy is that Governments have less influence in the short run and more influence in the long run than people often believe.

**The Convener:** If the chancellor's predictions miraculously come to pass in all respects, what will be the impact on household budgets and the standard of living at the end of that period?

**Paul Johnson:** I am trying to remember the numbers. At present, our view is that household incomes in 2015 will be no higher than they were in 2001, so there will have been a decade and a half of no growth in living standards, which we have not experienced in any period for which we have any data.

A combination of things is going on in that regard. One is that there was a surprisingly low level of growth in real incomes in the period up to 2008, followed by a big drop in real incomes, some cuts in social security spending and increases in taxes. Even if earnings start growing in the next couple of years, as the OBR predicted, people will still be not much better off in 2015 than they were 15 years earlier, and they will be worse off than they were in 2008. Seven years after the recession, household incomes will still be lower than they were in the year before the recession, even if earnings growth starts motoring forward again.

**The Convener:** To what extent have interest rates been factored into that? Gavin Brown touched on interest rates and, in my view, they are likely to remain low for a period of time yet because of a lack of demand in the economy. If demand picks up and interest rates rise, there will clearly be an impact on household mortgages. Given that the property market has not recovered at all since the recession, what will the impact be in terms of negative equity and people's ability to pay their mortgages? Will it lead to further economic difficulties down the line?

**Paul Johnson:** That is an area in which the recession has had a very differential impact on people in different situations. A number of home owners with mortgages—particularly those who are a little older, rather than first-time buyers—have done pretty well in many ways. They have had very low rates of interest, and there is quite a lot of evidence to suggest that mortgages have been paid down in response, so a bunch of households have therefore done quite a lot to take themselves out of debt.

However, there is also a group of younger home owners with higher levels of mortgages, for whom their mortgage may be very high relative to the value of their house. Any significant increase in interest rates could therefore have a pretty significant negative effect on those younger groups, which have done particularly badly in the recession.

At the forefront of the Bank of England's mind when it thinks about increasing interest rates will be the effect that an increase might have, not just on households but on companies that have grown used to this historically unprecedented period of extraordinarily low interest rates. Of course, many households and businesses will not have seen the low interest rates pushed through to them as much as we might have expected. Another uncertainty will be how the banks will respond to increases in interest rates. If those increases come as the economy and the banks' balance sheets are recovering, we may see rather less than the full increase passed through, because we will be in a very different economic world.

**The Convener:** You talked about income inequality and the fact that 2010-11 saw the biggest decrease in inequality for 50 years because the income of the poorest decile fell by only 1 per cent, whereas income fell by 3 per cent for those in the middle and by 5 per cent for higher earners. Last night at the David Hume Institute, you talked about the way in which inequality will rise as the economy grows. However, that is not inevitable—surely it is down to the policies that are implemented by the Government of the day.

**Paul Johnson:** To some extent, it is because of what we know about planned policies that we predict that inequality will rise. We know that the planned policy is that for this year, next year and the year after, benefit rates for most working-age people will rise by 1 per cent. Therefore earnings have to rise only in line with inflation for the gap to grow between people in work and people out of work.

**The Convener:** If inflation is above 1 per cent.

**Paul Johnson:** Yes, if inflation is above 1 per cent—we can reasonably assume that that is likely. As earnings start growing faster than inflation, as we hope they do and, indeed, as the OBR predicts they will, that will pull earners away from non-earners.

Having a different set of policies on benefits could mitigate that effect. That is very much what happened back in the 2000s. The previous Government spent a very substantial amount of money on increasing benefits and tax credits, which was very effective in keeping a lid on inequality, at least among 90 per cent of the population. Over the period from 1997 or 2000 to 2008 incomes grew a bit faster in the lower middle of the income distribution than they did in the upper middle. Certain incomes—those of many pensioners, but especially those of people who benefited from tax credits—grew faster than the incomes of people with middle-level earnings. Even in that period, the top 5 per cent or so saw their incomes pulling away from everyone else's, so that on standard measures of inequality there was in fact an increase in inequality, even when the Government was explicitly spending tens of billions of pounds on increased benefits.

**The Convener:** I want to talk to you a bit more about chapter 7, on the tax and welfare reforms planned for 2013-14. You say:

> "The government has clear strategies both in relation to income tax for individuals on low incomes and for corporation tax, and has stuck to them".

However, you also say:

> "Elsewhere, a clear tax strategy is lacking".

You give the example of fuel duties, for which you say that

> "policy has been set in a haphazard way by repeatedly delaying (and eventually cancelling) annual cash-terms uprating that would otherwise have kept their level constant in real terms".

What has been the impact of that? I am not necessarily talking about the tax itself, because an argument can be made that if fuel duty is not increased, that helps household budgets and, indeed, businesses. However, what has been the impact of the lack of a clear strategy?

You go on to talk about the change in April under which

> "future Local Housing Allowance rates – which set the maximum rents against which private sector tenants can claim Housing Benefit – will depend upon historical local rent levels but not current ones."

You say that that is

"difficult to square with any intelligible policy objective."

11:00

**Paul Johnson:** The issue of a tax strategy is genuinely important. That is not a specific criticism of this Government, as there was no discernible tax strategy under the previous Government. A tax strategy is important so that firms in particular have some understanding and certainty about where the tax system will go in the future. To be fair, there is a lot of consultation about very specific changes to the tax system, but there is no sense of the direction in which the Government wants the tax system to go. We know that there are things that could be done to the tax system to make it more efficient, such as reforms to corporation tax, reforms to VAT and changes to how the income tax and national insurance system works, but there is no sense of where that is going.

It is also difficult politically. Last year's budget introduced the wonderful word "omnishambles" to the English language. In my view, that word was used not because all the tax policies in the budget were silly but because they were not seen as part of a long-term strategy. The policies appeared to have been thought up on the back of an envelope and to be a hotch-potch of different things. For example, the boundary between where the 20 and the 0 per cent VAT rates apply is, to some extent, going to be arbitrary. Moving that boundary to gradually increase the number of things within the 20 per cent rate is a perfectly rational policy, but the policy did not look rational in the way that it was announced in the budget, because it did not look as if it was part of a long-term policy strategy.

Another example is the removal of the additional personal allowance for pensioners. Given that the main personal allowance is rising to £10,000, that meant that the difference between the main personal allowance and the pensioner personal allowance was becoming rather small. Had the chancellor said in 2010 that it would make sense to align the pensioner allowance once we get to £10,000, that would have looked like a sensible strategy rather than a one-off bit of politics, which is how it appeared at the time of the budget.

There is a political issue. That is something that also applied to the previous Government, which introduced a lower temporary rate of tax, very low rates of capital gains tax and a zero rate of corporation tax, and then abolished them all. Doing all that is economically and politically costly, so there is a strong case for having a tax strategy. Whatever people may think of the strategies in other areas of Government, for example for health, schools and higher education, we pretty much know what those strategies are. We really do not know what the strategy is on tax. That is surprising and economically costly, given that taxes raise the money that is spent on everything else.

On the point about local housing allowance, the issue is as you read out. In 10 or 20 years, we will end up in a world in which the amount of housing benefit a person can get will relate to relative rent levels today, rather than what has happened to rents and incomes over the intervening period in the particular area. An area in which rents sometimes rise a lot faster than inflation and then go down will end up with a different cap from an area in which rents rise at the same level each year. We will end up with the odd system in which the amount of housing allowance a person can claim will depend on a bizarre set of historical factors, rather than on the current situation in the local area.

**The Convener:** I want to let colleagues back in, but I have one final question. You say in chapter 9:

"Stamp duty land tax (SDLT) is wholly ill-conceived and increasing it makes it worse."

As you know, stamp duty land tax will be replaced by a land and buildings transaction tax. Do you have any pointers on how to avoid some of the mistakes of the stamp duty tax?

**Paul Johnson:** My understanding is that you have avoided one of the problems by not having a sort of tranche system—

**The Convener:** A slab system.

**Paul Johnson:** Exactly. With stamp duty, if you increase the price of, say, a £2 million house by a pound, the tax might increase by as much as tens of thousands of pounds. That is clearly—to use a technical term—crackers and it has an impact on the number of transactions.

The real problem, however, is the impact on welfare. Let us imagine two households next door to each other, one of which has children and wants to trade up and the other of which wants to trade down because the children have left home. The mutually beneficial transaction that might ensue might very well not happen because of the high tax costs. The economic welfare costs of such transaction-type taxes can be quite significant. They might also reduce labour mobility, which could be quite important. It certainly reduces welfare and a better way of taxing housing would be through a rationally redesigned council tax.

That said, I understand why we have a transaction tax on housing—it is very easy to raise money from it. In that respect, it looks pretty efficient to Her Majesty's Revenue and Customs.

**Jamie Hepburn:** Although many of my questions about taxation and benefits have been explored, I still have a few about the welfare reforms, which you refer to in the summary of chapter 7 of "The IFS Green Budget". I am paraphrasing slightly, but you suggest that universal credit

"could constitute a welcome simplification"

of the current system. To be fair, you use the word "could", but I note that it is commonly argued that it is good to simplify systems. Indeed, Michael McMahon and I thought the same at the outset of our work as members of the Welfare Reform Committee. However, my own assessment of the welfare reforms is that simplifying the system is easier said than achieved and I am beginning to wonder whether the system has been oversimplified with the removal of certain processes that allow for a nuanced approach. After all, the lives of those going through the system have various aspects that can currently be taken into account and, in many cases, that facility has been removed. Is it fair to say that the system is being oversimplified?

**Paul Johnson:** There might be some unintended consequences. However, I suspect that, once universal credit is up and running, no one will think that its workings are far too simple.

If the systems work—and I stress the word "if"—universal credit has a number of big potential advantages such as the relative automaticity of payments and the fact that there will be much less of a change and an easier transition as people move into and out of work. Moreover, the smoother incentive structures that it creates will get rid of the worst of the work disincentives and, for the first time, it will provide a genuine incentive to work a relatively small number of hours. Those are all genuine improvements.

Nevertheless, there are, as you suggest, a number of concerns. The biggest unknown effect will be the removal of the salient point at which people know that, if they work 16 hours a week—or perhaps it is 24 now—their income rises. A lot of people are clustered around that number of hours because the system makes it very clear that they are rewarded for working them. However, under the new system's very smooth structure, 11 hours will earn someone a little bit but not very much more than 10, and 16 will earn them a little bit but not very much more than 15. We do not know how that is going to play out. For example, are a lot of people who are currently on 16 hours going to move down to, say, 10, or are they going to go up? Economic models cannot quite deal with the importance of such salience, and losing it might be significant.

There are some distribution issues, and there will be winners as well as losers. Also, the fact that council tax benefit has been taken out of universal credit and there is a wide range of more and less sensible systems that have been designed by English local authorities to deal with that will, for some groups, undo a lot of the good that universal credit might do.

**Jamie Hepburn:** We should make it clear to people who might be watching this and who are not aware of the fact that, in some English local authorities, there might well be no scheme for council tax benefit.

**Paul Johnson:** I think that all local authorities will have a scheme, but there are certainly plenty where people on the very lowest incomes will lose out and some where the combination of council tax benefit and universal credit will create poverty traps in which, as people earn a bit more, they will lose more than 100 per cent of their income.

**Jamie Hepburn:** I thought that I had caught on the news that some local authorities are wrapping the money up in their local authority settlement and will not be putting a scheme in place.

**Paul Johnson:** You might be right.

**Jamie Hepburn:** I presume then that the Scottish Government's introduction of the council tax reduction scheme—which, although it is not called council tax benefit, essentially apes the previous system—is welcome in lessening any impact.

**Paul Johnson:** It will clearly make things work a bit better here than in many areas of England.

**Jamie Hepburn:** I do not know whether you are comfortable about discussing the policy implications of some of these welfare reforms but, going back to my point about oversimplification, I note the presumption in the new system of direct payment to the recipient whereas the previous presumption with housing benefit—and this is without getting into the whole issue of the bedroom tax—was that it would be paid directly to the landlord. Registered social landlords in Scotland and in the rest of the UK have expressed concern that such a move will undermine their revenue base and make their lives more difficult. What is your perspective on that matter?

**Paul Johnson:** I cannot quantify that, but I think that this genuinely radical change to the payment of housing benefit will have a number of consequences. I know that it will make borrowing more expensive for some RSLs because their income stream will be less certain.

**Jamie Hepburn:** Indeed. In fact, I believe that, in its last downgrade, Moody's downgraded some housing associations. Is that essentially what you are talking about? Does the fact that their income stream will be undermined make it more difficult for them to borrow?

**Paul Johnson:** I do not know whether that has happened, but it makes sense. It will have that effect. The Government's—perfectly reasonable, I think—reasoning behind this is that if you want any kind of market to work and if you want people to take personal responsibility, you will have a better world if people get the money themselves and are responsible for spending it appropriately. That is the potential benefit, but the potential cost is that some people will get themselves into arrears and trouble, which will cause problems for them and their landlords.

**Jamie Hepburn:** Estimates have varied for the amount of money that will be removed from the Scottish economy because of the welfare changes—the ones that I have seen have been between £2 billion and £2.9 billion. The people concerned are not saving for a rainy day—they are spending that money in their local economy. Arguably, the changes could harm economic recovery.

11:15

**Paul Johnson:** Yes. I do not know the numbers for the amount of money being removed from the economy, but the changes will reduce the disposable income of a group of people who would, on the whole, spend all of that income. We would expect the short-term effect on the economy to be negative. There might be a longer-term positive effect if they change work incentives and they change the number of people in work. That is less certain, however. If money is taken out of people's pockets, that will have a short-run negative effect.

**John Mason:** I have two points to raise. One of them follows on from the point that has just been made. Leaving aside the question of fairness—of whether some people should have more than others—do you think that it makes a difference to the economy if we put £10 into the hands of a poorer person, whether they are working or not, or £10 into the hands of a richer person?

**Paul Johnson:** I do not know the formal figures on that but, as we have just discussed, poorer people are much more likely to consume all their income, and richer people are more likely to save it. In that sense, putting more money in the hands of poorer people rather than richer people is more likely to have a positive impact.

**John Mason:** One paper that I was reading mentioned the assumption that defence expenditure benefits everybody. Is the reality any more nuanced than that? For instance, does it matter to the economy whether the Government spends money on the army, the navy or the air force? Will it all just have a general impact? Does it matter where the Government spends the money geographically—north, south, east or west?

**Paul Johnson:** To be honest, I do not know much about defence spending and what impact it may or may not have on the economy. Where the Government spends money clearly makes a difference, however. There are parts of England and the rest of the UK that are much more dependent on Government spending than others are. First, that is in terms of the proportion of the workforce in the public sector. I do not know the numbers for Scotland, but the numbers for Wales are extremely high. That clearly has an impact on the local economy, both in the short run and in the long run. The long-run impact of that might not be positive if it is squeezing out private spending.

Related to that, there are clear regional differences in public-private pay differentials, which will also make a difference to the way in which regional economies work. As we highlight in our document, the scale of public sector job losses has been very substantial, and more than the Government or the OBR was expecting. To the extent that those are geographically concentrated, they will have a pretty big effect on the local areas concerned.

**The Convener:** I would think that, if the choice is between buying Trident missiles from the United States, which means having to make a cash transfer to the US, and procuring equipment in the United Kingdom, that surely makes quite a significant economic difference for defence.

**Paul Johnson:** I am not sure that I want to get into the Trident debate.

**Jean Urquhart:** I think that I am right in saying that the majority of benefits are paid to people who are currently in work.

**Paul Johnson:** If we take the whole benefits system, we will find the vast majority goes to people who are not in work—that is obviously the case if we include pensioners. If we consider working-age benefits, although I do not have the number in my head, I imagine that most of the money is going to people who are not in work.

**Jean Urquhart:** I have a couple of points to make around that. One is about lost income to the Treasury. A lot of minimum-wage jobs in retail, for example, which is declared to be a growing sector, are held by people who work so few hours that they are ineligible to pay national insurance and so on. It is not that they are not able to work a 40-hour week like everybody else, but there is a policy of employing more people for fewer hours, because that benefits the company. The other issue is the number of companies that are registered offshore in order to avoid the same thing—to avoid paying national insurance—and how we can curb that.

My next question goes back to inequality and gender politics. Do you think that there should be positive discrimination by the chancellor—by any chancellor—so that there is more equality between men and women, given that women are known to be the poorest in society at every level?

**Paul Johnson:** On the first of those questions, there are certainly more people working part-time and for small numbers of hours. Many of them appear to want to work more hours. How much of that is to do with the national insurance system I do not know. The national insurance system certainly plays less of a negative role in that respect than it used to, because it has been restructured in a way that makes it a bit more sensible. It is an interesting part of the lack of strategy for taxation that the personal allowance for income tax is rising quite fast, whereas the point at which people start to pay national insurance contributions has not risen at all. Nobody in work has been taken out of direct tax as a result of the increase in the personal allowance, because they are still paying national insurance contributions.

I do not think that companies being registered offshore makes any difference to national insurance contributions. Payment is made on the basis of where the person is employed. There is always an issue, however, over the point at which taxes are introduced.

I do not necessarily want to take a view on what the chancellor should be doing as regards gender equality. It remains the case that earnings among women, particularly women working part-time, are significantly lower than those among men. There has been some catch-up, however, particularly among full-timers.

The benefit reforms will have differential effects by gender. For instance, universal credit will affect lone parents differently from how it will affect single people and couples. I know that this is not necessarily a gender issue but, as I have described, families with children have generally done a lot worse as a result of reforms under the present Government than those without children.

On pension reform, the Public Service Pensions Bill that was published a month or so ago will have a significantly positive effect on women in the short run, particularly those who have spent time out of the labour market prior to 2002. A lot of women who are retiring from 2018 onwards will get significantly more from the state pension than they would previously have expected.

My last point on gender is that women make up a very large proportion of the public sector workforce, so one would expect the very large numbers of job losses in the public sector to have a particular impact on women.

**The Convener:** I realise that you have a taxi to get in about 15 minutes—I will ask you one more question if that is okay. Basically, it is on the impact of the Public Service Pensions Bill on the public finances.

**Paul Johnson:** That will be a game of two halves, as they say. The initial impact will be more spending on pensions—although the Government designed the policy to be cost neutral in the short run. More will be spent on a group of pensioners, particularly the ones I described, but there will be savings from the abolition of savings credit and from a group that the Government describes as those who are mostly living outside this country with less than 10 years of contributions. There are no data available to anyone outside of the Government that can confirm or otherwise whether that is the group that will lose. There are two groups of losers in the short run, and a group of winners in the short run, which will be mostly women who have spent time out of the labour market, plus the self-employed, plus people who have spent time contracted out of the state earnings-related pensions scheme—SERPS—but I will not go into the details of that. There will be some windfall gains for that group through the 2020s and probably in the early 2030s.

In the long run, the Public Service Pensions Bill will have a reasonably significant effect on reducing spending on pensions from about 2040 or so. That is because the bill reduces the pension eligibility of almost everybody in the long run by fixing a single rate at £144, which is less than even low earners or people out of the labour market were earning from the combination of the basic state pension and the state second pension. The overall result is 0.5 per cent or perhaps 1 per cent of GDP lower spending on pensions in the long run—I cannot remember the number—compared with what was previously planned. That is quite significant.

The other element of the Public Service Pensions Bill is to suggest—but still not to say in detail how it will occur—that the pension age will rise in line with longevity in the long run. Clearly, that is a very important component of pension policy, and it is an important determinant of spending on pensions.

By way of advertising, I should mention that we are putting out a report this Friday on the effect so far of the increasing female state pension age, which is increasing from 60. We have the first evidence on the effect that that is having on employment rates among 60-year-old women.

**The Convener:** That brings our questioning to an end. This is the longest session that anyone has had to endure from the Finance Committee in the two years for which I have been convener. Thank you very much for your detailed answers.

Thanks also to committee members for their questions.

The committee agreed to take the next item in private.

11:27

*Meeting continued in private until 11:35.*

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