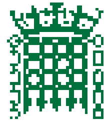

House of Commons

Treasury Committee

The 2003 Pre–Budget Report

Third Report of Session 2003–04

Report, together with formal minutes, oral and written evidence

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The Treasury Committee

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Summary

The economy

The Committee notes that the UK economy's weathering of the recent economic slowdown has been achieved despite the weakness amongst its major trading partners in the EU. Despite a disappointing trend in investment and exports, the level of growth achieved for 2003 is likely to have been within the range forecast by the Government at the time of the Budget (although lower than that forecast at the time of the 2002 Pre-Budget Report). Economic activity has been supported by a successful complementarity between monetary and fiscal policies. Recent data suggest that the imbalances in the economy have been reduced but not removed.

For the future, it is vital that UK economic policy adapts as anticipated to the upswing in the global economy, to avoid potential problems flowing from the current imbalances. The Committee is concerned about the impact of the fall in the dollar, although some of the evidence received on this was reassuring. The Committee notes also continuing uncertainty over the impact of corporate pension fund deficits, given the lack of official information.

The Committee notes the Governor of the Bank of England's view that the switch to the new CPI inflation measure should not have major significance for monetary policy, given the focus for policy on inflation two years ahead, but that the change will need careful explanation in the short term.

Public sector finances: fiscal balance and the golden rule

The golden rule was introduced to ensure that borrowing over the course of a cycle is only incurred to fund investment. The Committee notes that there is scope for greater clarity in the way the rule is framed. The Government remains on track to meet the golden rule, but will only meet it if its central forecasts for economic growth, tax revenues, spending and the likely end of the economic cycle are met. The UK's fiscal position is comparatively strong in international terms and should remain so if it strengthens as planned.

Tax receipts

Tax receipts have come in weaker than expected despite growth being on target. The Committee recommends research into why this has occurred, and calls for more information to be published on how receipts from the major taxes are forecast.

Income tax receipts have come in under forecast for the last 3 years. The Treasury's projections imply increasing numbers of people paying tax at the higher rate. The further information called for on how the major taxes are forecast should therefore include greater detail on how the income tax forecasts are made up.

Public expenditure

The Committee notes that the margins provided against overruns in the coming years in "annually managed expenditure" (mostly social security payments and debt interest) are unusually low by historical standards and calls for an explanation on the reasons for this. In respect of capital expenditure, the Committee notes evidence that (despite increased end-year flexibility and three year planning) some departments are still failing to manage their capital spending programmes as efficiently as they might and also that some further transparency is needed over the classification of current and capital spending.

The Committee notes the importance of ensuring that increases in public expenditure result in improved outcomes rather than cost inflation. It agrees with the Treasury and commentators that the current measure of government output does not adequately reflect any improvements in quality and therefore welcomes the newly-announced Atkinson review of measures of government output, productivity and prices. Any under-estimate of the real growth of public sector output could affect estimates of GDP growth and the output gap.

Other issues in the PBR

On housing, the Committee notes and discusses briefly the interim Miles and Barker Reviews of fixed-rate mortgages and housing supply, and the preliminary announcement about proposals to allow self-administered pension funds to invest in residential property.

The Committee also makes brief comments on the taxation of small incorporated businesses (in the light of possible plans to address higher the high level of take-up of tax advantages from incorporation), on the balance needed in the attack on child poverty between direct financial assistance for parents and more indirect support for services, and on the future limits for ISAs.

1 Introduction

This inquiry

1. The Chancellor made his statement to the House on the Pre-Budget Report (PBR) 2003[1] on Wednesday 10 December.[2] In accordance with previous practice, we conducted an immediate short inquiry, with a view to reporting to the House as soon as possible after the Christmas recess. Accordingly we held three evidence sessions in the week following the statement, from outside experts[3] on 15 December, Treasury officials[4] on 16 December and the Rt Hon Gordon Brown MP, Chancellor of the Exchequer,[5] on 18 December. We have also received written submissions from a number of outside experts and bodies.[6] We are most grateful to all those who have given this evidence,[7] which is printed with this Report.

The Pre-Budget Report

2. The Pre-Budget Report is one of the key elements of the Government's system for managing the economy and the public finances, as set out in the Code for Fiscal Stability published in November 1998.[8] It is intended to "encourage debate on the proposals under consideration for the Budget" and to be consultative in nature.[9] The document itself has grown steadily in size since 1997.[10] In addition, it is accompanied (like the Budget itself) by a range of announcements about tax and other measures, and a large quantity of consultation papers. It is clearly helpful to public debate for as much relevant information as possible to be placed in the public domain as soon as possible, and we therefore welcome the attempts that the Treasury is making to increase openness. At the same time, effective consultation is aided by simplicity and it is therefore appropriate to sound a note of caution about continued increases in the level of physical documentation.

3. In our Report on the 2002 PBR,[11] we recommended that "every year the Government should set aside time, ideally on the floor of the House before the Christmas recess or very shortly after, for a half or full day's debate on the Pre-Budget Report". In their response, the

1 H M Treasury Pre-Budget Report 2003, Cm 6042 (hereafter Pre-Budget Report 2003)

2 HC Debates, 10 December 2003, cols 1061–1070

3 Mr Robert Chote (Director, Institute of Fiscal Studies), Professor Peter Spencer (University of York), Mr David Walton (Chief European Economist, Goldman Sachs) and Mr Martin Weale (Director, National Institute of Economic and Social Research)

4 Mr Jon Cunliffe (Managing Director, Macroeconomic Policy and International Finance), Mr Nicholas Holgate (Director, Welfare Reform), Mr John Kingman (Head of Enterprise and Growth Unit), Mr Jonathan Stephens (Director, Public Spending) and Mr Andrew Lewis (Head of Tax Policy Team)

5 Accompanied by Mr Ed Balls (Chief Economic Adviser) and other officials.

6 Including papers on the tax provisions of the PBR, from Mr Edward Troup (Head of Tax Strategy, Simmons & Simmons) and Mr John Whiting (Tax Partner at PricewaterhouseCoopers), and a paper from one of the Committee's advisers on regional productivity, Professor Iain McLean.

7 And to the Committee's adviser on public expenditure issues, Professor David Heald, now of Sheffield University

8 The Code was laid before Parliament under section155 of the Finance Act 1998 as part of the Pre-Budget Report 1998.

9 *Code for Fiscal Stability* (HM Treasury November 1998) (Introduction and para 16)

10 The 2003 PBR comprised some 265 pages, up from 225 last year and 112 in 1997

11 Second Report, *The 2002 Pre-Budget Report*, HC (2002–03) 159

Government indicated that they would “consider the need for a debate on the 2003 Pre-Budget Report, either in the Chamber or in some other forum, nearer the time”.[12] As at the time that this Report has been prepared, there is no indication that there will be such a debate on this year’s PBR.[13] **We regret this omission, given that transparency and openness demand that government financial statements like the PBR should be subject to parliamentary scrutiny in the Chamber of the House of Commons. We reiterate our recommendation that every year the House should hold a half or full day’s debate on the Pre-Budget Report.**

4. In last year’s report, we also noted that the new practice of announcing the planned recess dates at the beginning of the annual parliamentary session should make it easier to announce the date of the Budget longer in advance than had often been the case. We observed that in 2002 the Chancellor had given almost three months’ notice of the Budget date. However, in 2003 only just over one month’s notice was given. In our Reports on the 2002 PBR and the 2003 Budget we recommended that there should always be at least two months’ notice.[14] In their response, the Government declined to give such a commitment, indicating only that they would “announce the date of the Budget at the earliest convenient opportunity”.[15] We have received no acceptable explanation as to why the Treasury will not agree to this modest recommendation. **We can only repeat our view that as much notice as possible for the Budget date is desirable and we therefore urge the Government to regard the 2002 practice—of at least 2 months’ advance notice—to be at least a working target. Advance notice for the Pre-Budget Report is also helpful. The announcement of the date for this year’s Pre-Budget report and statement was made during oral Question Time on Thursday 13 November, less than one month before the statement. We believe that the same arguments hold for advance notice for the Pre-Budget Report as for the Budget.**

12 Treasury Committee, Second Special report of Session 2002–03, *Government Response to the Committee’s Second Report: the 2002 Pre-Budget Report*, HC 528, paragraph (c)

13 Excluding the brief debate in a Standing Committee on the Government’s assessment as set out in the PBR for the purposes of section 5 of the European Communities (Amendment) Act 1993 (see Standing Committee Debates for the Fifth Standing Committee on Delegated Legislation 11 December 2003). This debate does not provide the opportunity for an in-depth debate on the full range of issues. This year it took place only one day after the statement, before there had been time for proper consideration of the statement and accompanying documentation

14 Second Report, *The 2002 Pre-Budget Report*, HC (2002–03) 159, para 8; Seventh Report, *The 2003 Budget*, HC 652, para 5

15 HC (2002–03) 528, para (d); HC (2002–03) 1028, para 1

2 The Economy

The recent past

5. After what the OECD has termed a “drawn-out period of fits and starts”[16] the global economy finally started to acquire momentum through 2003. Monetary and fiscal policy in many of the major economies continues to support growth and since the spring easing geopolitical tensions, steadier oil prices and recovering confidence have combined to produce sharp rebounds in the US and Japanese economies and added further strength to the recovery already under way in much of Asia. The OECD has revised upwards its spring forecast of 1.8% growth for the OECD area in 2003[17] and now expects growth of 2.0%. It expects the UK economy to enjoy growth close to the OECD average this year, some way behind expected growth of 2.9% in the US and 2.7 % in Japan, but well ahead of the 0.5% growth expected in the euro area.[18] **We note the European Commission’s comment that “the UK economy weathered the recent global slowdown well”.**[19] **This is particularly notable in the face of the continued weakness in activity in its major trading partners in the euro area.**

6. In spite of the clear signs of recovery in the global economy in recent months, risks flowing from the scale of current global imbalances remain. In particular, many commentators agree with the Treasury’s assessment that “a sharp fall in the value of the US dollar would have significant implications for growth in those economies that are dependent on US trade, and might also hit US domestic demand by pushing up long-term interest rates and reducing household purchasing power.”[20] In that context, **the Committee is concerned that the recent fall in the dollar may jeopardise global recovery prospects, although some of the evidence we received on this point was generally reassuring**. Professor Spencer told us that “provided that we can see the dollar adjusting in an orderly kind of way, as we have done fortunately so far, then it is not just US exporters that benefit…., but the European economy benefits in the sense that the stronger euro means that upward pressure on price inflation is reduced. Remember that the ECB has found it extremely difficult to cut interest rates in Europe because consumer price inflation has remained doggedly above its 2 per cent target.”[21] Mr Cunliffe from HM Treasury also noted that the problems created for the eurozone by recent currency moves had to be set alongside the strong US growth performance and that “the effect is the net of those two and even though the euro has been strengthening against the dollar in the third quarter of this year, eurozone exports, particularly to the US, have strengthened particularly in the third quarter.”[22]

16 OECD Economic Outlook No 74, Preliminary Edition, November 2003

17 OECD Economic Outlook No 73, Preliminary Edition, April 2003

18 Forecasts based on OECD Economic Outlook No 74, Preliminary Edition, November 2003

19 EU Commission Autumn Forecasts

20 Pre-Budget Report 2003, Box A2, p 174

21 Q 6

22 Q 96

7. In the 2002 Pre-Budget Report the Treasury forecast UK growth in 2003 of 2½ to 3%,[23] slightly above the average forecast from independent forecasters[24] at the time of 2.4%. In the last Budget the Treasury reduced the forecast to 2–2½%, consistent with the consensus view of independent forecasters at the time.[25] The Treasury currently estimates that the UK economy will have grown by 2.1% in 2003, near the average of independent forecasts.[26] In spite of UK growth emerging broadly in line with forecasts, recent months have been marked by significant revisions to the economic data. As the Governor of the Bank of England has remarked, these have tended to dissipate some of the "statistical fog"[27] that had previously surrounded the economy. As the Treasury notes,[28] the revisions have also served to reduce, but not remove, some of the imbalances that had appeared in the UK economy. Consumer spending growth has generally been revised down a little and fixed investment growth in recent years has been revised up. The net trade position has also emerged a little stronger after the revisions. Even so, comparing the Treasury's current estimates for 2003[29] with its forecasts at the time of the Budget,[30] two of the main areas of disappointment are fixed investment and exports. Looking at fixed investment, growth is now expected to be about half the 4¼–4¾% projected in the spring. For exports, meanwhile, the latest estimates point to a small fall this year rather than the small rise originally expected, although the disappointing trend in exports is offset in terms of the GDP arithmetic by a smaller rise in imports. **In spite of a rather disappointing trend in fixed investment and exports, current estimates of UK economic growth in 2003 are consistent with the reduced forecast of 2–2½% growth published by the Treasury at the time of the last Budget.**

8. As the world economy has recovered, the concerns about global deflation the Committee noted in the spring[31] have receded. The Governor of the Bank of England has indicated that the Bank has been engaged in a strategy in recent years of "stimulating domestic demand to compensate for weak external demand in the face of a strong exchange rate"[32] and this policy has been broadly appropriate to the circumstances. **Throughout a volatile period in the world economy the Committee observes that the MPC has continued successfully to maintain UK inflation close to the target laid down by the Chancellor. Moreover, while maintaining inflation inside the target range, monetary policy has also been able to provide substantial support to growth by delivering historically low short term interest rates to the economy.**

9. The Bank's pro-growth strategy has been supported by fiscal policy and Professor Spencer observed that "were it not for the strength of public spending as we go into [2004], I think [the economy] would still be growing well below trend…. As the PBR says, fiscal

23 Pre-Budget Report 2002, Cm 5664, Table A2, p 158

24 Forecasts for the UK Economy, HM Treasury, 20 November 2002

25 Budget 2003, HC 500, Table B5, p 234

26 Pre-Budget Report 2003, Table A8, p 197

27 HC (2002–03) 1337 Q 44

28 Pre-Budget Report 2003, paragraph A25, p 178

29 Pre-Budget Report 2003, Table A10, p 200

30 Budget Report 2003, Table B10, p 242

31 Seventh Report of Session 2002–03, *The 2003 Budget*, HC 652–1, para 11

32 Mervyn King, Speech to East Midlands Development Agency, Leicester, 14 October 2003

policy has supported monetary policy in keeping us going through this period."[33] **The successful complementarity of monetary and fiscal policy has played a key role in delivering a UK economic performance over the past few years which the IMF describes as "enviable"34. Key tests for both monetary and fiscal policy nevertheless lie ahead as recovery emerges.** As the IMF also noted, "the external environment is now improving, and macro-economic policies should tighten to rebalance external and domestic demand". Our expert witnesses broadly supported this view. Mr Walton noted that "the big challenge for policy now is to stop the UK economy from growing too fast as we go forward from here".[35] Professor Spencer noted that it would "be extremely tricky for the Monetary Policy Committee to be [as] adept at slowing this process down and rebalancing the economy as it has been adept in keeping the economy going through the world recession"[36] and that "if you believe in fiscal fine-tuning, it is now time to start tightening up on the public sector side".[37] **As the global economy recovers it is vital that UK economic policy adapts as anticipated to the upswing, to avoid potential problems flowing from the current imbalances in the economy.**

The outlook for the UK economy

Table 1

Comparison of latest UK GDP growth forecasts, % change

	2003	2004	2005
HM Treasury*	2.1	3 to 3½	3 to 3½
Bank of England**	n.a.‡	2.7	2.8
OECD***	1.9	2.7	2.9
European Commission†	2.0	2.8	2.9
Av of Ind Forecasts††	1.9	2.6	2.7

* Pre-Budget Report 2003
** November 2003 Inflation Report
*** OECD Economic Outlook, September 2003
† Autumn forecast, October 2003
†† Forecasts for the UK Economy, HM Treasury, November 2003
‡ Bank has not published a full 2003 estimate since substantial data revisions in October

10. After the Budget last spring we noted that "economic forecasters generally agree about the outlook for the UK economy in 2003" and that most "expect the recovery to gather pace somewhat in 2004, although the Treasury's forecasts stand out in terms of their optimism regarding the scale of the acceleration in UK growth anticipated".[38] As Table 1 shows, this remains broadly true although since the Budget the average of independent forecasts of UK growth for 2004 has risen from 2.4%[39] to the 2.6%[40] recorded currently. **The Treasury's economic forecasts for 2004 and beyond continue to look more**

33 Q 32

34 IMF, United Kingdom – 2003 Article IV Consultation, 18 December 2003

35 Q 9

36 Q 9

37 Q 32

38 Seventh Report of Session 2003–03, *The 2003 Budget*, HC 652–1, para 13

39 Forecasts forthe UK Economy, HM Treasury, April 2003

40 Forecasts forthe UK Economy, HM Treasury, December 2003

optimistic than most, although the gap between the Treasury's assessment and that of most other forecasters has narrowed, with most independent forecasters now a little more optimistic about growth in 2004 than they were in the spring.

Consumption

11. As the Treasury observes, "while underlying consumption growth appears to have eased since the second half of 2002, it has continued to outpace increases in disposable income, thereby contributing to continued steady growth in demand for personal borrowing since Budget 2003."[41]

12. Many economists have identified the continued build up in personal borrowing as a potential source of instability in the economy, particularly given the role played in its build up by the housing market. The UK's position is far from unique. The OECD have warned that "in a variety of countries—including the United States, the United Kingdom and Australia—households remain highly indebted and may suffer large wealth losses, especially in the housing sector, should interest rates increase abruptly".[42] Treasury officials argued that such fears were misplaced. Mr Cunliffe told us that "when you look at the debt service to income ratios, the amounts of their income people are paying in mortgage payments or interest payments generally are low." [43] Although the Treasury also notes that "while mortgage equity withdrawal has increased, households [in aggregate] have simultaneously been building up their holdings of financial assets", there is no discussion in the Budget documentation of the distributional impacts or of the extent that the households purchasing the financial assets are the same as the households building up liabilities. In addition, the Bank of England has flagged that there is "evidence of large unsecured borrowing relative to income by a small proportion of individuals. This may not necessarily be a problem currently, although it could become one if these borrowers experienced adverse financial shocks, such as unexpected increases in interest rates or falls in income."[44]

13. When asked for the Treasury's view on the risks posed by the build up in personal debt should interest rates start to rise, we were told that "questions of how interest rate increases affect consumption are really questions for the Bank of England because short run demand management of the economy is their job and not ours."[45] The Governor noted that in aggregate the ratio of interest payments to income is running at "half the level that it was in the early 1990s, and again it will require a very, very dramatic rise in interest rates to get us back to where we were in the early 1990s in aggregate. From that picture, I think people have exaggerated the vulnerability of the economy to likely changes in policy" but "there are minority groups of households, if you look at households facing ratios of debt servicing to income of more than 40, 50%, where it would not require a very large increase in interest rates for those families to find themselves with the sorts of difficulties that they had faced

41 Pre-Budget Report 2003, para A71, p 190

42 OECD Economic Outlook No 74, Preliminary Edition, November 2003

43 Q 97

44 Bank of England Quarterly Bulletin, Winter 2003, p 425

45 Q 98

ten years ago".[46] However it is plain that the Bank takes a very limited view of its role on the issue of how to respond to any problems created by the rise in personal debt levels if they do not have an effect on the economy in aggregate. Professor Nickell of the MPC told us "That is not to say that higher rates of bankruptcy, more families getting into difficulties and so on is not an extremely important issue. It is an issue which may concern many people in Britain and also some branches of government. It is an issue which you will be extremely interested in. It is just that there is little practical relationship to monetary policy."[47] **While the probability of either a fall in house prices or a rise in interest rates on a scale that would create widespread problems for households should be viewed as very limited, we think it is nevertheless important for both the Treasury and the Bank of England to consider how policies could impact on individual households whose debt servicing ratios have become unsustainable.**

Fixed capital formation

14. We noted earlier[48] that one of the areas of disappointment in the UK's economic performance through 2003 has been the trend in fixed investment. We highlighted in our report on the Budget[49] that the Treasury's optimism here was one of the more controversial aspects of its spring economic forecasts, with most forecasters expecting a much more modest recovery in fixed investment through 2003. In spite of fixed investment over the past year only growing at around half the rate originally expected by the Treasury, the Pre-Budget Report still expects a relatively robust 6–6½% rebound in fixed investment activity in 2004.[50]

15. In part the Treasury's optimism on the investment outlook is fuelled by a projected 30% rise in general government gross fixed capital formation, although much of this rise represents public sector investment originally scheduled for calendar 2003 slipping into calendar 2004. The effect is that general government investment spending is still expected to be near target over the financial year 2003–04, thanks to a large surge in spending in the first quarter of the calendar year/final quarter of the financial year.[51] The Government is currently engaged in a programme that implies a large increase in public sector fixed investment. This inevitably poses problems for managing a smooth flow of spending in this area. The persistence of a pattern of large surges in spending concentrated in the final few weeks of the financial year is not one that is conducive to efficiency and value for money in the spending of public money. Despite the welcome improvements in the control of public expenditure including allocating resources to departments on a three-year basis and giving them more flexibility to carry forward unspent resources, the NAO recently noted "a continuing bias to a higher proportion of both revenue and capital spending in the last two months of the year. Some departments lacked sufficiently complete information to ensure that expenditure was spent in a measured way throughout the year".[52] The Chancellor

46 26 November 2003, HC (2002–03) 1337 Q 85

47 18 September 2003, HC (2002–03) 1114, Q 93

48 para 7

49 Treasury Committee, Seventh Report of Session 2003–03, *The 2003 Budget*, HC 652–1, para 16

50 Pre-Budget Report 2003, Table A6, p 192

51 Qq 106–109

52 NAO *Managing resources to deliver better public services* HC (2003–04) 61

acknowledged that "I think [the Committee's] point about departments getting it right is taken on board."[53] Treasury officials also indicated that discussions with departments about ways of tackling the problem are underway.[54] **The Committee attaches the highest importance to securing the best possible value for money in public spending. It is disappointing to note that, despite the welcome improvements to the control of public expenditure that have enhanced flexibility, many departments are still failing to manage their capital spending programmes as efficiently as they should. We recommend that the Treasury takes action to improve the planning and monitoring of public sector capital spending programmes within the financial year. We would welcome a report on any such action in the 2004 Spending Review.**

16. Alongside the strong growth in public sector gross fixed capital formation, a recovery in business fixed investment is generally expected. Data revisions suggest that the trend here over the past couple of years has in any case been less depressed than once thought. Many outside forecasters nevertheless suspect that the Treasury's forecast of a 3 to 3½% rise in business investment in 2004 and a 5½ to 6¼% rise in 2005[55] may prove rather optimistic. For example, the Treasury's assessment that "with corporate profitability having risen over the past year and company balance sheets far healthier than during the late 1990s ICT boom, businesses are well positioned to step up investment as the global recovery gathers pace into 2004"[56] strikes a notably different tone to the Bank of England's view that "there may be a number of factors limiting the recovery in companies' investment spending. Capital gearing remains high, there has been little sign of pressure on physical capacity at this stage and pension fund deficits may be diverting cash away from other uses…..the [Monetary Policy] Committee expects business investment to continue recovering, albeit moderately."[57] Professor Spencer also expressed some caution on the outlook for corporate fixed investment, noting that "one of the reasons for our pessimism relative to the Treasury is that we remain concerned about the state of the company sector finances and the effect of pension fund deficits on business expenditure." [58]

17. The problems potentially flowing from large pension fund deficits surfaced in the course of our inquiry into the 2003 Budget. Our May report on the Budget noted that "the potential impact on the broader economy of the current weak state of many pension funds is a serious one that does not yet seem to have received the attention is deserves….We recommend that the Treasury should co-ordinate with relevant bodies the publication of aggregate data to enable the issue to be more readily quantified and assessed."[59] In its reply, the Treasury stated that "Pension funds' statistics are an important issue for the ONS and Government statistical service more widely. The recent report of the Review of Pension Contributions Statistics (conducted by a committee comprising academics, industry experts and officials from various Government departments) and subsequent action plan highlighted areas for improvement in the information available on pension funds. One of

53 Q 278

54 Qq 109–111

55 Pre-Budget Report 2003, Table A6, p 192

56 Pre-Budget Report 2003, para 2.35, p 26

57 Bank of England Inflation Report, November 2003, p 27

58 Ev 71

59 Seventh Report of Session 2003–03, *The 2003 Budget*, HC 652–1, para 17

the action points was to consider whether a statistical digest or fact sheet could be produced, bringing together all available pension statistics. The action points are being taken forward by ONS, HMT, DWP and others."[60] There appears, however, to have been little or no progress in this area in recent months. While Mr Cunliffe noted that "There is information on pension fund deficits. As I recall, it is not easy to compile an aggregate figure."[61] When asked for a progress report on compiling aggregate figures, Treasury officials had little to add to the Treasury's original response to our Budget 2003 Report.[62] The Committee has noted, however, that private surveys continue to point to a multi-billion pound deficit in UK company pension funds, even though the scale of the problem has been reduced after the recent revival in the equity market.[63] **The Committee is disappointed at the lack of progress on improving official pension fund statistics. The health of UK company pension schemes appears to be a major gap in the information flow into the Treasury's assessment of the economic outlook. Given its crucial impact on British households, we recommend that the Government show much greater urgency in ensuring the provision of regular and reliable official information on pension fund deficits. We further recommend that the Chancellor report on this issue expressly in the 2004 Budget.**

The output gap

18. Central to the Treasury's broad economic forecasts is an assessment of the output gap that is notably higher than most forecasts. Treasury officials told us that "our forecast is based on the [assessment] that there is an output gap of around 1½ per cent in the economy and that output gap will close over two years. We have seen in the past when the economy is closing similarly sized output gaps, in the mid 1990s, for example, growth has been around 3½ per cent and in the 1980s it was higher. Of course the increase in the trend rate of growth has made it more possible that we can reach a rate of 3 to 3½ per cent." [64]

19. Many independent forecasters feel that the output gap is much lower than the Treasury suggests, but all our expert witnesses agreed that the output gap is, in practice, very hard to assess with any confidence.[65] Given the importance of the issue in assessing policy, however, not least because of the difficulties in dating economic cycles arising from data uncertainties, several commentators have suggested that transparency could be further improved by giving an authoritative, independent body the task of judging issues such as the dates of the cycle and the UK's cyclical position. The benefit would not be so much that the judgement made by such a body would necessarily be better than that made by the Government but that it would be seen to be independent.[66] One of the supporting studies published as part of the euro assessment looked at measures to improve the credibility and transparency of fiscal policy. The discussion paper argued that the more active fiscal stabilisation policy became, the greater was the "the case for enhancing independent

60 Government Response to the Committee's Seventh Report on The 2003 Budget, HC (2002–03) 1028, para 8

61 Q 103

62 Q 279

63 Research by AXA Investment Management, for example, was quoted in the *Financial Times*, 1 December 2003, p 5

64 Q 94

65 Q 5

66 Q 5, Q 46

surveillance. This could be achieved by increasing the role of independent analysis (e.g. for technical elements such as 'dating' the economic cycle) or strengthening the monitoring of fiscal policy, through existing structures such as the EU."[67]

20. Mr Balls, Chief Economic Adviser to the Treasury, argued that at least the Government's current approach made its assumptions about the output gap explicit, suggesting that "until 1997, government in the UK did not publish estimates of the output gap and they did not publish estimates therefore of the cyclically-adjusted fiscal balances, and so it was not possible to reach a judgment as to where you were in the cycle…. It is a strength of the system in the UK that there is now an open public debate about the trend growth rate, the level of the output gap, when the cycle started, when the cycle ended."[68] **The Committee welcomes the improved transparency in recent years provided by the Treasury's explicit discussion of issues such as the output gap and the cyclical position of the UK economy. It encourages the Treasury to explore ways of further improving transparency, which may include closer involvement of outside bodies or experts in the judgements made.**

The switch in the inflation target

21. In his June 2003 statement to the House on UK membership of the single currency the Chancellor stated that the Harmonised Index of Consumer Prices was "a better measure [of inflation], will improve the quality of our target, is in line with best international practice and is used by every other G7 nation but Japan, and by our neighbours in Europe";[69] as a result he had "written to the Governor of the Bank of England today stating that subject to confirmation at the time of the Pre-Budget Report I intend to change the inflation target at that time. The inflation target for Britain will be set on the consumer prices definition. I can confirm that pensions and benefits and index-linked gilts will be calculated on exactly the same basis as now."[70] The shift in the target measure of inflation was confirmed in the Pre-Budget Report, with the Chancellor announcing an immediate switch to a new target of 2% CPI[71] inflation, with the open letter system being triggered should inflation stray by more than 1% from this target.

22. The Treasury noted that "the rate for the new target is half a percentage point lower than the old target. The gap reflects the differences in the way CPI and RPIX inflation are measured, notably the formula effect, which means that CPI inflation tends to be lower than RPIX inflation on average. The level of the new target is set to be consistent with previous target in two years time, that is, the typical time horizon for monetary policy purposes",[72] although the current gap between the two measures is 1.3 percentage points, primarily reflecting the impact of rapid rises in housing costs. Housing costs and council taxes are excluded from CPI inflation but included in RPIX inflation.

67 *Fiscal Stabilisation and EMU*, HM Treasury, June 2003, para 23, p 5

68 Q 285

69 HC Deb, 9 June 2003, col 408

70 HC Deb, 9 June 2003, col 414

71 It was announced at the time of the PBR that the ONS had retitled the HICP as the Consumer Price Index (see New Inflation Target: the Statistical Perspective, ONS December 2003)

72 Remit for the Monetary Policy Committee of the Bank of England and the New Inflation Target, HM Treasury, 10 December 2003

23. Professor Nickell of the Monetary Policy Committee has argued that in spite of the current wide gap between the two inflation measures "in the long run, the stance of monetary policy would be unaffected and even in the short run there would be little noticeable difference".[73] Most of our expert witnesses seemed to agree with this assessment, with few expecting any dramatic impact in, for example, the labour market arising from the switch in inflation targets.[74]

24. In spite of this assessment from our independent experts, the Chancellor announced to the House that "because discipline in pay setting is essential in both private and public sectors, I have …. written today to Public Sector Pay Review Bodies informing them that our inflation target is 2 per cent."[75] However, there appears to be a ready recognition from the Treasury that even in the public sector it would be unrealistic to expect pay awards simply to follow the inflation target. The Chancellor confirmed to us that "I am not being prescriptive in announcing a pay policy"[76] and Treasury officials confirmed that "the Chancellor has written as a courtesy to the Pay Review Bodies to let them know of the change in the inflation target, so that is one of a number of factors which they can take into account in their recommendations, but the overwhelming issue for Pay Review Bodies is the need to recruit, retain and motivate workers in the appropriate sectors, and that is the key issue which the Government is directing the Pay Review Bodies to consider."[77]

25. The Governor of the Bank of England has, however, indicated that to switch inflation targets at a time when the gap was so wide did pose problems for the presentation of monetary policy. In September he told the Committee "on the latest reading, the difference between the [two inflation] measures was 1.5%, and, although this difference is expected to narrow substantially over the next two years, it may well remain at or above 1% well into next year. In such circumstances, the change in the target will need to be explained extremely carefully."[78] He expanded on this in November, telling us that this involved "explaining to people at large why it is that [inflation] is presently above the target and then suddenly it will appear below the target and yet from our point of view we do not see that as having major significance for monetary policy".[79] The Chancellor told us that, as the Bank had reported in the previous inflation report, "they will be setting interest rates based on their assessment of the likely level of inflation two years ahead…[at which time] the CPI is expected to be 2% and RPIX is expected to be 2.5%".[80] The Bank has yet to publish a formal projection for CPI inflation but the Governor made it clear to us in November that "the central view of the gap between RPIX and [CPI] inflation looking two years ahead is around half a percentage point" so that "looking two years ahead it does not make very much difference to monetary policy". **Although the Governor of the Bank of England has indicated that he does not think the switchover will be of major significance for monetary policy, given the focus on inflation two years ahead, we note his comments**

73 "Two Current Monetary Policy Issues", speech 16 September 2003

74 Q 80

75 HC Deb, 10 December 2003, col 1063

76 Q 363

77 Q 255

78 18 September 2003, HC (2002–03) 1114, Q 2

79 20 November 2003, HC (2002–03) 1337, Q 61

80 Q 355

regarding the need for care in the short term in explaining the switch in the inflation target from RPIX to CPI inflation and will scrutinise the progress made in enhancing public understanding of the change.

3 Public Sector Finances

The fiscal balance

The framing of the golden rule

26. On the Treasury's forecasts, fiscal policy tightens going forward and the public finances are "on track to meet the golden rule"[81] (which focuses on the current budget judged across the cycle). The Pre-Budget Report thus confirms that the Treasury expects to see the "cyclically adjusted surplus, which allows underlying or structural trends in the indicators to be seen more clearly by removing the effects of the economic cycle….returning to balance in 2006–07." [82]

27. Given the central role it has acquired in UK fiscal policy discussion in recent years, the Committee was nevertheless surprised to find a degree of uncertainty among experts about exactly how the "golden rule" was calculated. In the Pre-Budget Report 2002, for example, the section on the golden rule states "the projections show that the Government is firmly on track to meet the golden rule. Over the period of this cycle, from 1999–2000 to 2005–06, the current budget is comfortably in surplus, with an accumulated surplus of £46 billion."[83] Similarly in the 2003 Budget Statement it was announced that "we meet our golden rule over the cycle….We will not only achieve a balance but achieve an estimated surplus at £32 billion."[84] The Pre-Budget Report, however, appears to change the emphasis in assessing the golden rule away from the simple summation of cash figures for the current surplus to a summation of the current surplus each year as a percentage of GDP, stating that "the projections show that the Government is on track to meet the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over the whole cycle of around 0.2% of GDP, equivalent to a margin or surplus in this cycle of £14 billion."[85] As both Mr Chote[86] and Mr Walton[87] noted, this *apparent* change in definition of the golden rule, from the average current surplus over the cycle to the average current surplus *expressed as a percentage of GDP* over the cycle, effectively takes the surplus over the cycle from £4 billion to £14 billion. Mr Balls contended that "the accusation that we have changed our methodology is just untrue"[88] and the way the golden rule was calculated was clearly referenced in "footnote 8 on page 34"[89] of the 2003 Pre-Budget Report. **The Committee accepts that the substance of the golden rule has not changed, but differences in phrasing in recent Treasury documents may have been a source of some confusion. We recommend that the presentation of the Government's progress towards**

81 Pre-Budget Report 2003, para B7, p 202

82 Pre-Budget Report 2003, para B7, p 202

83 Pre-Budget Report 2002, Cm 5664, para B7, p 182

84 HC Deb, 9 April 2003, col 284

85 Pre-Budget Report 2003, para B7, p 202,

86 Ev 63–64

87 Q 26

88 Q 295

89 Q 295

meeting the golden rule should be standardised and be based on the average annual surplus of the current budget as a percentage of GDP.

28. A lack of clarity was also evident in the debate about fiscal policy and how the golden rule applies to the so-called "cautious case". The Pre-Budget Report states that "the average surplus on the current budget in the cautious case is no longer positive, though the government is on track to meet the golden rule."[90] Putting aside the issue of whether the discussion should actually be focussing on "the average surplus on the current budget as a percentage of GDP", our economic experts found this statement confusing.[91] In reality, Treasury officials confirmed to us that "the cautious case has never been part of the framework of meeting the golden rule"[92]. The Chancellor told us that the "cautious case" meant that he had "deliberately over-achieved [the golden rule] in the early phase of [the cycle]. We did that by instituting a cautious case, which was put in to ensure that in the early phase of the cycle, when you did not know the path to output and revenues, you over achieved."[93] **The Treasury should make the role of the cautious case in the fiscal planning process through the cycle clearer in the Budget and Pre-Budget Report documentation.**

29. There is, in addition, an issue as to whether, in purely economic terms, a small breach of the golden rule is significant. Several of the expert witnesses we questioned suggested that minor breaches were of little economic importance.[94] The way in which the fiscal rules are expressed may need further development given the considerable amount of evidence the Committee has heard in the course of this inquiry about the margin of error around fiscal projections.[95] There is a danger that policy will be excessively influenced by the danger of "very small breaches which are due to very small shocks in the economy which, with the best will in the world, the Chancellor could not actually anticipate very easily."[96] To be certain of meeting the golden rule as currently framed, the Chancellor effectively needs to aim for a current surplus over the cycle even if the intent of the golden rule is simply that Governments should not borrow to fund current spending.

The fiscal position

30. The Pre-Budget Report indicates that the estimated net borrowing requirement for 2003–04 has risen from £27.3 billion at the time of the Budget to £37.4 billion in the Pre-Budget Report,[97] and for 2004–05 it has risen from £24 billion to £31 billion. In both cases the bulk of the deterioration in the public finances can be traced to a weakening in the current surplus, rather than any changes in net investment. The current surplus for 2003–2004, for example, has deteriorated by £10 billion since the Budget. The Treasury's view nevertheless remains firmly that the public finances remain "on track to meet the golden

90 Pre-Budget Report 2003, para 2.74, p 39

91 Q 35ff.

92 Q 257

93 Q 295

94 Q 93

95 see para 32 below

96 Q 40

97 Pre-Budget Report 2003, Table B2, p 204

rule"[98] and the Pre-Budget Report projects that the annual surplus on the current budget will be back in balance by 2006–07.[99]

31. In the 2003 Budget and 2002 Pre-Budget Report documentation the Treasury included a table showing the factors underlying changes in projections of public sector borrowing.[100] These disaggregated the changes into those attributable to the automatic stabilisers, other non-discretionary factors and discretionary measures including policy decisions in the respective PBR and Budget. **We were surprised that there was no table contained in the 2003 PBR breaking down the changes in public sector borrowing since the previous forecast between those attributable to the automatic stabilisers, non-discretionary factors and policy decisions. We ask the Treasury to re-introduce such a table in the Budget (and future Budgets and PBRs).**

32. When questioned about the £10 billion overshoot in borrowing in 2003–04, Treasury officials suggested "that the difference between our forecast [at the time of the] Budget and what has happened now is in line with the standard error for fiscal forecasting over the last 20 years… and it is within the line of the normal uncertainties".[101] Treasury documentation itself suggests average absolute errors of 1.1% of GDP in deficit forecasts one year ahead and 1.6% two years ahead.[102] On the basis of these error margins, Mr Weale suggested "it is probably fair to say that the Chancellor's own forecast implies that the chance of breaking the golden rule in the current cycle is between one in four and one in five".[103] Professor Spencer, meanwhile suggested that on a slightly more cautious economic view than the Treasury, his view was that in 2005–06 there was "a 50–50 chance of breaching the golden rule, or in the following year, with a much greater probability of violation."[104]

33. It seems reasonable that the margin allowed for error within the Chancellor's fiscal arithmetic should narrow as the cycle progresses. As Mr Chote pointed out to the Committee, "there is no case for overachieving the golden rule *ex post* unless you are near the debt to GDP ceiling in the sustainable investment rule and you want to create some room for some more investment. So, in that sense, the Chancellor may be taking the view that as we are now four-and-a-half years into the cycle, you do not need quite as much caution at this stage as you would have done when you started out." [105] As Mr Chote went on to point out, however, "the debate is, how much caution do you think is appropriate at any given point in the cycle?" and the view of many of our expert witnesses was that there was now very little room for any further slippage in the fiscal arithmetic.

34. The IMF has expressed similar concerns about the robustness of the Chancellor's fiscal projections to those voiced by the Committee's experts witnesses. After noting that "the PBR sees a turnaround in the public finances even in the absence of policy actions" it

98 Pre-Budget Report 2003, para B7, p 202

99 Pre-Budget Report 2003, Table B2, p 204

100 See Budget 2003, Table 2.3 p 28, and Pre-Budget Report 2002, Cm 5664, Table 2.4, p 25

101 Q 93

102 HM Treasury *End of year fiscal report*, December 2003, Tables 2.6 and 2.7 and Charts 2.4 and 2.5

103 Ev 74 (para 9)

104 Ev 72

105 Q 38

concluded that “We see significant risks to [the Treasury’s] projections. On unchanged policies we see only a small improvement over the forecast horizon, with the deficit about 1 percentage point of GDP above the government’s projections by 2006/07….in this scenario the risk of breaching the golden rule is not trivial.”[106]

35. In our report on the last Budget we observed that the margin for error around the Government’s fiscal position was narrowing, but the Committee still felt able to conclude with some confidence that “the Chancellor is on course to meet the golden rule during the current cycle.”[107] **While the extra borrowing envisaged since the time of the last Budget means that there is now less slack, the Government remains on track but will meet the golden rule only if its central forecasts for economic growth, tax revenues, spending, and the likely end of the current cycle are met. The Government will have to remain mindful of the consequences of any further unplanned increases in borrowing arising from any shortfall in planned tax revenues.**

36. The sustainable investment rule states that “public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.”[108] The Treasury’s forecasts in the current Pre-Budget Report continue to suggest that the sustainable investment rule will be met by a wide margin.[109] However, the EU recently noted in its Autumn Forecasts that “the ratio of gross debt to GDP….will be close to 40% by the end of 2005.”[110] Indeed on a Maastricht basis, not used in assessing the sustainable investment rule, the UK debt/GDP ratio rises to 41.5% by 2008–09 on the current Treasury projections.[111]

37. While the fiscal arithmetic continues to meet the golden rule and the sustainable investment rule on the Treasury’s central forecasts, the Treasury’s projections also show that on a Maastricht basis the public sector deficit is now expected to reach 3.3% of GDP in 2003–04,[112] breaching the Maastricht limits. The Chancellor told us that the UK’s fiscal deficit as a percentage of GDP remains relatively modest by current international standards and, on current projections, falls more rapidly going forward than in many other major economies. He suggested that “fiscal policy [has been] supporting monetary policy during a period when there has been a world downturn and to have a borrowing requirement of 3.4 per cent is perfectly affordable, and indeed our plans are perfectly affordable.”[113] The IMF has noted that “the widening of the deficit has played a useful countercyclical role, and public debt remains at a low level.”[114] However, the IMF goes on to argue that “a gradual decline in the deficit is now appropriate. This is not only to meet the fiscal rules, but also for broader reasons: strengthening fiscal fundamentals (at present the cyclically adjusted

106 IMF, United Kingdom – 2003 Article IV Consultation, 18 December 2003

107 Seventh Report of Session 2003–03, *The 2003 Budget*, HC 652–1, para 49

108 Pre-Budget Report 2002, Cm 5564, para 2.7, p 15

109 Pre-Budget Report 2003, Table 1.1, p 4

110 European Commission Autumn Forecasts

111 Pre-Budget Report 2003, Table B1, p 202

112 Pre-Budget Report 2003, Table 2,6, p 33

113 Q 266

114 IMF, United Kingdom – 2003 Article IV Consultation, 18 December 2003

primary balance is in deficit involving, over time, a rising stock of debt): and reducing the burden and risks for monetary policy by limiting the interest rate increases and thus lowering the risk of a hard landing for house prices." **The Committee notes that the UK's fiscal position remains comparatively strong internationally and should remain so if it strengthens as planned through economic recovery.**

End of year fiscal report

38. The 2003 PBR saw the publication of the second annual *End of year fiscal report*.[115] The focus of the report is on performance against the fiscal rules and fiscal policy objectives, with an analysis of the forecasts and outturn for the year ahead forecasts published in Budget 2001 and Budget 2002. The differences between the forecasts and the outturn borrowing figures are compared against historic performance. **The *End of year fiscal report* should analyse the Treasury's performance in the preceding two years against its forecasting record separately for receipts, and different portions of expenditure. It should also analyse the forecasting records of previous Pre-Budget Reports.**

Tax receipts

39. Tax receipts in 2003–04 are now expected to be £422.8 billion, £5.5 billion weaker (see Table 2) than forecast in the 2003 Budget. This shortfall is expected to occur despite the fact that the economy is forecast to grow by 2.1% in 2003, within the forecast range at the time of Budget 2003 of 2 to 2½%. Net taxes and social security contributions are now expected to account for 35.9% of GDP in 2003–04, compared to a forecast of 36.3% in the 2003 Budget.[116] The Treasury attributes the shortfall in receipts to the fact that "growth in wages and salaries in 2003 has been lower than projected, reducing revenues from income tax and NIC", with these factors partly off-set by higher than projected VAT revenues and a higher than assumed rise in equity prices since the Budget.[117]

Table 2: Changes in current receipts since Budget 2003 (£ billion)

	Estimate 2003–04	2004–05	2005–06	2006–07	2007–08
Effect on receipts of non-discretionary changes in:					
Economic deteminants audited by the NAO	½	1½	2	2	2½
of which: Equity price assumption	½	1	1½	1½	1½
GDP Components	–4	–5½	–5½	–5	–4
of which: Wages and Salaries	–3½	–4	–4	–3½	–3
Consumers' expenditure	–½	–½	–1	–1	–½
Other	–2	–½	–1	0	1
Total before discretionary changes	–5½	–4½	–4½	–2½	–½
Discretionary changes	0	0	0	½	½
Total change	–5½	–4	–4	–2	0

Source: HM Treasury Pre-Budget Report 2003, page 215

115 HM Treasury December 2003

116 Pre-Budget Report 2003, p 221

117 Equity prices have risen by around 20%; the NAO-audited assumption at the time of the 2003 Budget was that they would only rise in line with money GDP

40. Mr Cunliffe explained that while "the growth forecast is on track, the composition of growth has been different from the way it was forecast and in particular growth has happened in less tax rich parts of the economy than we forecast".[118] Deutsche Bank believed that while "receipts growth is expected to undershoot in the current fiscal year, it can not be attributed to disappointing economic growth…but rather the nature of that growth i.e the Treasury has been too optimistic about the level of receipts the economy is able to generate".[119] Mr Chote told us that in "the same way that trains have the wrong sort of snow" there has been "the wrong sort of growth", with average earnings "growing less quickly than expected" being one reason why income tax revenues had been lower than expected.[120] In recent years a decline in receipts as a proportion of GDP has also occurred in other large economies including the US, where tax receipts as a proportion of GDP, having reached 20.8% of GDP in 2000, declined to 17.9% of GDP in 2002 and a projected 16.5% in 2003. Some of this weakness in US revenues reflects the introduction of the 2001 and 2003 tax cuts but other factors represent structural deterioration. The Congressional Budget Office has published some research looking at possible causes of this reduction in tax revenue and why it came as a surprise.[121] **Receipts have come in weaker than expected despite growth being on target for the Treasury's forecast. The factors behind this decline in tax receipts may be structural or may be cyclical. The Treasury's projections for tax revenues up to 2008–09 suggest that it does not see the problem as predominantly a structural one. This is contrary to the view of some of our expert witnesses. A shortfall in expected receipts for a given level of GDP is a phenomenon that has also occurred in other countries including the USA, although compared to countries in continental Europe the UK's public finances remain in good shape. In the USA research has been undertaken into why revenues as a percentage of GDP have declined. We recommend strongly that the Treasury undertake similar research in the United Kingdom and publish it as soon as possible.**

41. The 2003 PBR forecasts assume that net taxes and social security contributions as a percentage of GDP will rise from 35.9% in 2003–04 to 38.2% in 2008–09, the highest since the early 1980s. The Treasury explains that the increase is largely driven by "normal fiscal drag; the recovery of financial company profits; and strong growth in tax receipts such as VAT refunds which have no overall impact on fiscal aggregates"[122] As Table 3 indicates the main taxes driving the projected rebound in receipts are income tax and corporation tax. Income tax receipts as a share of GDP are expected to rise over the forecast period from 10.7% to 11.6%. Non-North Sea corporation tax receipts as a share of GDP rise from 2.3% to 3.2%.

118 Q 93

119 Deutsche Bank, Focus Europe, 8 December 2003

120 Q 57

121 For example, see Congressional Budget Office revenue and tax policy briefs, *Where Did the Revenues Go?*, and *Revenue projections and the stock market*, www.cbo.gov

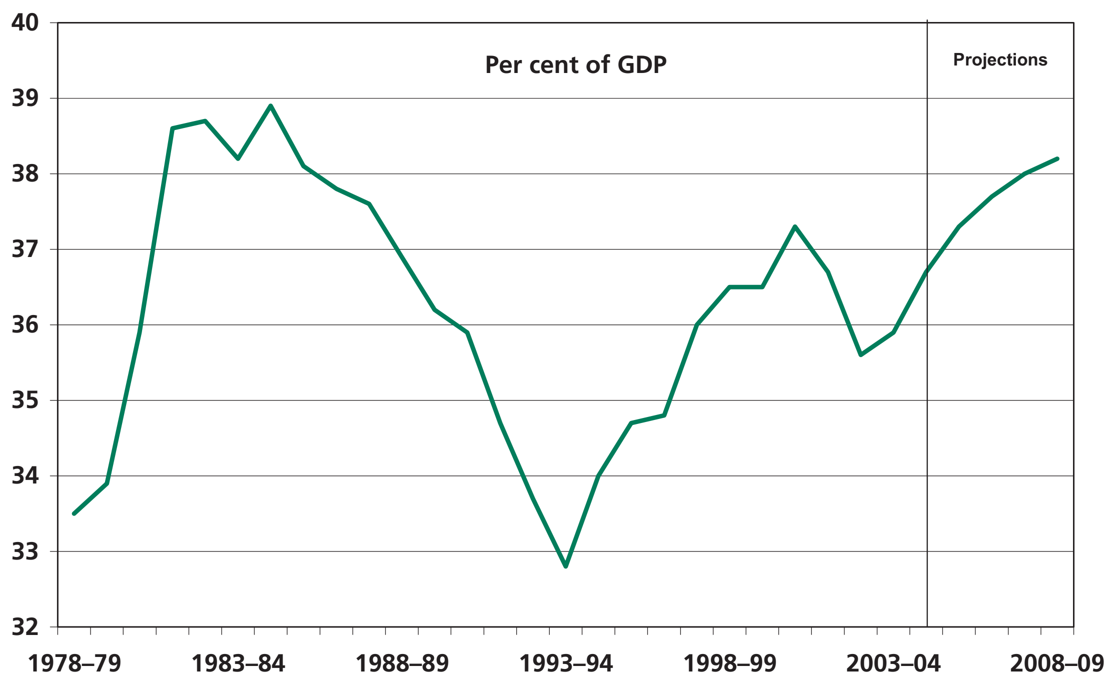
122 Pre-Budget Report 2003, para B59, p 220

Table 3: Current receipts as a proportion of GDP

Current Receipts as % of GDP	Outturn	Estimate					
	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Income Tax	10.7	10.7	10.9	11.1	11.3	11.5	11.6
Non-North Sea corporation tax	2.5	2.3	2.7	3.0	3.1	3.2	3.2
Tax Credits	-0.3	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3
North Sea Revenues	0.5	0.4	0.3	0.3	0.3	0.3	0.2
VAT	6.0	6.2	6.1	6.1	6.1	6.1	6.1
Excise Duties	3.6	3.5	3.5	3.4	3.4	3.3	3.3
Social Security Taxes	6.1	6.5	6.7	6.7	6.8	6.8	6.8
Other	6.6	6.6	6.7	6.9	7.0	7.1	7.2
Net Taxes & Social Security Contributions	35.6	35.9	36.7	37.3	37.7	38.0	38.2

Source: HM Treasury Pre-Budget Report 2003, page 220

Chart 1: Tax-GDP ratio[123]



Source: HM Treasury Pre-Budget Report 2003, page 221

42. Professor Spencer believed that "the behaviour of taxes on income suggests that the surge in the run up to [2001] was the result of special factors like the stock market boom that are not likely to be repeated". He believed the Treasury's forecast was based on the view that the "tax flows of the millennium represent the norm to which we will soon return".[124] Mr Weale agreed that the Treasury "were treating what seemed at the time a

123 Net taxes and social security contributions as defined in Table 3

124 Ev 70

period of great revenue buoyancy as a period of normality to which the economy is expected to return" adding that "even if such trends exist, the projection of them forward is less than prudent."[125] Mr Walton was more optimistic, suggesting that there was some justification for the forecast, in that the depression in the tax ratio over the last year or two had been "partly for some special reasons [some of which] will tend naturally to come back."; but he thought the Treasury was a "bit optimistic" in the medium term profile for the tax ratio.[126] In regard to the risks to the public finance projections the Treasury highlights risks to global and domestic growth, similar to those surrounding their growth forecasts.[127] There is no discussion of risk to receipts as a percentage of GDP or of the extent to which the receipts in 2000 may have been exceptional. **We note that the Treasury continues to project a rise in the ratio of tax receipts to GDP over the forecast horizon from 35.9% in 2003–04 to 38.2% in 2008–09. We recommend that the Treasury includes in future Budgets a discussion of the risks underlying this tax forecast. This assessment should be informed by the research we recommend the Treasury carry out at paragraph 40 above. This will be an opportunity for the Treasury to explain in more detail the assumptions on which it makes its tax forecasts.**

Income tax

43. Income tax receipts expected in 2003–04 have been reduced by £3.3 billion relative to the forecast in Budget 2003. Income tax receipts have now been weaker than forecast in the last three Budgets. This had followed a period where income tax receipts had been consistently higher than forecast since 1997. Back in Budget 2001, the Treasury put forward a number of possible reasons for this overshoot, including changes in the earnings distribution with "above average increases at higher earnings levels" and "the introduction of self-assessment" having a delayed effect of increasing PAYE payments; it stated that "other things being equal, the unexpected increase in income tax receipts is unlikely to be unwound in the future" and the 2001 forecasts carried these increases forward.[128] Since 2001, income tax levels have been consistently below those projected by the Treasury. HSBC have noted that these shortfalls have occurred "despite the continued fall in unemployment"[129] relative to the consensus forecast. Also, as shown in the *End of year fiscal report*, only a small part of these shortfalls can be attributed to slower growth in overall wages and salaries.[130]

44. The Treasury is now expecting an increase in income tax receipts of £6.2 billion in 2003–04 followed by an increase of £9.5 billion (around 8%) in 2004–05. Professor Spencer told us that "even if earnings growth does move back to the sort of 4/4.5 per cent range which would begin to pose problems for the Monetary Policy Committee, and even if there were a favourable shift in the earnings distribution, it is still very hard to see 8 per cent

125 Ev 74 (para 13)

126 Q 3

127 For risks surrounding the public finance projections, see Pre-Budget Report 2003 paras B21–B23; and for risks surrounding economic projections, see paras A16–A18

128 Budget 2001 paragraphs C37–C41

129 HSBC, World Economic Watch, 5 December 2003

130 HM Treasury, *End of year fiscal report*, December 2003 pages 21–23 (para 3.10 and tables 3.2–3.3)

growth in income tax".[131] The Treasury told us that of the increase "around two-thirds come from average earnings growth at its long-run average [growth] of wages and salaries. We expect some to come from recovery in the financial sector company profits linked to bonuses. Some of that will come from higher interest rates leading to higher tax on interest income. Finally there is fiscal drag…in the equation".[132] Mr Lewis told us that the single biggest driver of the increase in the overall effective rate of income tax was "the assumption [the Treasury] makes about the return of income growth of higher rate tax paying individuals, particularly through things like city bonuses, which were a big feature of the late 1990s and were associated with the growth in financial company profits".[133]

45. Mr Chote noted that the "effective higher rate threshold (i.e. the basic rate limit plus the personal allowance) has fallen from 161 percent of average earnings in 1996–97 to 143 percent in 2003–04, which has seen the number of higher rate taxpayers rise from 2.1 million to 3.3 million. If we were to assume that earnings rose by 2 percent a year on top of inflation (slightly less than the trend rate of increase in productivity), then the effective higher rate threshold would drop to 129 percent of average earnings over the next five years. This would increase the number of people paying higher rate income tax to around 4.2 million by 2008–09". The Chancellor told us that people "should be cautious about years ahead which depend on a whole series of assumptions, including about average earnings that were certainly not true last year and are certainly not true this year"[134] and that "the reasons that income tax will rise are not simply fiscal drag; they depend on what is likely to happen to bonuses; they depend on the number of people likely to be in work; they depend on the interest that is paid and the tax receipts from the interest that is paid".[135]

46. **Since the projection forward of an improved relationship between income tax receipts and GDP in 2001, receipts have consistently come in under the Treasury's forecast. We note that the Treasury's projections of income tax receipts, which rise as a share of GDP, imply increasing numbers of people paying income tax at the higher rate. We would welcome more information on the proportion of salaries paid in annual bonuses and how the Treasury is forecasting them going forward. To improve our understanding of the 2004–05 forecasts we ask the Treasury to publish the components of the forecast in greater detail differentiating between PAYE, self-assessment, bonus payments and income at standard and higher rates.**

Tax forecasting

47. In the light of the change between economic growth and revenues in the current year we asked the Treasury whether they would consider publishing more information on their tax forecasting process. Mr Cunliffe told us that "models are not, if you like, mechanical machines where you put something in at one end and it comes out the other. They are a lot more complex than that." But he told us that the Treasury "would be very happy to explain

131 Q 63

132 Q 126

133 Q 135

134 Q 323

135 Q 321

how we model particular taxes".[136] The *End of year fiscal report* reviews the outturn receipts with forecasts in previous budgets but the focus is on "retrospective analysis" which, as the Treasury states, "is important as it can highlight shortcomings of particular forecasting methods, and suggest ways in which the forecasting performance can be improved" as well as "helping to ensure transparency".[137] **To improve transparency and aid the Committee and other outside observers to understand the forecasts for tax revenue, we recommend that the Treasury should publish details of how the receipts from the major taxes are forecast, including wherever possible the model used and all the economic determinants that feed into the model.**

Public expenditure

48. The Treasury's spending plans continue to call for total managed expenditure[138] to rise more rapidly than the broader economy. After an increase of 7.3% in 2002–03, current plans forecast a rise in expenditure of 9.8% in 2003–04, followed by a reduction in the growth rate to 5.8% in 2004–05. Total managed expenditure in 2003–04 is now forecast to be £460.2 billion, some £4.5 billion more than expected at the time of the Budget. This increase mainly reflects the carrying forward of £2.5 billion of the special reserve used to meet the costs of conflict in Iraq and the UK's other international obligations.[139]

49. Annually managed expenditure is now forecast to be £2.1 billion higher than in the 2003 Budget. Mr Chote told us that the main contributory factors were "higher than expected take-up of the child and working tax credits, higher expected debt interest payments, higher social security benefit spending…and accounting adjustments". He also noted that "the AME margin – the contingency reserve within annually managed expenditure has now been reduced to £0.3 billion in 2003–04 and to zero in the following two years".[140] We note that this is the lowest the AME margin has been set since the 1998 Comprehensive Spending Review[141] (although there still remains a reserve in the three year limits for Departmental spending). Although Mr Stephens for the Treasury told us that the AME margin "had been drawn down. In that sense it is fulfilling its purpose",[142] **we note that it is unusual to provide no margin at all for annual managed expenditure in future years. An explanation should be given as to why it is envisaged that, in contrast to previous practice, no AME margin is provided for the next two financial years.**

The division between current spending and investment spending

50. It is important in assessing the public finances that government expenditure is correctly allocated between current spending and capital spending. On 12 December the Rail Regulator published his 2003 review of access charges payable by train operators to

136 Qq 153–156

137 *End of year fiscal report*, HM Treasury December 2003, pp 1–4, p 30

138 Total Managed Expenditure (TME) is the sum of Annually Managed Expenditure (AME – mostly social security payments and debt interest payments) and Departmental Expenditure Limits (DELs – the spending limits for departments agreed under the periodic Spending Reviews).

139 Pre-Budget Report 2003, para 2.57, p 32

140 Ev 63 and Ev 64

141 Figures for the previous AME margins are shown in Table 2.4 page 29 of the 2003 IFS Green Budget

142 Q 172

Network Rail for the five years beginning 1 April 2004. The Regulator reported that "Ten days [before the publication of the access charges review] the DfT and the SRA made a joint submission to the Regulator in which they explained that for accounting reasons it would be desirable for the SRA in future to increase the amount of money that it pays in grant to Network Rail, allowing access charges to be set at a lower level". These accounting reasons were explained in a footnote as "Specifically the fact that, although higher access charges would be used to support capital expenditure by Network Rail, an increase in franchise support would be classified as current expenditure and the Government's rules prohibit borrowing to cover expenditure over the economic cycle."[143] The Regulator considered it "regrettable that such fundamental issues should be raised at such a late stage in the review" given the "considerable efforts" he had made "to establish the SRA's financial position, in accordance with his statutory duties".[144]

51. Mr Stephens, Director of Public Spending at the Treasury, told us that the allocation of spending was "determined according to national accounts principles and decided ultimately by the ONS" and that "there are switches that go on, on a regular basis that reflects changes in the substance, in the nature of the spend or changes in the view that professional statisticians take of that spend".[145] Mr Stephens told us that what the Regulator had set required "a substantial increase in capital expenditure by Network Rail" and that it was "clearly desirable that the accounting form should follow the substance [of the expenditure]".[146] The Chancellor told us that there was "a dialogue between the Regulator and other bodies" but that "decisions about the funding of Network Rail are a matter for the Regulator".[147] **We note the Regulator's concern at officials' late intervention. It is essential that the allocation of public spending between capital and current expenditure is carried out in a way that reflects the substance of the spending. Government funded increases in capital expenditure on the railways must be correctly treated. We request that the Treasury provides further information and transparency in regard to the classification of current and capital spending.**

Measuring real government output

52. A principal concern for the Government is the extent to which increases in spending are feeding through into increased provision and quality of services combined with value for money, rather than higher costs. Budget 2002 announced significant increases in public spending and the Treasury notes that "The composition of this growth between increases in real output and prices has important implications for evaluating the Government's drive to improve public services".[148] The Treasury also notes that "in the second and third quarters of 2003, nominal government consumption was up about 11¾ per cent on a year earlier, split into measured real growth of just around 4 per cent and an increase in the implied deflator of 7½ per cent – well in excess of input cost inflation."[149] Mr Cunliffe told

143 Rail Regulator, Access Charges Review 2003: Final conclusions para 18

144 Rail Regulator, Access Charges Review 2003: Final conclusions para 19

145 Q 177

146 Q 180

147 Qq 296–297

148 Budget 2003, p 184

149 Pre-Budget Report 2003, Box A4, p 184

us there was a real issue about "the measurement of outputs in the public sector; about capturing quality increases in outputs, about capturing the full range of outputs and about capturing investment in future capability" and that the 7.5% measure of public sector inflation "falls out of a measurement that we do not think is accurate".[150] To investigate these problems Sir Tony Atkinson had been asked by the National Statistician to undertake a review of the future development of measures of government output, productivity and associated price indices so as to advance methodologies.[151]

53. The IMF recently noted that "current plans involve sharp increases, [in expenditure] with associated risk of inefficiencies". They welcomed the initiative to "improve the measurement of output in public services" but noted that "continuing increases in indicators of public sector costs, particularly in areas such as transportation, where measurement problems are less significant, would be a cause for concern as they could indicate supply bottlenecks".[152] Mr Walton, referring to some work carried out by Goldman Sachs on public expenditure, told us that some of the increases in costs were "catch up; in particular wage costs were held down very substantially in the period from the mid 1980s through to the mid 1990s, and that at some point had to be unsustainable" but "what there has been, as far as we can tell from the data, is a big increase in non-wage costs". He added that the review was "very welcome".[153]

54. The Chancellor told us that "the existing indicators which have been used for many years do not reflect properly the quality improvements which are taking place. If a fall in class sizes reduces productivity, by definition that is a problem because the quality of teaching is undoubtedly higher".[154] The Chief Economic Adviser added that "if you take all of the improvements in school buildings in the last six or seven years, all those new buildings do not count as output either because it does not affect the number of pupils who are in the schools. The fact that schools are better equipped, they have got facilities, are safe to be in and clean, that does not count at the moment in the way in which output is measured"[155] **This Committee attaches the highest possible emphasis to ensuring that any increases in public expenditure are delivered efficiently and result in improved outcomes, rather than in cost inflation. The current measure of government output does not adequately reflect improvements in quality and is therefore a bad measure of public sector productivity. It is absurd that a reduction in class sizes, for example, should count merely as an increase in cost and a reduction in productivity, with no account taken of any improvements in the quality of education. We welcome the Atkinson review of measures of government output, productivity and associated price indices. We note that the preliminary findings of the review are to be published by July 2004, in time to inform the 2004 Spending Review.**

55. Goldman Sachs recently noted that "if real public sector output is in reality much higher than official data imply, this would also mean that aggregate GDP growth has been

150 Q 157

151 Pre-Budget Report 2003, Box A4, p 184

152 IMF, United Kingdom—2003 Article IV Consultation, 18 December 2003

153 Q 73

154 Q 343

155 Q 345

higher and closer to trend than the Treasury believes".[156] Mr Cunliffe told us that the "real output" for the increase in government spending was being under-estimated and to the extent that "real outputs are higher, that would affect the growth in the economy".[157] **In the light of the review of the measurement of government output, the Treasury should assess the extent to which any under-estimation of the real rate of growth of public sector output could affect estimates of GDP growth and the output gap.**

156 Goldman Sachs, European Weekly Analyst, 12 December 2003

157 Q 161

4 Other Issues

The housing market

56. At the time of the assessment of the five tests on entry into the euro, the Chancellor stated that "most stop-go problems that Britain has suffered in the last fifty years… have been led or influenced by the housing market. The volatility of the housing market and potential for higher inflation is a problem for stability that we are determined to do more to address to produce greater stability and reduce the risks of inflation irrespective of the decision on the euro."[158] Two reviews were announced: by Professor David Miles into the supply and demand factors limiting the development of fixed-rate mortgages in the UK and by Ms Kate Barker into the issues affecting housing supply in the UK. Both these reviews produced interim reports published at the time of the PBR,[159] with final reports with policy recommendations to follow at the time of the Budget. The CBI welcomed the Barker review which "recognises the problem of housing supply and the part played in that by planning restrictions and hope that appropriate policy action will result"; however they hoped that neither of the reviews aimed at housing would "result in any new tax on the property sector, nor in any unnecessary regulatory intervention in the markets".[160] In regard to the Barker review Mr Weale told us that "The main mechanism for improving the housing situation is to ensure that more houses are built. Without having more houses being built, if you simply make it easier for people to invest in housing through the introduction of real estate investment trusts, then one might think that that will add to rather than reduce upward pressure on house prices."[161]

57. The Chancellor would not "draw conclusions" on how long it would take for a substantial move to fixed-rate mortgages and before any reforms from these two reviews produced a detectable difference in terms of smoothing the operation of the macroeconomy, but told us that the Treasury had asked "Ms Barker and Professor Miles to look at these issues and report to us".[162] **The Committee believes that improving the functioning of the UK housing market has a key role, not only in terms of stability and growth in the UK economy, but also in tackling social inequalities by improving the access of families and others to decent housing at an affordable price. We also note the important role of the housing market in promoting labour mobility and regenerating deprived areas. We welcome the interim reports of the Miles review of fixed-rate mortgages and the Barker review of housing supply. Alongside any policy recommendations their final reports should also estimate how long it would take for any shift to fixed-rate mortgage finance in the UK, and improvements in housing supply, to produce a detectable difference in terms of smoothing the operation of the**

158 HC Deb , 9 June 2003, col 411

159 Review of Housing Supply, Kate Barker, HM Treasury December 2003; the UK Mortgage Market: Taking a Longer-Term View, David Miles, HM Treasury December 2003

160 Ev 58 para 9

161 Q 79

162 Qq 392–383

macro economy. We may examine the detail of any recommendations made as part of our regular scrutiny of the Budget.

58. After reaching a peak in the first quarter of 2003, house price inflation then moderated. For 2003 overall, annual house price inflation on the Nationwide index was 15.6%. There has been a divergence in performance between regions with house price growth in London in single digits but with growth rates of 30.1% for the North and 27.3% for Yorkshire and Humberside. The RICS recently estimated that the ratio of house prices to average income was 6.1 in the third quarter of 2003.[163] There may be structural reasons why a permanent rise in house prices relative to incomes is justified. Mr Cunliffe told us that "The amount of their income people are paying in mortgage payments or interest payments generally are low compared with the rates we saw at other times in the housing market house of high price increases in the late 1980s, early 1990s. If you look at the affordability, it is not clear to me that we are actually in a position where there will be a sharp break in confidence." As the Bank of England Governor has noted, loan to value ratios have not risen by as much as in the late 1980s.[164] Indeed, in the third quarter of 2003 only 22% of loans were for more than 90% of the property's value, compared with figures of over 40% in the late 1980s and early 1990s. However, the proportion of new borrowers with loan to income ratios in excess of three and a half has risen substantially in recent years,[165] but due to low interest rates the initial burden of the debt is much reduced (although the low inflationary environment will mean that debts will not be eroded as quickly). It is borrowers that have a large mortgage to income ratio who are exposed most to unexpected rises in interest rates and could benefit most from a fixed mortgage payment. However, as they are likely to be spending a higher than average proportion of income on their mortgage in order to purchase a house, they will be most interested in the initial costs and, as Professor Miles identified, "variable rate products and short-term (two-year) fixed-rate mortgages look very much cheaper than longer-term fixed rate products".[166] Using the prices given in the Miles review, for a borrower with an advance of 5 times income the cost of a discounted variable rate will be around 39.9% of net income, compared with around 47% of net income for a 5-year fix.[167]

59. The document accompanying the budget "Simplifying the taxation of pensions" included proposals to "allow pension schemes to invest in all types of investments including residential property".[168] Mr McPhail of Hargreaves Lansdown was quoted as saying that "It is hard to reconcile the stated ambition of controlling the housing market's disproportionate influence on the economy with a proposal that will allow billions of pounds of pension fund money to wash into the housing market".[169] There has been some comment in the press as to the extent to which individuals may be able use their pension fund to purchase single houses, or even to transfer in second houses and holiday lets, rather than invest through any new form of Real Estate Investment Trust. The Chancellor told us

163 RICS press release, House prices to rise 6% in 2004, 23 December 2003

164 Bank of England, Inflation Report Press Conference, 12 November 2003

165 Council of Mortgage Lenders

166 The UK Mortgage Market: Taking a Longer-Term View, David Miles, HM Treasury December 2003, p 2

167 The UK Mortgage Market: Taking a Longer-Term View, David Miles, HM Treasury December 2003, Table 4.3, p 56

168 HM Treasury, Simplifying the taxation of pensions: the Government's proposals, 10December 2003

169 Financial Times, *Investing freedom for funds*, December 13 2003

that the proportion of houses in "the private rented sector is very low…far lower than in Germany, France or America" and that Shelter had issued a report saying that it was "necessary to get more incentives into the private rented market so that we can have more private rented housing available and we are looking at how it can be done". He added that the Treasury had not committed itself "either to billions of pounds of incentives or to expecting there will be billions of pounds of property investment by pension fund companies".[170] **The Treasury should assess the extent to which allowing self-administered pension funds to invest in residential property by buying individual houses, rather than via any new type of Real Estate Investment Trust, will increase the sensitivity of the economy to the housing market and create opportunities for abuse. If the proposals are implemented the Inland Revenue should ensure that a robust regime is in place to prevent tax avoidance.**

Taxation of small incorporated businesses

60. The Pre-Budget report notes a range of measures and targeted tax reductions to support small businesses. Edward Troup, Head of Tax Strategy at Simmons & Simmons told us that "The introduction of a 10% corporation tax rate in 2000 (reduced in 2002 to 0% on the first £10,000 of corporate profits and 10% on the next £40,000) has encouraged large numbers (probably several hundred thousands) of the self-employed to incorporate their businesses. This permits a significant saving of income tax and NICs as self-employed earnings (taxed at basic rate of 22% plus NICs of 11%) can be converted into dividends (subject to corporation tax at 10% or 0%) which are not subject to further income tax in the hands of basic rate taxpayers".[171] Mr Chote told us that "the move to zero corporation tax rate does seem to have turned out to be very costly for the government in the sense of encouraging people who are self employed to incorporate themselves. That was something which was predictable, and plenty of people predicted that it would turn out to be a very expensive policy."[172]

61. The PBR indicates that "The Government is concerned that the longstanding differences in tax treatment between earned income and dividend income should not distort business strategies" and that it "will therefore bring forward specific proposals for action in Budget 2004, to ensure that the right amount of tax is paid by owner managers of small incorporated businesses on the profits extracted from their company".[173] John Whiting of PricewaterhouseCoopers noted that this development "has caused a deal of concern to such businesses and their advisers" and added that "surely it would have been possible to give a more detailed explanation of what is envisaged".[174] Mr Troup noted that "If the reduced and zero rates are not achieving their intended result, the Government should not adopt a complex retaliatory response, but should repeal these measures and if appropriate, offer tax reductions to all small businesses (incorporated or self-employed) in some alternative way".[175] **We would welcome further details (in advance of the Budget)**

170 Q 381

171 Ev 72

172 Q 68

173 Pre-Budget Report 2003, para 5.91, p 117

174 Ev 76

175 Ev 72

of the nature of the Government's proposals for changes to the way tax is paid by owner managers of small incorporated businesses on the profits extracted from their company.

Child poverty and the Child Tax Credit

62. The 2000 Spending Review included a target to "Make substantial progress towards eradicating child poverty by reducing the number of children in poverty by at least a quarter by 2004".[176] The Pre-Budget Report announced that the 'child element' of the Child Tax Credit "will increase from April 2004 by £180 to £1,625 a year, equivalent to a weekly increase of £3.50".[177] This measure will increase support to families with children by almost £1 billion each year.[178] The IFS has previously noted that "for a given level of expenditure, increasing the per-child element of the child tax credit will have a larger direct impact on poverty than increasing the family element or increasing child benefit".[179] Mr Chote told us that it was "quite possible that the Chancellor is going to hit the [child] poverty target on the basis of this increase";[180] he added that there was some concern that "having a target that is so clearly fixed as a target of relative income" could create "an excessive bias towards trying to deal with child poverty through direct cash transfers, when it might well be more appropriate to take some money and devote it to services like…Sure Start". The Chancellor told us that "by raising the 'per child' element we were able to do more about the position of lower and middle income families" and that, by 2004, "Before housing costs there is absolutely no doubt in our view that we [will] meet the 25 per cent cut in [child] poverty since we set the target"[181]. The Chancellor also noted that in addition to the increased tax credit the Budget had announced "a new scheme to help lone parents get into work".[182] **We welcome the Government's action to reduce child poverty and note the substantial progress made so far. The approach needs to establish an effective balance between providing income to the parents through the tax credit system with expenditure on services aimed at increasing opportunity for both the parent and the child.**

Savings

63. The savings ratio for the United Kingdom is low, particularly for people on low incomes, and hence Government policy has been to encourage people to save. In that context cash ISAs have proved popular with low income earners, as the Nationwide Building Society and Halifax Bank of Scotland testify. To reduce cash ISAs from £3000 to £1000 per year, and share ISAs from £7000 to £5000, appears to run counter to a policy of encouraging people to save. **We, therefore, request an explanation for this apparent contradiction in policy and recommend that the proposed ISA reductions should be reconsidered.**

176 HM Treasury PSA target 8 (joint target with Department for Work and Pensions)

177 Pre-Budget Report 2003, para 5.19, p 98

178 The actual costs given in the PBR Table B4 are £885 million in 2004–05, 925 million in 2005–06 and £955 million in 2006–07

179 *What do child poverty targets mean for the child tax credit? An update*, Mike Brewer, IFS, December 2003

180 Q 87

181 Qq 341–342

182 Q 374

Conclusions and recommendations

The Pre-Budget Report

1. We regret this omission [of a debate on the PBR], given that transparency and openness demand that government financial statements like the PBR should be subject to parliamentary scrutiny in the Chamber of the House of Commons. We reiterate our recommendation that every year the House should hold a half or full day's debate on the Pre-Budget Report. (Paragraph 3)

2. We can only repeat our view that as much notice as possible for the Budget date is desirable and we therefore urge the Government to regard the 2002 practice—of at least 2 months' advance notice—to be at least a working target. Advance notice for the Pre-Budget Report is also helpful. The announcement of the date for this year's Pre-Budget report and statement was made during oral Question Time on Thursday 13 November, less than one month before the statement. We believe that the same arguments hold for advance notice for the Pre-Budget Report as for the Budget. (Paragraph 4)

The economy: the recent past

3. We note the European Commission's comment that "the UK economy weathered the recent global slowdown well". This is particularly notable in the face of the continued weakness in activity in its major trading partners in the euro area. (Paragraph 5)

4. The Committee is concerned that the recent fall in the dollar may jeopardise global recovery prospects, although some of the evidence we received on this point was generally reassuring (Paragraph 6)

5. In spite of a rather disappointing trend in fixed investment and exports, current estimates of UK economic growth in 2003 are consistent with the reduced forecast of 2–2½% growth published by the Treasury at the time of the last Budget. (Paragraph 7)

6. Throughout a volatile period in the world economy the Committee observes that the MPC has continued successfully to maintain UK inflation close to the target laid down by the Chancellor. Moreover, while maintaining inflation inside the target range, monetary policy has also been able to provide substantial support to growth by delivering historically low short term interest rates to the economy. (Paragraph 8)

7. The successful complementarity of monetary and fiscal policy has played a key role in delivering a UK economic performance over the past few years which the IMF describes as "enviable". Key tests for both monetary and fiscal policy nevertheless lie ahead as recovery emerges. (Paragraph 9)

8. As the global economy recovers it is vital that UK economic policy adapts as anticipated to the upswing, to avoid potential problems flowing from the current imbalances in the economy. (Paragraph 9)

The outlook for the economy

9. The Treasury's economic forecasts for 2004 and beyond continue to look more optimistic than most, although the gap between the Treasury's assessment and that of most other forecasters has narrowed, with most independent forecasters now a little more optimistic about growth in 2004 than they were in the spring. (Paragraph 10)

10. While the probability of either a fall in house prices or a rise in interest rates on a scale that would create widespread problems for households should be viewed as very limited, we think it is nevertheless important for both the Treasury and the Bank of England to consider how policies could impact on individual households whose debt servicing ratios have become unsustainable. (Paragraph 13)

11. The Committee attaches the highest importance to securing the best possible value for money in public spending. It is disappointing to note that, despite the welcome improvements to the control of public expenditure that have enhanced flexibility, many departments are still failing to manage their capital spending programmes as efficiently as they should. We recommend that the Treasury takes action to improve the planning and monitoring of public sector capital spending programmes within the financial year. We would welcome a report on any such action in the 2004 Spending Review. (Paragraph 15)

12. The Committee is disappointed at the lack of progress on improving official pension fund statistics. The health of UK company pension schemes appears to be a major gap in the information flow into the Treasury's assessment of the economic outlook. Given its crucial impact on British households, we recommend that the Government show much greater urgency in ensuring the provision of regular and reliable official information on pension fund deficits. We further recommend that the Chancellor report on this issue expressly in the 2004 Budget. (Paragraph 17)

13. The Committee welcomes the improved transparency in recent years provided by the Treasury's explicit discussion of issues such as the output gap and the cyclical position of the UK economy. It encourages the Treasury to explore ways of further improving transparency, which may include closer involvement of outside bodies or experts in the judgements made. (Paragraph 20)

14. Although the Governor of the Bank of England has indicated that he does not think the switchover will be of major significance for monetary policy, given the focus on inflation two years ahead, we note his comments regarding the need for care in the short term in explaining the switch in the inflation target from RPIX to CPI inflation and will scrutinise the progress made in enhancing public understanding of the change. (Paragraph 25)

The fiscal balance

15. The Committee accepts that the substance of the golden rule has not changed, but differences in phrasing in recent Treasury documents may have been a source of some confusion. We recommend that the presentation of the Government's progress

towards meeting the golden rule should be standardised and be based on the average annual surplus of the current budget as a percentage of GDP. (Paragraph 27)

16. The Treasury should make the role of the cautious case in the fiscal planning process through the cycle clearer in the Budget and Pre-Budget Report documentation. (Paragraph 28)

17. We were surprised that there was no table contained in the 2003 PBR breaking down the changes in public sector borrowing since the previous forecast between those attributable to the automatic stabilisers, non-discretionary factors and policy decisions. We ask the Treasury to re-introduce such a table in the Budget (and future Budgets and PBRs). (Paragraph 31)

18. While the extra borrowing envisaged since the time of the last Budget means that there is now less slack, the Government remains on track but will meet the golden rule only if its central forecasts for economic growth, tax revenues, spending, and the likely end of the current cycle are met. The Government will have to remain mindful of the consequences of any further unplanned increases in borrowing arising from any shortfall in planned tax revenues. (Paragraph 35)

19. The Committee notes that the UK's fiscal position remains comparatively strong internationally and should remain so if it strengthens as planned through economic recovery. (Paragraph 37)

20. The *End of year fiscal report* should analyse the Treasury's performance in the preceding two years against its forecasting record separately for receipts, and different portions of expenditure. It should also analyse the forecasting records of previous Pre-Budget Reports. (Paragraph 38)

Tax receipts

21. Receipts have come in weaker than expected despite growth being on target for the Treasury's forecast. The factors behind this decline in tax receipts may be structural or may be cyclical. The Treasury's projections for tax revenues up to 2008–09 suggest that it does not see the problem as predominantly a structural one. This is contrary to the view of some of our expert witnesses. A shortfall in expected receipts for a given level of GDP is a phenomenon that has also occurred in other countries including the USA, although compared to countries in continental Europe the UK's public finances remain in good shape. In the USA research has been undertaken into why revenues as a percentage of GDP have declined. We recommend strongly that the Treasury undertake similar research in the United Kingdom and publish it as soon as possible. (Paragraph 40)

22. We note that the Treasury continues to project a rise in the ratio of tax receipts to GDP over the forecast horizon from 35.9% in 2003–04 to 38.2% in 2008–09. We recommend that the Treasury includes in future Budgets a discussion of the risks underlying this tax forecast. This assessment should be informed by the research we recommend the Treasury carry out at paragraph 40 above. This will be an opportunity for the Treasury to explain in more detail the assumptions on which it makes its tax forecasts. (Paragraph 42)

23. Since the projection forward of an improved relationship between income tax receipts and GDP in 2001, receipts have consistently come in under the Treasury's forecast. We note that the Treasury's projections of income tax receipts, which rise as a share of GDP, imply increasing numbers of people paying income tax at the higher rate. We would welcome more information on the proportion of salaries paid in annual bonuses and how the Treasury is forecasting them going forward. To improve our understanding of the 2004–05 forecasts we ask the Treasury to publish the components of the forecast in greater detail differentiating between PAYE, self-assessment, bonus payments and income at standard and higher rates. (Paragraph 46)

24. To improve transparency and aid the Committee and other outside observers to understand the forecasts for tax revenue, we recommend that the Treasury should publish details of how the receipts from the major taxes are forecast, including wherever possible the model used and all the economic determinants that feed into the model. (Paragraph 47)

Public expenditure

25. We note that it is unusual to provide no margin at all for annual managed expenditure in future years. An explanation should be given as to why it is envisaged that, in contrast to previous practice, no AME margin is provided for the next two financial years. (Paragraph 49)

26. We note the Regulator's concern at officials' late intervention [in the access charges review]. It is essential that the allocation of public spending between capital and current expenditure is carried out in a way that reflects the substance of the spending. Government funded increases in capital expenditure on the railways must be correctly treated. We request that the Treasury provides further information and transparency in regard to the classification of current and capital spending. (Paragraph 51)

27. This Committee attaches the highest possible emphasis to ensuring that any increases in public expenditure are delivered efficiently and result in improved outcomes, rather than in cost inflation. The current measure of government output does not adequately reflect improvements in quality and is therefore a bad measure of public sector productivity. It is absurd that a reduction in class sizes, for example, should count merely as an increase in cost and a reduction in productivity, with no account taken of any improvements in the quality of education. We welcome the Atkinson review of measures of government output, productivity and associated price indices. We note that the preliminary findings of the review are to be published by July 2004, in time to inform the 2004 Spending Review. (Paragraph 54)

28. In the light of the review of the measurement of government output, the Treasury should assess the extent to which any under-estimation of the real rate of growth of public sector output could affect estimates of GDP growth and the output gap. (Paragraph 55)

The housing market

29. The Committee believes that improving the functioning of the UK housing market has a key role, not only in terms of stability and growth in the UK economy, but also in tackling social inequalities by improving the access of families and others to decent housing at an affordable price. We also note the important role of the housing market in promoting labour mobility and regenerating deprived areas. We welcome the interim reports of the Miles review of fixed-rate mortgages and the Barker review of housing supply. Alongside any policy recommendations their final reports should also estimate how long it would take for any shift to fixed-rate mortgage finance in the UK, and improvements in housing supply, to produce a detectable difference in terms of smoothing the operation of the macro economy. We may examine the detail of any recommendations made as part of our regular scrutiny of the Budget. (Paragraph 57)

30. The Treasury should assess the extent to which allowing self- administered pension funds to invest in residential property by buying individual houses, rather than via any new type of Real Estate Investment Trust, will increase the sensitivity of the economy to the housing market and create opportunities for abuse. If the proposals are implemented the Inland Revenue should ensure that a robust regime is in place to prevent tax avoidance. (Paragraph 59)

Taxation of small incorporated businesses

31. We would welcome further details (in advance of the Budget) of the nature of the Government's proposals for changes to the way tax is paid by owner managers of small incorporated businesses on the profits extracted from their company. (Paragraph 61)

Child poverty and the Child Tax Credit

32. We welcome the Government's action to reduce child poverty and note the substantial progress made so far. The approach needs to establish an effective balance between providing income to the parents through the tax credit system with expenditure on services aimed at increasing opportunity for both the parent and the child. (Paragraph 62)

Savings

33. We, therefore, request an explanation for [the] apparent contradiction in policy and recommend that the proposed ISA reductions should be reconsidered. (Paragraph 63)

Formal minutes

Tuesday 13 January 2004

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard
Angela Eagle
Mr Michael Fallon
Norman Lamb
John Mann
Mr George Mudie
Mr James Plaskitt
Mr David Ruffley
Mr Robert Walter

The Committee deliberated.

Draft Report (The 2003 Pre-Budget Report), proposed by the Chairman, brought up and read.

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

Paragraph 1 read and agreed to.

Paragraphs 2 to 6 read, amended and agreed to.

Paragraphs 7 and 8 read and agreed to.

Paragraph 9 read, amended and agreed to.

Paragraphs 10 and 11 read and agreed to.

Paragraphs 12 and 13 read, amended and agreed to.

Paragraph 14 read and agreed to.

Paragraphs 15 to 22 read, amended and agreed to.

Paragraph 23 read and agreed to.

Paragraphs 24 and 25 read, amended and agreed to.

Paragraph 26 read and agreed to.

Paragraph 27 read, amended and agreed to.

Paragraph 28 read and agreed to.

Paragraphs 29 to 31 read, amended and agreed to.

Paragraphs 32 to 34 read and agreed to.

Paragraphs 35 to 38 read, amended and agreed to.

Paragraph 39 read and agreed to.

Paragraphs 40 to 45 read, amended and agreed to.

A paragraph—(*Mr Nigel Beard*)—brought up, read the first and second time, and inserted (now paragraph 46).

Paragraphs 46 to 48 read, amended and agreed to (now paragraphs 47 to 49).

Paragraph 49 read and agreed to (now paragraph 50).

Paragraph 50 read, amended and agreed to (now paragraph 51).

Paragraphs 51 and 52 read and agreed to (now paragraphs 52 to 53).

Paragraph 53 read, amended and agreed to (now paragraph 54).

Paragraph 54 read and agreed to (now paragraph 55).

Paragraph 55 read, amended, divided and agreed to (now paragraphs 56 and 57).

Paragraphs 56 to 60 read and agreed to (now paragraphs 58 to 62).

A paragraph—(*Mr Nigel Beard*)—brought up, read the first and second time, and added (now paragraph 63).

Summary read, amended and agreed to.

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

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select committees (reports)) be applied to the Report.

Several papers were ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

[Adjourned till Thursday 22 January at half past Nine o'clock

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Oral evidence

Taken before the Treasury Committee

on Monday 15 December 2003

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard
Mr Jim Cousins
Angela Eagle
Mr Michael Fallon
Norman Lamb
John Mann
Mr George Mudie
Mr David Ruffley
Mr Robert

Witnesses: **Mr Robert Chote,** Director, Institute of Fiscal Studies, **Professor Peter Spencer,** Professor of Economics, University of York, **Mr David Walton,** Chief European Economist, Goldman Sachs, and **Mr Martin Weale,** Director, National Institute of Economic and Social Research, examined.

Q1 Chairman: In the spring you told us the Chancellor was being too optimistic in both his economic assessment and his assessment of the public finances. Do you think he is still being too optimistic?

Professor Spencer: I believe he is too optimistic on the economy, but particularly optimistic on the side of tax revenues. If you look at table B11, page 220, you will see that tax is rising as a share of money GDP; in other words, tax revenues are bouncing much more strongly than money GDP. The share of tax in money GDP rises back to the figure of 37.3% by 2005–06, which of course was the peak that we saw back in 2000–01, at the turn of the millennium. It does not really matter how you look at this; it is very unlikely that tax will recover as a share of money GDP anything like as quickly as the Treasury are forecasting. There are several ways of arriving at that conclusion. One way is to look at a very detailed tax-by-tax analysis, particularly focusing on the areas like income tax and corporation tax that have exhibited the helter-skelter that we saw in the run-up to the election and since the tide turned afterwards. If you look at those factors, it is hard to think that they were keyed in with normal economic developments like the cycle in real GDP. It is also difficult to explain all of them in terms of the dot.com boom and events happening in the City, as the Treasury led us to believe this time last year in the PBR 2002. Rather, there are a lot of special factors in there which were reflected in a sharp swing away from earnings at the low end of the income scale towards top people's pay; and, sadly—or perhaps I should say gladly—it is very unlikely that we are going to see those special factors recurring any time soon. If I am right in thinking that, then we will continue with the kind of scenario that we have seen since this time last year, one in which the economy does perform as well as the Chancellor has forecast—the stock market has performed better than the Treasury suggested at the time of the Budget—but tax revenues will continue to disappoint. I am afraid that if that state of affairs continues, the Treasury will have to factor in sharper and sharper bounces in tax as a share of GDP in order to contrive revenue forecasts that meet the Golden Rule.

Mr Chote: In terms of economic growth—and my colleagues here are more expert in this subject than I am—clearly, when we met with you last time round it looked as though the Chancellor's forecasts of growth this year were in excess of those expected by the independent consensus; and now that does not look quite such a bad call as it obviously did at the time. However, for growth next year—the Chancellor is some way ahead of the consensus. It seems to me that that is not unnecessarilyy unreasonable, if he is right that there is as much spare capacity in the economy as his figures suggest—he has a negative output gap of 1.4% at the moment. I think that estimate is perhaps relatively large in comparison to those of some other forecasters, and if there is less spare capacity, then that might indicate that there is less room for stronger growth once the economy has bounced back to trend. In terms of the outlook for revenues—or indeed for the current Budget balance overall—it seems to me that the big question that has to be asked in saying, "are these a set of proven, reasonable forecasts?"—is whether it is reasonable to expect the structural underlying budget position to move from a deficit of 0.8% of GDP this year to a surplus of 0.6% of GDP in five years' time on the basis of "unchanged" policies? I am not entirely convinced yet—and we will not do our next proper forecasts until next month—that that is the case. One reason why you end up with tax revenues rising as a share of GDP year in, year out, is that as always we are assuming fiscal drag in these forecasts; in other words, that tax thresholds are raised in line with prices; that typically earnings grow more quickly than prices. To give an indication of the sort of impact that might have, the Treasury does not tell us what its assumptions are for average earnings growth, on the grounds

that that might be seen to be setting down some sort of going rate; but if you were to assume, for example, that earnings were to grow by 2% a year on top of inflation, a little bit less than the projected increase in productivity, then that would see the number of people paying higher rate tax rise by a million or more over the next five years. It has gone up from 2 million to about 3 million since 1996–97. The value of the effective high-rate threshold—that is the personal tax allowance plus the limit for the basic rate—was 161% of average earnings in 1996–97; it has fallen to 143% in 2003–04; and, if you have five years at 2% real earnings growth, you would be down to about 129% of average earnings. As I say, that would increase the number of people paying higher rate tax from around 3 million at the moment to something over 4 million. I think one needs to be a little careful about what we think of as "unchanged" policies in the forecasts. They are not quite as unchanged as some people would think.

Q2 Chairman: Martin or David, if you want to add to that to be taken into consideration, what is fuelling the Treasury's optimism?

Mr Weale: As Robert said, what is fuelling the Treasury's optimism is the assumption that the taxes rise even when nothing happens, or when output grows on trend. The surplus on the current Budget is expected to increase between 2006–07 and 2008–09 by 0.6% of GDP. This is shown in table B6. This is at a time when the economy is expected to grow on trend. It is not a cyclical recovery delivering this; it is what Robert described as fiscal drag, i.e., the tax limits biting lower and lower down. My view, as an alternative way of describing that would be to say it is an increase in taxation. Those of us who said that the Chancellor's projections were optimistic have been saying that they are optimistic unless there are tax increases built into them. Here, we have a very clear illustration of the sort of tax increase that is built in to the projections and makes the chance of delivering the surplus that the Government is hoping for greater than would otherwise be the case.

Q3 Chairman: David, you were more in keeping with the Chancellor's view of the growth in the economy the last time you were here.

Mr Walton: That is right. I tend to be at the more optimistic end of the range for growth. I would just reiterate that the Treasury's track record on forecasts tends to be better than most people's, so it would be wrong to be completely dismissive of their forecasts at any point in time. I think the Treasury's view is that to the extent it believes there is slack in the economy, then in some senses its forecasts going over the future are really just a technical assumption that that slack will get used up. That is a reasonable way of going about things, in the sense that if the slack is not taken up, then there will be a tendency for inflation to fall below the symmetric inflation target. It is not unreasonable, if you think there is slack, to have a period in which the economy is growing faster than trend. As Robert said, there may be a question as to whether or not there is as much slack as the Treasury suggests—and that is open to question. On the point about tax revenues, there are a couple of things I would say. The recent past has been quite unusual in that some of the things that are quite good for tax revenues have been very depressed. For instance, average earnings growth in the private sector has been running at around 2.5% over the past years, which is the weakest since the mid 1960s, and generally speaking, consistent with the inflation target, you ought to expect average earnings growth of somewhere around 4.5%. If you look at consumers' expenditure, there is often a lot of talk about a boom in consumption, but nominal household expenditure this year is going to only grow by somewhere between 3.25 and 3.5%, which will be the lowest increase that we have had since national accounts data began back in the mid 1950s. There is quite a lot of weakness in the nominal economy at the moment, which is what is important for tax revenues. Robert asked if it was conceivable that you could see a 1.5% improvement in the current budget over the course of the next five years. Of course you can. If you look at the swings you have seen in the public finances, then they really have been very substantial. I think there is some justification for thinking that maybe you have seen the tax ratio, having been somewhat depressed over the last year or two, partly for some special reasons—that some of that will tend naturally to come back. I actually think that the Chancellor is a bit optimistic in his medium-term profile, but I certainly do not think there is any real black hole in the finances, and I think there will be some tendency for this current budget deficit to get eliminated over the next few years.

Q4 Chairman: Thank you for the papers you have submitted; they have been very helpful to us in preparing for today. I would like to ask you about output gap. The Treasury assesses trend growth at 2.75% and argues that the recent data revisions indicate that that would be a conservative estimate. But in the papers you have given us, Professor Spencer, you say that the output gap is larger. David, you say it is smaller. The Bank of England told us a few months ago that it did not exist at all. We are all over the shop: where are we? Can we have a sensible discussion on this?

Mr Weale: The answer is that we can have a sensible discussion on it, but I do not think we can reach a conclusion. The people who have studied estimates of the output gap and looked at them with hindsight, have concluded that they are all over the place. Often, people worry about revisions to official statistics, but they are nothing compared with revisions to estimates of the output gap. The essential difficulty that one faces in trying to measure the output gap is that things are going wrong and right with the economy all the time, but you need four or five years of hindsight to be able to judge whether those changes have been temporary or permanent. You simply do not know at the time, and so a study of the United States output gap showed that on 43% of the occasions, estimated as at the date they were accruing, it had the wrong sign. These observations about the reliability or unreliability

with which the output gap is measured do not make me think that we should shy away from using the concept; but they do make me think that somewhere in documents like this there ought to be some reference to the uncertainty to the fact that estimates are bound to be prone to revision, and possibly some answer to the question, what the Chancellor will do if the estimates of the output gap in this document turn out to be wrong.

Q5 Chairman: So, like a packet of cigarettes, they should come with a big health warning.

Mr Weale: Absolutely.

Mr Walton: Three years ago the Treasury thought that output was 1% above trend; it now believes that output is running at 1.5% below trend. That is consistent with its view that trend growth is about 2.75% a year, whereas the economy has only actually grown by around 2% a year over that period. That is the mechanics of how you get to that answer. If you test it against other information, for instance the fact that unemployment has been relatively stable during that period—if you think the labour market is the ultimate arbiter of how much slack there is in the economy, then you can come to the conclusion that there is no slack over that time. The answer is probably somewhere in-between, given that wage pressures have been pretty subdued, particularly in the last year or so. That suggests that there is some slack in the labour market. Capacity utilisation in surveys is somewhere below normal. That is why it is my judgment that there is probably about 0.75 to 1% output gap. In the end, we do not know what potential output is. You cannot observe it and you cannot measure it. As Martin said, in the end this is something you have to judge over a number of years. What is clear—and this is one of the benefits of inflation targeting—is that the way to keep inflation stable, which is what the Bank of England has delivered, is to try and keep the output gap relatively small. The way to get swings in inflation is to have big swings in economic activity. Whatever the output gap is, it is not going to be enormous; and so the Treasury should not rely too much on a lot of slack to be taken up over the next years to get the public finances back into a very good position.

Professor Spencer: I think there are some very important checks that we can apply to the relatively simple mechanical calculation that the Treasury does, which is to project forward in terms of productivity, in the light of a recent peak cycle-to-cycle adjusted growth figure. In particular at ITEM we try to build up productive potential from investment and some of the labour and other factors that the Treasury does look at; and if you do that, then you see that contrary to what quite a few commentators said when output was revised up, instead of the output gap being reduced by the upward revision to GDP that we saw at the time of the Blue Book, it has possibly even risen because most of that upward revision to GDP came from investment which, of course, boosts the productive capital stock and hence productivity. So the checks that you run do tend to support the Treasury's view that there is quite a significant output gap at the moment. Quite whether it is 1.5% or a lot closer to David's 0.75%, I do not think any of us would go to the stake on. But that there is a significant output gap that partially explains the shortfall in the tax revenue, which is what we are focusing on here, I do not think is really in question.

Mr Chote: To put the uncertainty around the output gap into some sort of perspective, if you cast your minds back to the summer of 1996 when the former Chancellor had a panel of independent forecasters, on that occasion he asked them to come up with estimates of the output gap at the time, and they varied from 0.25% above potential to 3% below it. That gives you some sense of the amount of uncertainty there is around any particular estimate. Occasionally people have noted that by having a cyclically adjusted focus in the way we have the fiscal framework at the moment, we are putting, obviously, some power into the Chancellor's hands, on the grounds that he can estimate where that is, and there is a possibility of exploiting that for political reasons. However, the idea that you can find some external, universally accepted arbiter of this who is going to come up with a number with which everybody will be happy is rather improbable.

Q6 Mr Walter: I would like to look at the growth forecasts initially in an international context. The Pre-Budget Report says at table A1 on page 168 that during the first half of this year in the euro area output has stagnated. The dollar in the last week has gone to new depths against the euro. The pound is now higher against than the dollar than it has been since we exited the Exchange Rate Mechanism. The European Central Bank has lowered its 2003 growth forecasts for the euro zone. On the basis that the OECD has flagged up the risks to the European economy posed by this weakening of the dollar, do you think the Treasury's international growth assumptions still look plausible after the dollar collapse that we have seen in recent weeks?

Mr Walton: My view is that they are too pessimistic. They have euro area growth by 1.75%, which is pretty much the consensus forecast. The consensus reached a trough of 1.6% next year and it is currently running at 1.8/1.9%. My own perception is that there is a lot more momentum in the world economy, and we are seeing evidence of that pretty much every day; but in the end the Treasury will find a small positive surprise actually.

Professor Spencer: I would agree with that. I think there is developing momentum in the world economy. In respect of your worries about the dollar, I think the dollar adjustment against the euro is actually a win/win situation, essentially because the very strong dollar we saw was a symptom of the unbalanced world economy that carried with it all of those trading imbalances and other rather dangerous phenomena. Provided that we can see the dollar adjusting in an orderly kind of way, as we have done fortunately so far, then it is not just US exporters that benefit from that, but the European economy benefits in the sense that the stronger euro means that upward pressure on price inflation is reduced. Remember that the ECB has found it

extremely difficult to cut interest rates in Europe because consumer price inflation has remained doggedly above its 2% target. It is still at 2.1%. I think that as commodity prices and other import prices fall in Europe, that will bring CPI inflation down decisively below the 2% ceiling, and that will in turn lead perhaps not to interest rate cuts but it will defer the interest rate rises that we otherwise might have seen. I think it is a win/win situation for the world economy, helping it to re-balance.
Mr Weale: I am not so convinced that depreciations are always a good thing for the depreciating people, and that appreciations are a good thing for the appreciating people. I am also becoming increasingly optimistic about the euro area. Essentially, the reason was that the causes of the stagnation—very slow growth in consumer demand, weak investment demand and so on, were not very clear. They were more likely than not to come to an end at some point, and I think we are now seeing a situation where the financial situation in Germany has improved; but we are likely to see a restoration of more normal demand circumstances, and despite the appreciating euro, the euro area is likely to face growing export demand.

Q7 Mr Walter: You would say that the 6.25% growth in UK export markets, which is in their table, is probably right, and that the euro zone growth rate is too low.
Professor Spencer: I think the 6% growth in world trade is quite a reasonable assumption, and it is very close to our assumption.

Q8 Mr Walter: You are talking about 7.25% growth in the world.
Professor Spencer: I am not too sure that export growth will be quite as strong as that figure suggests. I think we could well lose that export share and continue to do so as a result of the very high value of the pound, which shows no sign of adjusting downward to remove some of the imbalances in our economy.

Q9 Mr Walter: Can I go on to the resilience of the UK economy. The OECD in its November *Economic Outlook* said that we continue to exhibit greater resilience than most other OECD countries. The European Commission in October said that we had weathered the recent global slowdown well. On the basis that we have performed relatively well through that slowdown, at the cost of growing imbalances in the economy. There seems to be a widespread optimism that those imbalances will now start to ease. Do you share that optimism?
Mr Walton: I do not know if the imbalances are going to ease. I would argue that they are not really that great to begin with. The current account deficit has been running at 1-2% of GDP for a few years now. Certainly, by US standards or even by the standards of the UK, that is quite a modest situation. I do think that the performance of the UK economy has been quite remarkable. The authorities have managed to keep the economy growing at close to a 2% rate, which is not far short of trend; when we have seen much greater weakness elsewhere. Unemployment is perhaps as good a guide to this as any. Unemployment is pretty much at its low point, whereas in the US it has risen by more than 2 percentage points and in the euro zone it has risen by about 1 percentage point. You have a situation where parts of the economy were exceptionally weak. Investment has fallen faster in the UK than pretty much anywhere. The external sector has been a big drag, but you have seen the Bank of England cutting interests rates quite aggressively. The housing market has kicked in to help the consumer, which is an important point to bear in mind if you are looking at reducing the sensitivity of the housing market. The housing market has been very supportive of the consumer, helping the economy overall to grow quite well. The big challenge for policy now is to stop the UK economy from growing too fast as we go forward from here. There will be a need for policy to make sure the consumer is not too strong in the face of a recovery in investment and the external sector. That is why almost certainly interest rates are going to have to rise quite a bit more, I suspect, over the next year, in order to achieve that balance.
Professor Spencer: The problem has been, obviously, that the stimulus from short-term interest rates has been brought to bear quite simply on the housing market and the high street, and that has left us with an economy that is tilted far too much towards those areas. What has been disappointing about our performance since the time of the Budget is that although consumer disposable incomes have been quite sharply slowed, not just because of increases in national insurance contributions and council tax, but essentially because of the downward pressure on earnings coming from a company sector that is trying to get its books back into balance. All of those tendencies which, at Budget time, looked as if they might lead towards a spontaneous re-balancing of the economy, with companies and therefore investment spending doing a little better and consumers and consumption doing commensurately worse—those have come to pass in the sense that disposable incomes have been squeezed. But although people have slowed their spending, they have continued to spend at a relatively high rate through borrowing. It is that which makes the adjustment going forward particularly tricky. It means that the rise in interest rates is coming to bear against a much higher debt level than you have ever seen in any previous circumstance like this, and it makes it extremely tricky for the Monetary Policy Committee to be as adept at slowing this process down and rebalancing the economy as it has been adept in keeping the economy going through the world recession. Although there is certainly momentum in the world economy and still in the housing market and the high street, I think going forward it remains rather risky.
Mr Weale: Could I draw attention to an aspect of the imbalances in the economy that is not widely discussed, and that is the low level of national saving in the United Kingdom? The United Kingdom and the United States save much smaller proportions of

their national income than do most other advanced countries. We are not quite the worst performer in Europe; I think that Portugal does worse. I find it slightly concerning that we are congratulating ourselves on having avoided all sorts of economic pitfalls through a process simply of spending as fast as we can because the long-term costs of that are that even if investment is taking place, it is paid for by foreigners and therefore the income accrues to foreigners rather than nationally rather than domestically; and so while we have kept ourselves going through the recession that other countries suffered, thanks to expanding public demand and rising house prices, those are both mechanisms that have long-term consequences for the evolution of people's incomes.

In the absence of the Chairman, Mr Michael Fallon was called to the Chair.

Q10 Mr Walter: Can I move briefly on to household borrowing. The PBR says: "Household borrowing inevitably poses risks to the forecast." The OECD has pointed out the fact that a back-up in interest rates cannot be ruled out in a context where all large OECD countries are now suffering from historically wide public deficits. There are widespread fears, which you have highlighted in some of your answers. The OECD suggestion that large public-sector deficits are adding to the risk by putting upward pressure on interest rates, and given that the rate cycle has probably turned upwards, as we have acknowledged, do you think that the UK fiscal deficit is now adding significantly to the pressure for high interest rates and that both the Treasury and the Bank has suggested that the risks from aggregate household indebtedness are limited? Do you agree with that assessment?

Professor Spencer: I feel that we have not really seen the full effect of government deficits. As you say, a lot of governments, most obviously in the US and the UK, have moved into a situation of much high levels of borrowing, compared to the situation which, even two or three years ago was marked by financial surpluses in the government sectors. I think the problem is that governments can do that and ultimately support the economy through a period of weak growth—or, in the case of the US, recession—without too much of a problem. The big problem on interest rates and in the financial sector comes when the private sector starts to revive; and it is at that point, when you look back historically that you see there has been a serious problem with public borrowing and with very high interest rates. I am afraid that in a recession, governments can borrow huge amounts of money without upsetting bond markets or anybody else; but the true test comes when private sector demands, both corporate and consumer, tend to pick up at the end of a period of slow-down.

Mr Walton: Financial markets are very good and integrated. The determinants of bond yields are largely due to what is happening globally as opposed to what is happening just in the UK. The rise in the UK budget deficit, while significant, is very small compared to the absolute rise in budget deficit either in the United States or in the euro area. The UK has in some sense contributed to the rise in yields, but it is not the main contributor by any means. As Peter says, when the private sector does begin to increase its spending, there is a risk that bond yields generally in the world will be somewhat higher. In terms of fine-tuning the consumer, what we do know is that the household sector is very sensitive to interest rate changes in the UK, largely because a lot of this borrowing takes place at the short-term interest rate rather than the long-term yield. If long-term yields suddenly rise sharply, a lot of households are going to find themselves are going to find themselves in a great deal of difficulty. They will find themselves in difficulty if short-term rates rise sharply; but short-term rates are only going to rise sharply if the rest of the economy is doing so well that the Bank of England has to make the consumer have a few more difficulties. The fact that the economy is quite responsive to policy is quite reassuring when looking at the next couple of years.

Q11 Mr Beard: The Treasury's optimistic tone on business investment remains strikingly at odds with the views of others such as the Bank of England's Monetary Policy Committee. The inflation report there said: "There has been little sign of pressure on physical capacity at this stage, and pension fund deficits may be diverting cash away from other uses. The Committee expect business investment to continue recovery albeit moderately." With 32% of the FTSE 350 companies still reportedly struggling with heavy pension fund deficits, do you think the Treasury is being too complacent in its forecasts of company investment?

Professor Spencer: As I said in my note to the Committee, I do think the Treasury has been too optimistic in forecasting business investment. There are two reasons for that. First, the cash-flow is nothing like as good as the figures at Budget time indicated. Then, the ONS put the company sector financial surplus at £16 billion for 2002. The revisions that we saw over the summer chopped that back to £4 billion, so there are doubts about that. I share your reservations about the effect of pension deficits, and not just because of their effect on FTSE big companies, but because of the kind of stories that city and accountancy contacts are telling me about the way in which those problems are impinging upon small and medium size enterprises. There you have got quite a backlog of—call them "deals"—that could go through in the form of small company takeovers, management buy-outs and those kinds of things, which are being frustrated according to some of my contacts, by problems on company sector deficits. I think there are two reasons there, in addition to the Treasury's point that investment typically lags output, for thinking that the investment figures that the Treasury have in place will not be seen.

Mr Walton: Trying to forecast investment is pretty hazardous. It is difficult to know what the past has been, let alone what the future is likely to be, given

the revisions that we see to the investment data. The one point I would make, though, is that if you look at investment as a share of profits, it is running at a historically low level, and that is very unusual, even allowing for some of these potential diversion of funds into pension funds. I would be very surprised if we did not see investment growing at least as strongly as the economy, and probably a bit faster. If the economy is going to grow by close to 3% next year, then it is not that unreasonable to think that business investment will grow by 3-3.5%.

Q12 Mr Beard: Is there not some contradiction between these growth rates for business investment, 3-3.5% and 6-6.25%—and a 1.5% output gap? Where you have got that much spare capacity in the economy, why should people be investing at these rates?
Mr Weale: One reason may be that there is a backlog of investment opportunities that they had not exploited over the last three years with a falling stock market, and they are now tending to make up to some extent for lost time. I agree with you. I worry about the 1.4% output gap. If I had to give a number, I would give a rather lower number.
Mr Walton: Looking at the US experience, the US appears to have very low rates of capacity utilisation, and investment in the last couple of quarters has been surging. Investment typically does take place. I doubt at the moment whether investment is doing much more than replacing the bit of the capital stock that is retired each year. If you start to see demand generally in the economy picking up, then you will need to see some tendency for the capital stock to increase. The capital stock is huge, investment is actually very small, and so the geared effect on the investment numbers can be quite significant.

Q13 Mr Beard: When this Committee considered the Budget earlier, we commented on the inadequacy of the pension fund statistics, and the Government in response told us that it was considering ways of plugging what appears to be something of a void in the official statistics when it comes to the health and pension funds. As far as you know, has this gap in our understanding of pension funds been made good in recent months?
Mr Weale: As far as I know, the Office for National Statistics is still working on it, but that is something that the national statisticians should be able to advise you on.

Q14 Mr Beard: The Treasury's forecast for general Government fixed investment in volume terms in calendar year 2003 have fallen very sharply, from 47% down to 15.5%, to be replaced by a large revision upwards in investment in calendar year 2004. At the same time, the cash figures for public sector gross investment in the financial years 2003–04 and 2004–05 have changed hardly at all or relatively little. Should this Committee conclude that the public sector's investment plans have therefore slipped badly again this year, but that the Treasury expects a big surge in the final quarter of the financial year? Is that the implication of these figures?
Professor Spencer: I do not think that is the case. If you look at the figures for the first three-quarters of this calendar year, which we already have, then the level of money spend has held up remarkably well. Before I saw the PBR I was thinking that perhaps the very strong 47% volume growth that we saw in the Budget report, which you have just reminded us of, I was beginning to think that although that was a very strong figure, it might be met. So I was extremely surprised to see this fall to 15.5%, which again is on a calendar year basis. Again, it goes alongside PBR financial year figures, which you quite rightly say are practically unchanged. The only way that I can reconcile the 15% and the very strong nominal spend numbers is to think that perhaps the cost of public sector investment must have risen quite dramatically over the eight months since Budget time. That is the only way that I can make sense of those figures. Hopefully, by the time of the Budget we will know a little more about that.

Q15 Mr Beard: But next year it accelerates again. Has anyone else any explanation?
Mr Walton: The point Peter makes is a general observation about the breakdown of public sector spending in real terms, versus the prices. You have seen this since 1988, with a 50% increase in cash spending but only a 14% or so increase in the output of public services. This is a potential phenomenon that runs across the whole of the government sector, not just investment. It gets magnified in investment because the numbers are so small, so 47% of a small number is not that different actually to 20% of a small number.

Q16 Mr Beard: We tended to get rid of this sort of lumpy spending at the end of the financial year by increased scope for carrying spending over.
Mr Walton: Not necessarily. It is just that what you are hopefully getting rid of is the unnecessary expenditure at the end of the financial year, just to make sure that it takes place in a given financial year. Investment is, by its nature, very lumpy. There can still be very big changes from one year to the next.

Q17 Mr Beard: The Treasury's forecasts project a current account deficit of over £30 billion a year, which is 2.25% of GDP, throughout this forecast period, and highlights the recent slump in the services balance of payments. Is this trade deficit sustainable? Should the trade deficit be receiving more policy attention as a potential source of instability?
Mr Weale: I do not think the trade deficit is a potential source of instability. I go back to the point I made earlier that what matters is the issue whether the country is doing enough saving or not. The balance of payments deficit is the difference between the amount that the country saves and the investment opportunities that there are in the

country. You could either have a trade deficit because you are doing a lot of saving, but even more investing; or you could have a deficit because you are doing a low level of investing and even less saving. My worry is that we are doing the low level of investing and even less saving, but the trade deficit is simply a consequence of that. In the end of course, unless all sorts of rather fortunate and implausible things are happening, you cannot run a trade deficit indefinitely; you do tend to build up overseas debts or foreigners build up claims on the United Kingdom and you have to have the money to service those debts. So, eventually, a trade deficit has to turn into a trade surplus, but you may still have a balance of payments deficit.
Mr Walton: There are some funny things going on in the data. For instance, exports from the UK to Europe are running at a much weaker rate than imports from the UK as measured on the continent. There is this mismatch between whether you look at it from this country or indeed from European countries. Also, if you look at financial services exports, which tends to be very well correlated with the stock market, they have been extraordinarily weak during the course of the past few quarters despite this very strong recovery in the stock market, so there has at least to be some question as to whether or not the data are actually measuring the reality. Indeed, if you look at business surveys, export conditions in business surveys have been a lot stronger than we have seen in official data over the past year or so.

Q18 Mr Ruffley: Mr Weale, you said something very interesting about the strength of tax receipts by 2007–08, which the Chancellor is forecasting, and you interestingly said that you cannot account for that restoration of strong and buoyant tax receipts just by economic growth, because economic growth would be trend, so there has to be another explanation for this increase in tax receipts that the Chancellor is inviting us to believe in. You said that you thought he must be factoring in discretionary tax rises. Is that the way you read it?
Mr Weale: Whether you call doing nothing a discretionary tax rise or not is obviously a matter of opinion, but the sort of thing that is factored in there is what Robert described: threshold increase only in line with prices, wages go up, so you get more and more higher rate taxpayers. There are all sorts of other areas where there may be reasons for projecting revenue buoyancy. Essentially, a characteristic of the fiscal system that, if left to its own devices and even if you—

Q19 Mr Ruffley: I thought you were saying something different because your answer just now seemed to suggest that it was a bit of fiscal drag and that that might account for these buoyant receipts. Is there not something about explicit tax rises that you think might be an explanation?
Mr Weale: I am not really distinguishing fiscal drag from explicit tax rises because we have got away from the 1960s–1970s environment where, if the Chancellor wanted to raise extra revenue, all he did was—

Q20 Mr Ruffley: Freeze allowances or thresholds?
Mr Weale: . . . freeze allowances in money terms and that was the way they were measured. The Rooker-Wise amendment required them to be indexed to the retail price index, but why not talk about a reference level having them indexed to earnings and describe, if you like, a Rooker-Wise Mark II, that allowances normally have to be indexed to earnings and that gives the reference point against which things are calculated. If that were done, I suspect that we would not see the extra revenue pouring in in the way that it does.

Q21 Mr Ruffley: Am I right in thinking that your estimate for the gap that might need to be closed was a £10 billion figure that you have mentioned in a different forum?
Mr Weale: That was in a different forum and that is a mixture of what would happen without this phenomenon and being generally less optimistic on the recovery in the tax take in taxes as a proportion of GDP. There are obviously a range of different numbers that one can come up depending on how optimistic one is and there are a wide range of perfectly plausible and defensible assumptions that can be made.

Q22 Mr Ruffley: Just going back to the buoyancy of the tax receipts by 2007–08, would it be fair to characterise your view that Gordon Brown will be in effect imposing tax increases to get to that point of higher tax receipts in 2007–08 that are not accounted for by economic growth?
Mr Weale: I must say that, by economic growth, I mean economic growth relative to trend. The tendency of taxes to rise when the economy is growing on trend, you can call fiscal drag if you like or you can call them tax increases.

Q23 Mr Ruffley: I think I know what I would like to call them. That is very helpful. Can I just go to something that, Mr Chote, you wrote which is very useful. Mr Brown predicted a year ago that he would overachieve the golden rule by £46 billion over the current economic cycle. In the Budget, he reduced the figure to £32 billion. Now, on a comparable basis, the figure would be around £4 billion. You also say that the Chancellor actually used a different calculation and came up with £14 billion. In other words, we are talking about this terrible decline in the current surplus over the cycle. The Chancellor does seem to have shifted the basis for the numbers he uses in calculating the golden rule from the nominal current surplus or deficit to the real inflation-adjusted figures, which is effectively revaluing the surplus upwards. Do you think that is a justifiable shift in the way he is

calculating his borrowing numbers or is it a bit of playing ducks and drakes with the borrowing figures?
Mr Chote: I think it is actually a sensible way of calculating data. As you say, the method he used in coming up with numbers, for example, in the last Budget speech and in the pre-Budget speech a year ago, was simply to add up in cash terms the surpluses and deficits from 1999–2000 through to the end of the cycle.

Q24 Mr Ruffley: Just the cash numbers?
Mr Chote: Add the cash numbers straightaway and that is how you ended up with 46, 32 and 4.5. What he has done this time is essentially to say, "Let us add up the surpluses and deficits as percentages of GDP in each of the financial years" and then you get a number at the end which is 1.4% of GDP and then you turn that into a cash number, which is £14 billion at the moment.

Q25 Mr Ruffley: It is very convenient changing it in this way, is it not?
Mr Chote: As I say, I think it is reasonable—

Q26 Mr Ruffley: It is very convenient.
Mr Chote: It is reasonable because £1 at the beginning of the cycle is worth more than £1 at the end of it.
Mr Walton: Can I just add one thing about the way they have changed it. I think the Chancellor has changed it in the way he has done it in his speeches but actually, because I came up with the same thing, if you add up their surpluses, they come to £4 billion over the cycle whereas, if you take an average of 0.2% of GDP for seven years and you have 1.4% of GDP, which gives you the £14 billon—

Q27 Mr Ruffley: He is going for the higher figure.
Mr Walton: But actually, if you look at the book that was published by the Treasury, the Balls and O'Donnell book, when they talked about the way you calculate the current budget, they did actually do it, that you take an average of the current surplus as a percentage of GDP over the cycle. So, the Treasury has actually been consistent in its presentation.

Q28 Mr Ruffley: Have they been consistent in the red books? They have not, have they? He has made a change here.
Mr Chote: In the PBR, there is one paragraph which explains how you get £4.5 billion and there is another paragraph which explains how you get to £14 billion. I have to say that I think the method that has been emphasised in the speech on this occasion is probably a more sensible one. I think that, in terms of public trust etc, it might have been nice to have explained on this occasion that it was being calculated on a different method from how it had been mentioned in previous speeches, but that is not to say that this is a particularly bad move, it is just an interesting piece of timing.

Q29 Mr Ruffley: It is an interesting piece of timing. Let us leave it there.
Mr Weale: May I make an observation on this, please? Under a previous Government, as far as I remember, there were 28 changes to the way in which unemployment was counted and they all had the effect of reducing the reported number of unemployed people.

Q30 Mr Ruffley: We are talking about borrowing here.
Mr Weale: Yes, I know that we are. In some sense, a response to that was to set up a statistical framework to make the statistical framework more independent of the Government. I think this episode demonstrates, as clearly as one needs, the importance of having the National Audit Office defining the rules and setting out rules on some basis or other which will then be there and fixed and not subject to revision in this way.

Q31 Mr Ruffley: That is very helpful.
Mr Walton: For instance, it makes a difference whether you use a geometric average as opposed to an arithmetic average, which is quite relevant these days for inflation. If the Government had used a geometric average, that £14 billion comes down to about £10 billion. Arguably, these are points of detail but it is nice to have the methodology.
Mr Ruffley: I do not think they are points of detail, they are points of public trust. That is very helpful.

Q32 Mr Fallon: Let us get back to the beginning of the fiscal stance. Is this the right point in the cycle to be borrowing so much?
Professor Spencer: Yes, I think it is. The economy has been growing rather slower than trend and continues to do so and in fact, were it not for the strength of public spending as we go into next year 2004, I think it would still be growing well below trend. The problem is that it is now appropriate, as the world economy and our exports and investment pick up, for that fiscal stance to be tightened up—if you look at it in terms of fiscal fine-tuning. So, yes, it has been right. As the PBR says, fiscal policy has supported monetary policy in keeping us going through this period but—if you believe in fiscal fine-tuning—it is now time to start tightening up on the public sector side.

Q33 Mr Fallon: Does anybody disagree with that?
Mr Weale: Could I make a general point? I would find it quite helpful for the Chancellor to say what he estimates the social cost of the government borrowing to be. The sort of thinking that is going through my mind is that if this borrowing has been a powerful and helpful stimulus, are the taxes that we are going to have to pay to service the debt going to be a permanent depressant on the economy and, in assessing the benefits of this fiscal policy, should we not also be paying some attention to those somewhere instead of just brushing them off into the future beyond the time horizon that we are concerned about?

Mr Chote: In terms of saying whether it is appropriate to be borrowing this much now, there are, in a sense, two ways to answer that question. One is whether it is appropriate in a macro-economic sense, whether you want this sort of stimulus supporting monetary policy at the moment and Martin and David have both touched on that question, and then there is the separate question of, is it appropriate to be borrowing this amount given the target of achieving the golden rule over the cycle? That is a separate question to which we will come.

Q34 Mr Fallon: We will come to it. When we reported on the Budget back in the spring, we said on the central case that the estimated surplus to meet the golden rule had fallen from £46 billion down to £32 billion. The evidence we have now seems to be that, whether we meet it or not now falls within the margin of forecasting error. How has that happened so quickly, that we have gone from £36 billion down to just a few billion so quickly?
Mr Chote: Essentially speaking, we had expected that the current Budget deficit was going to narrow by 30% between last financial year and this one. So far, during the financial year, it has actually been running at roughly double last year's levels. The Chancellor says in the PBR that he does not think that the deterioration is going to be quite that dramatic over the remainder of the year but that, over the year as a whole, the current budget deficit will be 65% larger rather than 30% smaller than he was anticipating at the time of the Budget and that bad news partly lives on in future years as well. So, the whole profile for the current Budget deficit has increased over that time and that is what is whittling away the £30 billion figure. There are a combination of factors which explain why that room for manoeuvre has been eroded. It includes deliberate policy changes, so the extra money that is being spent on the child tax credit for example. You then also have changes in estimates of revenue over the next few years. I think David has touched on a couple of them before. You have the fact that equity prices have risen more since the Budget than was assumed at the time, which means that the numbers look better. But, on the other hand, you have wages and salaries growing less quickly than expected which cuts income tax and national insurance receipts. You have consumer spending growing less quickly than expected which reduces VAT and excise duty. Then you have downward revisions from other factors like housing transactions etc. So, you have a combination of factors which have shifted down the whole profile for the current Budget and have essentially put back the period at which it recovers and moves back to balance by year and it is those affects year by year that whittle away—or certainly over the next three years—the remaining room for manoeuvre if you take that strict definition of the golden rule over those seven financial years.

Q35 Mr Fallon: When they discussed the standard cautious case, the Treasury then go on to state that the average surplus in the current Budget in the cautious case is no longer positive, the Government are on track to meet the golden rule. If they say it is no longer positive, is that Treasury-speak for saying that they are not in fact on track?
Professor Spencer: It is a polite way of saying that, on the cautious assumption where the trend level of output is lowered by 1% compared to where they believe it is, the golden rule would be broken. It is just a polite way of saying that.

Q36 Mr Fallon: Is the phrase "on track to meet the golden rule" a term of art or just happy drafting?
Professor Spencer: I think that is a reference to the central case. My interpretation of this is that, when the Treasury say that they are on track to meet the golden rule, they mean on the central case, ie the higher of the two lines, the black line in chart 2.8 on page 39. We are looking at the words directly underneath that.

Q37 Mr Fallon: When they use the phrase "on track", does that mean they are not meeting it at the moment?
Mr Weale: No, I think on track to meet the golden rule does mean, as Peter said, that, if things evolve as the spelt out in the central case, then the golden rule is met and indeed it is.
Mr Walton: It is on track because it is viewed over the economic cycle which has not yet come to a conclusion.

Q38 Mr Fallon: Your own memorandum, Peter Spencer, says that this is a polite way of saying that the golden rule is broken.
Professor Spencer: Yes and I stand by that. My interpretation of paragraph 2.74 is that, on the cautious case which is the green line in chart 2.8, as the PBR says, "the average surplus on current budget in the cautious case is no longer positive" and, as I say in my note, that is quite simply a polite way of saying that, on the cautious case, as usually defined, the golden rule is breached. The sentence goes on to say, "Though the Government is on track to meet the golden rule" and that I take to mean that the Government are on track on the central case to meet the golden rule.
Mr Chote: There is something of a paradox here which affects both the discussion at this point and of these numbers for the cumulative expected overachievement to the golden rule and Mr Ruffley referred to the fact that it was a bad thing that we were seeing a projected surplus decline. It is worth bearing in mind that, if you take a strict number of years definition of the cycle over which you are supposed to achieve the golden rule, it is appropriate to have a fair amount of caution early on, but you do not actually want to end the cycle discovering that you have in fact overachieved it because your caution remained intact throughout. There is no case for overachieving the golden rule *ex post* unless you are near the debt to GDP ceiling in the sustainable investment rule and you want to

create some room for some more investment. So, in that sense, the Chancellor may be taking the view that as we are now four-and-a-half years into the cycle, you do not need quite as much caution at this stage as you would have done when you started out and that therefore you can start to—I think he uses the phrase here—eat into this margin. Similarly, in Budget 2001, the Chancellor was projecting that he would overachieve the golden rule over the cycle by more than £100 billion. You would not actually want to have done that by the end of it. There would be no case for that. The question about whether there is enough caution relates to the fact that that figure has moved down from £100 billion to £4.5 billion and we still have two-and-a-half years of the cycle to go. So, I think that the debate is, how much caution do you think is appropriate at any given point in the cycle? The idea that you whittle away some of the caution as the cycle goes on does not seem to me unreasonable.

Q39 Mr Beard: Is there general agreement on when the cycle ends?
Mr Weale: It is impossible to know now when the cycle is going to end for exactly the same reason that we discussed earlier that, in measuring the output gap, you need several years of hindsight. So, for example, it is perfectly possible that, in a year's time or 15 months' time, the Chancellor will say, "We have met the golden rule" and views of the cycle will change over the subsequent four or five years leading to the conclusion that, say, the cycle ran on for an extra year and therefore the golden rule was not met. I think this is unfortunate but it simply demonstrates the unfortunate choice of the Chancellor's fiscal rule. I think most people would think it rather strange to define a fiscal rule with reference to something that effectively you cannot measure until at least one General Election afterwards.
Mr Walton: I think, more generally, these are really good rules of thumb. The aim of fiscal policy is to ensure sound and sustainable public finances and, one of the problems that I actually have with these rules is that, on average if they are achieved, you are certainly going to have sustainable public finances in the UK but, even if they are breached slightly, you are still going to have sustainable public finances. It is a little like the inflation target. If inflation turns out at 2.7 or 2.3, nobody is going to turn around, if that has been the average over a number of years, and say that the Bank of England has failed to achieve its inflation target. Yet, the way in which these rules are set up, if you have a very small surplus on the current budget over the cycle, then you have achieved the rules. If you have a very small deficit, then you have failed. Well, in no economic sense have you failed. That, I think, is one of the difficulties that I have with this fiscal framework as it stands.

Q40 Mr Fallon: That is what I wanted to come to because you have here a rule that is set by the Chancellor and the test of whether you meet it or not is also concluded by the Chancellor because he defines the cycle. With the monetary policy example you gave us, of course there is a sanction: the Governor has to write a letter. Do you not think that, with the golden rule, there should be some kind of sanction and that something should have to happen rather like if you breach—and it is not a good example, perhaps—the Growth and Stability Pact? There are penalties involved.
Professor Spencer: I think there is a general problem here. Obviously, one begins to talk about factors impinging upon parliamentary sovereignty over taxes but I think that what we really need—and it comes back to Martin's suggestion—is some sort of National Audit Office which will look at economic assumptions. I think that what we really need for fiscal policy is some sort of parliamentary or other body for simply assessing on a technical basis whether or not fiscal rules have been met. The problem extends far wider than that. If you refer to the Stability Pact in Europe, what we really need there is some sort of supranational body that can audit the performance of national governments on the fiscal side, but not with any huge sanction other than public credibility.
Mr Walton: I think that you have to make a judgment as to whether a small breach in the rule is better than a distortionary tax increase which may be the alternative or indeed a cut in public expenditure and those inherently I think are political decisions. Clearly, if you breach them by a massive amount, then you are going to get penalised by financial markets and you will lose political credibility. I do think there is a danger that you are talking about very small breaches which are due to very small shocks in the economy which, with the best will in the world, the Chancellor could not actually anticipate very easily. It could just as easily have gone the other way where you have a surplus which is bigger than desirable over the cycle, which also would not have been that good.

Q41 Angela Eagle: So, what you are saying, David, is that the rules are good for smoothing off the top and bottom of a boom-and-bust type cycle and creating more economic stability, but it is not a disaster if they are missed by a tiny amount, overshot or undershot by a tiny amount.
Mr Walton: Absolutely. They are good rules of thumb.

Q42 Angela Eagle: They are good in themselves.
Mr Walton: But they are not something that should have a kind of legal status which, if they are breached, there is some penalty. That is one of the problems that the stability pact has had because Germany and France, although they breached the rules, in no sense do I believe that they have actually conducted an irresponsible fiscal policy. So, that is the difficulty.

Q43 Angela Eagle: So, they are kind of rules of thumb rather than the kind of rule you would expect on a football pitch with red cards and yellow cards?

Mr Walton: I think they are rules of thumb. I think the Government have raised them to a status which is more—

Q44 Norman Lamb: Raised their status substantially! One quick supplementary to Peter Spencer. Do you have something in mind akin to congressional budget office, something independent that assesses the forecasts and statistics?
Professor Spencer: That is exactly the model that I have in mind and of course, when it comes to assessing the state of the business cycle, the obvious model there is the US National Bureau of Economic Research, which has a cycle dating committee which again, with a little bit of hindsight, can go back over time to see where the turns in the cycle actually come. So, I think there are several models out there and those are two of them.

Q45 Norman Lamb: In terms of transparency, presumably you are not particularly much in favour of the current arrangement whereby the Chancellor can ask the National Audit Office, on a sort of cherry-picking basis, to audit certain assumptions within his own statistics.
Professor Spencer: As I said, when we were looking at the Budget, I think that is better than nothing but I think it can certainly be improved upon.

Q46 Mr Beard: Why should the National Audit Office have a better crystal ball for predicting the end of the cycle than the Treasury?
Mr Weale: I do not think the point is that it is better at it, the point is that it is politically independent. If there were a perfect crystal ball, the Treasury would simply need to buy it. It is because of my belief that there is not one that I think it needs at least to be done independently of the Treasury.

Q47 Norman Lamb: Could I just ask about the position for 2004–05 because, on the one hand, the Chancellor is predicting growth above trend and yet, on the other hand, on the basis of the assessment for the Growth and Stability Pact, the position improves from 3.3% down to 2.6%, still pretty close to the limit of what is at least at present acceptable under the pact. Does that not indicate a structural problem, that you have such a high level of deficit despite growth being above trend?
Mr Weale: One has to distinguish growth being above trend from the economy being above or below trend. It is perfectly possible of course if you are recovering from a period of economic weakness to have above-trend growth at the same time as you still have an output gap and therefore you have revenues being depressed, but I agree with you because I am not as optimistic as the Government about the size of the output gap and probably also not as optimistic about the scope for revenue to pick up. I think there has to be a certain amount of concern that, as in France and Germany, so too this economy is starting to suffer from a structural deficit rather than cyclical deficit and the reason why that might have happened is easy enough to understand. Around the turn of the century, tax revenues were really rather buoyant. People started to think that those were permanent increases in tax revenues. As it turned out, there may have been only temporary tax buoyancy which has gone away again. We do not know, we need time to find out, but there is a real risk that the deficit has become structural rather than simply cyclical.

Q48 Norman Lamb: Do the others of you agree that it looks structural?
Professor Spencer: I think there are two points on the stability pact. One is clearly that it does not apply to the UK because the UK is not in the single currency.

Q49 Norman Lamb: Just an indication of the size of the deficit.
Professor Spencer: The second is that France and Germany ran deficits above 3% of GDP last year and they are doing it again this year—in fact, it is going to be around 4% of GDP—and they will be above—

Q50 Norman Lamb: Does the position of above-trend growth and still a very substantial deficit not indicate something structural?
Professor Spencer: Except that I do not think the slack in the French and German economies is appreciably greater than the slack that exists in the UK economy. So, in that sense, I think the UK's relative fiscal position, particularly on the debt side, is much better than many of these other Euroland countries.

Q51 Angela Eagle: Is not the problem that we are having here that the Growth and Stability Pact or any number of fiscal rules are politically chosen with reference to economics? They are not numbers that ought to be set in stone *per se*, are they?
Mr Weale: I think one can see it the other way round. Governments are like households: you can always borrow a bit more without it seeming to matter. So, whatever sort of fiscal rule you adopt, you can easily—and, on the continent, they have and, in Britain, we may—get into a situation where you say, "It is daft to stick to this. It would be much more sensible just to borrow a bit and it is not really going to do any harm." It does not do any harm, but what it does mean is that you have some extra debt and you have to collect the taxes to pay the interest on that and, if that is what you want, fine. Fiscal policy does have this problem. People want to have some sort of framework because, until then, things just went all over the place and, once you have a framework, you can always think of good reasons for not sticking to it quite as strictly as perhaps you had hoped when you set up the framework.

Q52 Norman Lamb: I am keen to establish whether there is a general view that the deficit looks structural rather than cyclical; can I have a quick view from Robert Chote and Peter Spencer, please.

Professor Spencer: On the Treasury's figures, the underlying deficit, ie the cycle adjusted current balance, is worth 0.8% of GDP, and on that basis you would say that, of the unadjusted deficit, about half of the deficit is due to cyclical factors as taken into account by the Treasury's adjustment, and the rest of it, the 0.8%, is indeed structural. Importantly, as time goes on and the economy moves back to trend, if those calculations are anything like accurate, we will be left with the 0.8% deficit as an underlying deficit.

Q53 Norman Lamb: So then there have to be either tax rises or cuts in spending?
Professor Spencer: The only way you can correct a structural deficit is either through tax increases or spending reductions or, as others have already said, through the cumulative effect of fiscal drag.
Mr Fallon: We must move on now, and turn to revenue.

Q54 Norman Lamb: I want to ask one question on revenues before handing over to George. Council tax. The Chancellor has revised upwards the projections for council tax for 2004–05 and 2005–06 by £100 million and £300 million (Table B14). Is this one of the ways in which he is aiming to get in more revenue than would otherwise be expected? It is locally-financed expenditure, page 224, table B14, and you can see changes to the projections, 0.1 in 2004–05, 0.3 in 2005–06.
Mr Chote: And lower than expected for this year, so whether that has a great deal of effect in terms of shares of GDP over the longer term, I am not clear.

Q55 Norman Lamb: But the changes for 2004–05 and 2005–06 would imply increases in council tax of over 10% and over 6% for those two years.
Mr Walton: Except if locally-financed expenditure has come in £400 million less in this year, I am not aware of my council tax bill having gone down as compensation for that, so I am not necessarily sure it follows that council tax bills are higher as they take up that shortfall in spending.

Q56 Mr Mudie: We have touched on revenues with David but how serious would it be if the figures for this year and next year came in even lower than they have been revised to? Would it just be a matter of concern and political fanfare about being over-optimistic about revenues, or is it more serious than that.
Professor Spencer: It is serious because we are already, on the Treasury's figuring, on the verge of breaking the golden rule. If there were a further deterioration compared to that projection, then we would break the golden rule and either the Treasury and the Chancellor would lose a great deal of credibility having nailed their colours to that particular mast, or there would have to be a very significant change in policy, either tax increases, explicit tax increases announced in the Budget with all the fanfare associated with that, or cutbacks to the announced increases in public expenditure.

Q57 Mr Mudie: If I give you some figures, 2000–01 was 106; 2001–02 was 110; 2002–03 was 112—it was projected six months ago at 114; 2003–04 is 180; 2004–05, incredibly, is 128. Last year we had the Treasury arguing that this was all fiscal drag, etc, etc. They were projecting 114 and it has come in at 112 for 2002–03. This year, does anyone stand by this 118 when I tell you a year ago it was projected to come in at 123, was revised downwards to 122 six months ago, and has now been revised down to 118? It would still be £6.2 billion up on last year which is greater than the last two years. Now, are there things I am missing in terms of income tax?
Mr Chote: One of the issues that has arisen in the same way that trains have the wrong sort of snow is that the Chancellor has had the wrong sort of growth, and therefore the average earnings have been growing less quickly than expected which is one reason why income tax has been weaker.

Q58 Mr Mudie: But this is projecting up. I have already put into the market the fact that it has come down from 123, which I said last year was quite wrong on the trend. Are you speaking to the 118? Do you stand by that, because, remember, I will see you in six months' time as I said to the Treasury a year ago!
Mr Chote: Next month we will do our forecast—

Q59 Mr Mudie: Well, can you tell me too, then, if you stick by the 118, what do you see in the air that upholds the projection to £128 billion in income tax for 2004–05?
Mr Walton: That is just a 0.2% of GDP increase in the share.

Q60 Mr Mudie: Which you have not managed in the last four years?
Mr Walton: That is absolutely right but if average earnings goes back to its normal growth rate of around 4.5% or so, given the fiscal drag that we talked about, then you would normally expect to see the income tax share rise a bit as the GDP. Of all of these components—

Q61 Mr Mudie: Do you stand by the 128 then?
Mr Walton: I personally think it is probably as good a forecast as any.

Q62 Mr Mudie: We have got you on record with that!
Mr Chote: In terms of the impact of the cycle, table B11 reinforces the point that if you look at the share of GDP coming out of income tax—

Q63 Mr Mudie: Peter, you are more pessimistic. Go on?
Professor Spencer: The 128.3 represents an 8% increase in income tax on the year and although that is possible it is very unlikely that, even if earnings growth does move back to the sort of 4–4.5% range which would begin to pose problems for the Monetary Policy Committee, and even if there were a favourable shift in the earnings

distribution, it is still very hard to see 8% growth in income tax, and I think that is true of a lot of these tax projections.

Q64 Mr Mudie: Take the current receipts. It had an actual increase of £6 billion in the year 2000–01; it went up by £6.6 the next year; this year the Treasury is projecting a £26.3 billion increase. Now, I think £10 billion of that is probably National Insurance but it still moves from £6.6 to £16.6, and next year they are projecting a £33.4 billion increase. Now, if these are important figures and I asked you how important they were, this is not optimistic: I would take a close look at my accountant if he was doing books like this for me.
Professor Spencer: It is stretching judgment to the point of credulity, I am afraid.
Mr Weale: The Treasury is building in an assumption of revenue recovery; they could turn out to be correct, or lucky depending how you want to put it, but I agree with Peter, that if I had been producing this forecast it would have shown slower growth.
Mr Chote: One of the big explanations for the expected jump in current receipts between 2003–04 and 2004–05 is a big jump in receipts from corporation tax which is quite volatile, and we have certainly had long-term scepticism about the medium term optimism—

Q65 Mr Mudie: I went through that last year with Sir Donald and he was wrong then. I see he is not coming tomorrow which is a pity! With that receipt standing out, coming higher, does this reflect the success in enforcement measures, or a shift in spending matter?
Mr Chote: There I think you will find that, if you look at the National Audit Office review of the assumptions, the Customs & Excise is expressing some puzzlement about this on page 6. They note the fact that the Treasury uses a conventional assumption of the yield of VAT as a share of consumer spending—basically their assumption is that it drops by 0.05 of a percentage point each year. In fact, it has dropped more sharply than that over the first three years of the economic cycle, which is why VAT revenues have come in weaker than expected, and suddenly this year it appears to have shot up by 0.3%, and I think there is a line here to the effect that Customs & Excise is "uncertain for the reasons about the volatility of this ratio". Now, part of it may well be the tax avoidance measures but clearly there is uncertainty, both in the Treasury and Customs, about what exactly has been going on with VAT revenue as a share of consumer spending in the last four years.

Q66 Mr Cousins: Very quickly, given the discussion that we have had about the difficulty of assessing income tax revenue increases, I wonder what you would feel, say, about assuming revenue from the introduction of a local income tax, or the introduction of, let us say, a 50% rate on incomes above £100,000.
Mr Chote: Whether that would be any more different than forecasting incomes—

Q67 Mr Cousins: Yes. Whether it would be quite a difficult exercise to assume income from that.
Mr Chote: It is a difficult exercise to assume a large number of revenues from these, as the revisions in the figures indicate. I would see no reason to expect that to be any easier than forecasting revenues from anything else.

Q68 Mr Cousins: But given that so much of the income tax revenue increases relies on fiscal drag anyway and an increase in the number of higher rate taxpayers, does it not seem to be rather perilous to assume large additional revenues, say, from a 50% tax rate on above £100,000 incomes?
Mr Weale: I must say I do not see the exercise as being particularly difficult, simply inaccurate. There are things which can be perfectly easy but at the same time inaccurate. I think economic forecasts are often criticised for suggesting spurious accuracy, and in some sense, though that is the debate we are having about these figures here, it is easy to believe that there is a spurious accuracy in Table B9 because the numbers are presented to the first decimal place, and I think we should always remember not that it is hard to produce these forecasts or that it is hard to produce accurate forecasts—simply that it probably cannot be done.
Mr Walton: And, indeed, in any Budget measure on table B4, none of those numbers are almost certainly going to be right. It is just the best guess that the Inland Revenue has about the revenues you will generate from these tax changes.
Mr Chote: Certainly some policy changes can have quite unexpected—to some people—effects, the implications buried away of the move to zero corporation tax rate does seem to have turned out to be very costly for the Government in the sense of encouraging people who are self-employed to incorporate themselves. That was something which was predictable, and plenty of people predicted that that would turn out to be a very expensive policy. So it has and, clearly, now they are looking for some way to reverse it.

Q69 Angela Eagle: Do the panel agree with Goldman Sachs International that the rise in public spending and borrowing has been an important source of demand during the global downturn?
Professor Spencer: Yes. As I said earlier, there is no doubt that quite fortuitously, given the Chancellor's desire to set fiscal policy for the whole of the cycle rather than to fine-tune that cycle, this extra spending has come on at a time when the economy and the financial markets could afford it very well and, as a result, it supported demand rather than leading to higher prices and interest rates.
Mr Walton: As the person who wrote it, I would agree! Although I did go on to say that the supply side benefits—

Q70 Angela Eagle: I am coming on to that.
Mr Weale: Could I just make the point that the idea that this has happened without higher interest rates, I think, is incorrect. There is more government debt in the economy than there would have been if the Budget forecasts that the Chancellor was providing two years ago had turned out to be accurate. The presence of that extra debt in the economy does mean that interest rates are higher than would otherwise be the case.
Mr Walton: Can I give a counter factor to that which is if you compare the US and United Kingdom performance versus the Euroland performance, the big difference in those two comparisons is that in the US and United Kingdom case there has been a very big fiscal expansion in the past three years but in Euroland there has been virtually no fiscal expansion, and the actual numbers for GDP tell the story themselves, which is that the consumer in particular has remained very much more resilient in the US and the United Kingdom than has been the case in continental Europe.

Q71 Angela Eagle: As has, indeed, employment and growth. There has been a step change in resources for key public service priorities including a 50% real terms increase in spending on education and, by 2008, on the NHS by 90%. We mentioned earlier the talk of 47% volume growth in expenditure on the public sector but this increase of only 15% in what is described as "output". Does anyone have any views on why there are such differences between the 47% spending and the 15% so-called increase in output? This comes to the supply side point you were making.
Mr Walton: I circulated a note on this which has tried to address some of these issues. I think it is good that the Chancellor has asked Sir Tony Atkinson to have a look at all these issues in some detail, but I think it is very difficult to measure the output from the public sector—

Q72 Angela Eagle: I was just about to ask you that.
Mr Walton: The Treasury makes the point that if you employ more teachers and class sizes go down then that does not get recorded as an increase in output. Education output is measured by pupil years as opposed to the size of classes so there are these difficulties, although I would have to say there are difficulties in measuring output in many parts of the economy; in the private services sector it is just as difficult in many cases. What I think is a little bit worrying is what you have seen is a step change in the trend of the cost of providing public services really in the last five or six years. On average, through the period from the 1950s through to when this Government came into power, what you saw was that public sector costs grew by about 1.25% faster than private sector costs, which is not unreasonable because public sector output is typically much more labour intensive and you tend to get less productivity as a result so therefore you tend to see this relative increase, but since 1998 that gap has been 4.3 percentage points a year. Some of it is explained by the fact—

Q73 Angela Eagle: Will some of that not be catch-up from a period when there was very little investment in public infrastructure, and also public sector wages decreased proportionately?
Mr Walton: Yes. This is not looking at the investment side: just at the provision of current services. It is true that some of it is catch-up; in particular wage costs were held down very substantially in the period from the mid-1980s through to the mid-1990s, and that at some point had to be unsustainable, but even if you adjust for that, of this acceleration that we have seen from 1.25% gap to 4.25, the increase in wage cost is less than half of that, so what there has been, as far as we can tell from the data, is a big increase in non-wage costs, and it is not clear what that money has been going on. That is why I think it is very welcome that there is some kind of review because, at the end of the day, you want to make sure you are getting value for money as opposed to going into this extra bureaucracy or whatever.
Professor Spencer: In the meantime there was, of course, the article in *Economic Trends* last July by Alwyn Pritchard, which looked at productivity in the public sector, and to support what David has just told us there is evidence there that, since the acceleration in public spending, prices have been rising rather faster. The relative price effect, in other words, has been biting into the real resources that the money spend makes available.

Q74 Angela Eagle: Again, is that mainly wages?
Professor Spencer: No. If you look at Alwyn's work it is not just wages but it is the goods and services that the public sector procures as well. There is a very detailed breakdown into labour costs and investment and current spending, broken down in some cases by programme.

Q75 Angela Eagle: So are you saying that the public sector is probably not as good as it needs to be at procuring and getting a decent deal in its supplies?
Professor Spencer: It is hard to know precisely what explains these numbers, but there is a suggestion that it is not getting value for money on procurement, and there is also more worryingly a suggestion that the actual productivity of translating those real resources once you have acquired them, into final output statistics—you know, hospital operations and lessons and that kind of final output—has been getting less efficient.
Mr Weale: Could I say that some of the changes that people have wanted politically, like reducing class size, would generally have been expected to lead to reductions in productivity because most of the studies I have read suggest that at least in primary schools reducing class size is a rather inefficient way of helping children learn compared with all sorts of other things that one can do, but at the same time on the question of productivity

I should mention some work we have been doing looking at measuring the productivity of the education sector by its outcomes, children's performance in terms of exams and so on, achievables—and achievables which have consequence for their future earning power, and on that basis you do get a rather different picture. You get the impression that the productivity of the education sector is actually rising, and rising reasonably rapidly. Now, one can ask all sorts of questions about whether the exams are as good as they used to be, and I am sure we all have opinions on that, but nevertheless it does highlight how, in this sort of area, the way in which you address the question does substantially affect the answer that you get.

Q76 Angela Eagle: I was coming to that. Are we in a state where we do not really have methods of measuring public sector output that are accurate enough, and do we need more of this kind of approach that you have just mentioned to try to get a more decent handle on what value for money we are getting out of this?

Mr Weale: I am quite sure that we need to do more research in this area. The Department of Health is also taking an interest in this issue because measuring the productivity of the health sector is not only very important, but also the public service target in the agreement with the Treasury essentially assessed the Department of Health on the basis of something that I do not think can be measured at the moment, ie there has to be a 1% improvement in quality every year, and at the moment there are not the figures there to measure that.

Mr Walton: There are two additional points. Given the step change that has happened comparing private and public sector costs, it is not just that there are biases but that those biases have increased sharply over the past three years, and it is not clear that that is the case. Also the example of teachers is a good one in the sense that employing more teachers has boosted labour costs, wage costs, but most of the gap is in non-wage costs. In other words, even if you change these output measures to take account of class sizes, that would not address much of this decline in productivity growth that is taking place. I circulated an example to you which was fairly trivial but which nevertheless illustrates it which is that if you take the Pre-Budget Report and the Budget you now pay £90 for them. Back in 1997 you paid £37 for the two, so you have seen 150% increase in the cost of the Budget and Pre-Budget Report. Now, there are still only two books so that in a sense is an astronomical increase, but it is also the case that the number of pages has gone up from 238 to 550 odd, so the cost per page has barely changed, so it depends what you are seeking to measure here really. If you think it is the number of pages that is important, then there has been no change at all in the productivity performance.

Q77 Angela Eagle: The other issue that I wanted to talk about was the rebalancing of the economy away from the concentration that there has been on retail consumers and the housing market. As the world recovery begins and picks up speed, in order to rebalance our own economy we have to shift away from retail and housing sectors which have been keeping our economy buoyant into the next phase. What do you all see as the major risks that we have to watch out for during this rebalancing? Some of you have hinted at some of them in the evidence to date.

Mr Weale: One of the main risks is the inherent volatility in consumption, and we are seeing both sides of this issue at the moment. People have mentioned that, in raising interest rates, the Bank of England needs to pay attention to the fact that people have bigger debt than they used to and this may affect the response to the interest rates increases as they come: the other side of that is that we do not know how much further scope there is for building up indebtedness. We know that debts are much bigger than they used to be, but I do not think either the Treasury or the Bank of England has a view on what the sort of natural level of household debt would be, ie if young people could borrow as much as was sensible, bearing in mind what they expect to have as future incomes, would they have more debt than they do at the moment or less, and we do not know the answer to that. So there is an imponderable there whether there is scope for topping up the debt further for quite a while, or whether consumers will suddenly take fright at the debt burden they are carrying and suddenly stop spending. All these sorts of things are risks.

Professor Spencer: I think that is a particular risk given the kind of momentum that we tend to see in not just the high street but in markets. We saw the huge momentum that got under way in the stock market over the turn of the millennium and there is a similar momentum, it has to be said, in the housing market as well. The problem is that trying to arrest that kind of momentum with quarter point increases in US interest rates in the case of the US stock market, or quarter point increases in United Kingdom interest rates to try and slow our housing market, is extremely difficult. What tends to happen is that the thing goes its own sweet way for quite some time until a very large adjustment occurs such as happened in the stock market. So I think essentially that kind of momentum and the difficulty of arresting that in a gradual kind of way, given that we are talking about an asset market, is the real danger now.

Q78 Norman Lamb: So you see a real risk in a crash in house prices?

Professor Spencer: I have not until now. I think to get a big correction in the housing market you need a significant rise in unemployment and a large rise in interest rates so I have not really been too worried, but I think the fact that it has gone on as long as it has and the momentum has built up does make a very sharp correction a real possibility now.

Mr Walton: I also think the housing market may be a challenge, because rapid house price inflation has been a necessary evil as part of the need to keep consumption growing in the face of this pronounced weakness elsewhere, and the challenge will be, if the rest of the economy now comes back strongly, that the Bank of England—and it is never going to put it in these terms or and it is not going to want to see the housing market crash because that would imply too big an adjustment—may well need to see house prices come down 5 or 10% from these levels in order to put some dampening effect on this buoyancy that we have seen in consumer spending growth, and that is not an easy process to manage. The very encouraging thing in many ways is that (a) the Bank of England is incredibly pragmatic, and we do get information about the housing market on a very frequent basis so, if it looks as though it has done too much, it can cut rates again, and (b) relating to that is the fact that interest rates are running at close to 4% or so and there is plenty of scope for interest rates to come down further, so the Bank of England has got quite a lot of policy instruments or room for manoeuvre on interest rates in order to manage that process.

Mr Fallon: I do not want to get diverted too much into monetary policy.

In the absence of the Chairman, Mr Beard was called to the Chair.

Q79 Mr Cousins: Directly following from that, the Government is looking at non macro economic ways of trying to improve the housing market with long term, fixed rate mortgages, trying to increase the rate of house construction, and the introduction of these investment trusts based on the housing market. Do you think that these are potentially effective instruments or not?

Mr Weale: I think the main mechanism for improving the housing situation is to ensure that more houses are built. Without having more houses being built, if you simply make it easier for people to invest in housing through the introduction of real estate investment trusts, then one might think that that will add to rather than reduce upward pressure on house prices, so I think the absolute key to this is finding out, in a situation where we do not have a large council house sector any more, how to get back to the sorts of levels of house building that we had in the 1950s and 1960s.

Mr Walton: A lot of these things are at the margin, to be honest. At the end of the day at any point in time the supply of housing is broadly fixed, and if you suddenly see real incomes growing quite quickly you tend to get house prices rising rapidly. We have gone through that process. We have also gone through a process where real interest rates in the world, particularly in the UK, have come down quite substantially, which probably means you can sustain higher levels of house prices than historically was the case. You are right that, if you want to keep house prices down, although it is not absolutely clear that that is a desirable policy, you do need more supply, and that is where I think the real estate investment trust comes in because, as I understand it, the idea of REITs is not particularly to increase speculative investment but to encourage house builders to build more, and the way that happens is that at the moment, if house builders have a land bank, it pays for them in a sense to sit on that in the hope it rises in value and then the net asset value of these companies goes up, whereas with real estate investment trusts they distribute all of their income, they do not pay tax themselves, it is the shareholders who pay the tax, and the shareholders therefore want to get as much income as possible, and the way you do that is by these property companies building such that they have properties to rent out which generate the income stream. So at the margin the move to real estate investment trusts is something which is likely to increase supply of housing, but these things are fairly marginal and are not going to transform the housing market overnight. As for the proposal on fixed rate mortgages, I am somewhat dubious about this. My own casual observation is, while interest rates have been falling steadily since the early 90s, it has been a mistake to lock into any fixed rate mortgage over that period. We may well be getting to a point where it does make more sense, but it certainly has not been wrong over the past decade or so just to stick with a short term mortgage, and it seems to me that the financial market in the United Kingdom is sufficiently sophisticated that, if there is a demand, then the market will be created. I cannot see there is much evidence of market failure in the provision of mortgages in the United Kingdom so I am a little bit doubtful as to whether there is anything that the Government can particularly do to encourage a move to a fixed rate mortgage market, or even if it is the right policy to be encouraged in the first place.

Professor Spencer: I share that scepticism. I think that the housing market is such an important part of the British economy and it has been so problematic that certainly we should try every way that we have to bring it under some sort of control, and micro economic measures are certainly on that list. The reports from Kate Barker and David Miles are very interesting but, of course, the problem is that they are interim reports, and although they have clearly analysed the problems very seriously we have yet to see what their solutions are. and I am afraid it is going to be very difficult to find micro measures that will be successful in helping with those markets.

Q80 Mr Cousins: Could I ask you about the shift to the new method of constructing measures of inflation? We had some very interesting exchanges I thought earlier on about the substantial weight that non labour costs have been attributing to the argument. Do you think there might be a problem in public sector wage negotiation if people's attention is directed at a measure of inflation which appears to be lower than the one that people are used to for bargaining purposes?

15 December 2003 Mr Robert Chote, Professor Peter Spencer, Mr David Walton and Mr Martin Weale

Mr Chote: In the same way that you can take a horse to water but you cannot make it drink I think you can probably draw the attention of wage bargainers to a different measurement of inflation but that does not necessarily mean to say they are going to take a great deal of notice! Given that at the same time as suggesting that bargainers should look at the new CPI measure we have also said it is appropriate to uprate benefits, for example, pensions in line with the existing measures of inflation, which I think, if you have a somewhat different message for different audiences, which rather blunts the argument. There is an interesting longer term question now about whether the Chancellor has been very explicit about not using the new lower inflation measure to upgrade things like benefits, etc. That is going to be a standing temptation for maybe this Chancellor in the future or future chancellors. Particularly if and when the new inflation measure, the European measure upon which it is based, then also includes housing costs as well, the difference is only really going to be then how it is measured, and if we think that the new inflation measure is measured in a more sensible way that generates a lower rate then why not upgrade benefits in line with that if we believe that is more sensible, and that would then make a much stronger argument for going to wage negotiators and saying, "Why do you not look at that measure as well?" But I think pointing different audiences at different measures makes it difficult to have a particularly hard-hitting message one way or the other.

Mr Walton: It should not have much effect in the sense that, if the 2% target for consumer price inflation is the same as 2.5 for RPIX, then whatever wage bargainers have been doing in recent years it certainly has been consistent with the 2.5% target, so in that sense really they should just go on with what they have been doing because to a first approximation that is likely to deliver an outcome that is quite close to the inflation target. If anything this represents a very slight loosening of the inflation targets, so if anything the message wage bargainers should probably take is actually that they can afford to bargain for slightly higher wage increases in order to push inflation up to the target, but that would be a very short-lived phenomenon.

Professor Spencer: I can see that leading to quite a tension in public sector wage negotiations because, on the one hand, the Government is arguing that the underlying rate of price inflation is only 2% and, at the same time, for the technical reasons that you say, the underlying rate of RPI inflation, the rate of inflation in the economy generally, has increased by a quarter of a per cent. That is essentially because, although the target has been lowered from 2.5% to 2%, the underlying trend in the RPI and, it seems from some of the numbers that we have got here, the GDP deflator, all of these indicators are coming out at 2.75% inflation in this current PBR whereas, of course, we are used to seeing them at 2.5%. If the actual rate of inflation has gone up by a quarter per cent and the Government has said that it has gone down by 0.5%, then that is going to be a source of tension.

Mr Weale: Could I make a point that, fundamentally, if the Government wants people to work in the public sector, it has to pay what they cost. Now, the problem which may arise is that often the Government does not realise what it costs to employ people until there has been quite a sustained spell of what they call shortages—not having enough nurses or teachers and so on. The sort of smoke that is generated by this change in the target may make it a bit more likely that that situation arises in the short term but, that said, if one thinks back to the really rather long period we had where the Government was trying to set public sector wages independently of labour market conditions in the economy as a whole, and then talking about shortages as though that was quite unconnected with its wage policy, that went on for a period probably of more than ten years, but compared with that sort of thing this change in the index I think will have a rather small effect.

Q81 Mr Cousins: One thing that the Government is clearly signalling is a move towards recruitment and retention premia that are negotiated locally. In fact, an instance is given of how this could be applied in the context of, I think, hospitals in a document that the Government has produced. What do you see as being the implications of that for inflation?

Mr Weale: I think the implications essentially ought to be that the Government is able to provide services more efficiently and therefore more cheaply so reducing overall inflationary pressures. The sorts of problem with national pay scales is that if you set national wage rates to deal with areas in the country where there are the shortages I was referring to, then you find in other parts of the country you are paying over the going rate for the public services and that, of course, is a burden on the taxpayer and tends to exert upward pressure on wages generally. So this is an attempt to make wages more responsive to local conditions and I think that can be only welcomed.

Q82 Mr Cousins: Do you agree with that?

Mr Chote: Yes, broadly.

Professor Spencer: Yes.

Q83 Mr Cousins: So these recruitment and retention premia would sit on top of the national pay rates, would they, or, of course, in the case of areas where hospitals had more nurses and doctors than they could cope with and were turning them away, those recruitment and retention premia presumably would not be applied there?

Mr Weale: That is what I would expect. Within areas where it is easy to recruit doctors and nurses, then why pay recruitment and retention?

Q84 Mr Cousins: Would you mind telling me where those areas are?

Mr Weale: There are presumably some areas where it is easier—

Q85 Mr Cousins: Presumably, but you do not know. You have just asserted that this is going to produce a much more flexible—
Mr Walton: I think Martin's point really which he started off with was that at the end of the day—

Q86 Mr Cousins: Do forgive me, Mr Walton, I am asking Mr Weale this. You have just made an assertion; I am puzzled to know where it is that we are turning doctors and nurses away from hospital gates.
Mr Weale: If we take the example of firemen, my understanding from what I read in the newspapers was that there were parts of the country where, when jobs for firemen were advertised a lot of people applied for them, and it was only in the high cost of living areas where there were these apparent shortages of firemen. I understand also that in some towns in the country you find families where the wife is a nurse and is the chief breadwinner in the family. I think you would be unlikely to find that in the south east, and the reason is that a nurse's salary in areas of the country where housing is cheap does go an awful lot further than it does in central London.

Q87 Mr Beard: Can we leave it there and just round off on two questions that relate to the child tax credit? How effective will be the £180 increase in the per child element of the child tax credit in helping the Government meet its target of reducing child poverty by a quarter by 2004?
Mr Chote: We estimated a few weeks ago that the Chancellor effectively needed to announce an increase of £3 a week on top of the previously assumed and promised increase in line with average earnings in order to expect to hit the target. What he has done, in effect, is to increase it by £2.50 a week on top of the correspondence to average earnings. There are also, as has been pointed out, some freezes to the thresholds of other parts of the tax credit system, but nonetheless the net effect still remains very strongly and effectively targeted on the poorest families with children. My guess would be that, although formally speaking it is not quite what we anticipated will be necessary to hit the target, it is an awfully long step in that direction and that frankly, given the errors in the survey from which the child poverty numbers are calculated, it is quite possible that the Chancellor is going to hit the poverty target on the basis of this increase.

Q88 Mr Beard: Have you or anyone else done any work on how the Government should balance providing money to the parents and the children through tax credits against improving services aimed at disadvantaged children, such as Sure Start?
Mr Chote: We have not done an explicit cost benefit analysis of the two but I think that is a very important issue, particularly in the context of deciding what measures of child poverty you are going to seek to target in the next phases, as it were, having reduced it by a quarter and seeking to halve it and then reduce it entirely. I think there has certainly been some concern in some parts of Whitehall that, by having a target that is so clearly fixed as a target of relative income, ie the number of children in households with incomes below 60% of the median, that creates an excessive bias towards trying to deal with child poverty through direct cash transfers, when it might well be more appropriate over the longer term to take some money and to devote it to services like, as you say, Sure Start. My guess would be that, as the Government articulates what it thinks it should be targeting in the next phases of reducing child poverty, it is more likely to be a more multi dimensional measure, and that might well be a suitable basis upon which one can have a discussion about the appropriate balance. It clearly does make sense to have a mixture of both services and direct cash transfers.

Q89 Mr Cousins: Mr Weale, are you in favour of reproduction premia to reflect the differential costs of raising children and the differential trade-offs of the income you sacrifice of having children in different parts of the country?
Mr Weale: Could I give a general answer to that based on what I know of Denmark, and Denmark is the country whose fertility rate has held up, and the reason I understand that that has happened is because the Government there has really got to grips with essentially making it easy for women with children to handle careers at the same time. I suspect that as other European countries come to grips with declining birth rates so they will have to look rather carefully at countries where birth rates are holding up, and see what they can learn from them.
Mr Beard: I think we should leave it on that happy note. Thank you very much.

Tuesday 16 December 2003

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard	Mr George Mudie
Mr Jim Cousins	Mr James Plaskitt
Angela Eagle	Mr David Ruffley
Mr Michael Fallon	Mr Robert Walter
John Mann	

Witnesses: **Mr Jon Cunliffe,** Managing Director, Macroeconomic Policy and International Finance, **Mr Nicholas Holgate,** Director, Welfare Reform, **Mr John Kingman,** Head of Enterprise and Growth Unit, **Mr Jonathan Stephens,** Director, Public Spending, and **Mr Andrew Lewis,** Head of Tax Policy Team, HM Treasury, examined.

Q90 Chairman: Good morning. Welcome to the Committee to you and your colleagues. Can you introduce yourselves formally, please, for the shorthand writer.
Mr Cunliffe: On my far left I have Nicholas Holgate, our Director of Welfare Reform. Next to me is Andrew Lewis who is the Head of the Tax Policy Team. I am John Cunliffe, the Managing Director for Macroeconomic Policy and International Finance. On my right is Jonathan Stephens, our director of Public Spending. On my far right, John Kingman, who is the Head of our Enterprise and Growth Unit.

Q91 Chairman: Welcome. At the time of last year's PBR there was a projected cumulative surplus over the cycle on the current Budget of £49 billion. The Permanent Secretary, Gus O'Donnell, at the time, assured us that the Treasury did "not view this as an amount which can be blown going forward". Twelve months later the fiscal position has unravelled quite rapidly, so what has happened?
Mr Cunliffe: Since the Budget projection two things have happened, I think. One, revenues have come in weaker than we expected at Budget time and there are reasons for that. The other is that on the expenditure side there has been an increase in expenditure, particularly discretionary expenditure to do with Iraq, which has increased the expenditure side. Those two together have led to an increase in net borrowing of around £10 billion.

Q92 Chairman: As simple as that?
Mr Cunliffe: I can go into the details. On the revenue side, the loss of revenue is mainly around taxes on income, income tax and social security contributions. You can look at it two ways. The main driver there is that average earnings have been lower than were forecast at Budget time and lower than the rate that the Bank of England generally takes as being in line with sustainable growth. We think behind that a number of things have happened. The economy and the labour market have proved to be more flexible in the face of global demand shocks so to that extent average earnings have been weaker. You can also look at it from the other side which is that the revisions to the national accounts which ONS produced in September actually showed that growth had been higher in past years than we thought. Of course the tax take which came in in past years remained the same, that has not been revised up. So if you look at the previous year, 2002–03, the effective tax take has turned out to be lower than we thought it was at Budget time. Going forward, we have written all those numbers into the projections, so the projections have been lowered for that. If you ask me what the main reasons on the revenue side were, the main reasons are lower than expected earnings growth, particularly wages and salaries growth which has affected income tax and National Insurance contributions and, looked at another way, a lower effective tax rate which, as I say, we have knocked through. On the expenditure side there is a very large discretionary item of $2\frac{1}{2}$ billion for Iraq and then there are other increases in expenditure of roughly the same amount to do with social security payments. There are higher than forecast take-ups of tax credits, that is a new system going forward, so the forecasting I think has to be seen in the light of a new system. It is those two things taken together.

Q93 Chairman: What about the fiscal position, is that not particularly disappointing given that the Budget forecast of growth to the Treasury between 2 and $2\frac{1}{2}$% this calendar year is looking broadly on track?
Mr Cunliffe: First of all, the growth forecast is on track, the composition of growth has been different from the way it was forecast and in particular growth has happened in less tax rich parts of the economy than we forecast, and that is the average earnings point just seen a different way. Average earnings have not grown by as much as we thought they would. I think the other point I would make is that the difference between our forecast and budget on what has happened now is in line with the standard area for fiscal forecasting over the last 20 years. There are uncertainties in fiscal forecasting which is one of the reasons going forward we use cautious assumptions and it is within the line of the normal uncertainties.

Q94 Mr Walter: I wonder if I could look for the moment at your GDP forecasts and look at the context of the way you have adjusted those forecasts

over the last couple of years. In the spring you had to cut your growth forecast again, 2003, back towards the consensus figure, and that has proved to be broadly correct, but you keep assuring us of how cautious your assumptions are. The forecast for 2004–05 remains the highest of any of the major forecasters and I just wondered whether you felt this was consistent with a prudent approach to planning public finances?

Mr Cunliffe: First of all, I talk separately about forecasting the public finances and forecasting the economy and forecasting economic growth. I think actually our record this year has been pretty good compared with outside forecasters. We forecast 2 to 2½% budget; the Bank of England was lower than that. By September most of the economic forecasters had revised their forecasts down and were showing the figures around 1.5 or 1.6. Then in the last quarter of the calendar year they had come to meet us and they are now all above two. I think if you look back over the past our forecasting record over the last five years certainly has been better than the IMF, better than the National Institute, better than the consensus of independent forecasters if you look at the average error in our forecasts. So I think generally looking backwards our forecasts have been pretty robust. I think some of the witnesses that you had here at Budget time pretty much said that. Looking forward, the forecast for calendar 2004 is 3 to 3½%. I think as far as outside forecasters are concerned, they are moving up. The Bank of England has moved their forecast up, two-thirds of the outside forecasters who have recently updated their forecast have moved upwards and they stand now around 2.6 or so. Actually our forecast is not done on this in terms of what other people are forecasting, our forecast is based on the forecast that there is an output gap of around 1½% in the economy and that output gap will close over two years. We have seen in the past when the economy is closing, similar size output gaps in the mid 1990s, for example, growth has been around 3½% and in the 1980s it was higher. Of course the increase in the trend rate of growth has made it more possible that we can reach a rate of 3 to 3½% so I do not think our forecast is optimistic and I expect other forecasts to continue drifting up towards it. The public finances, of course, are forecast on the lower end of that for cautious reasons, so 3%.

Q95 Mr Walter: Can I just stick to the GDP forecast for the moment and look at it then in an international context. The OECD said in November, talking about the weakening of the dollar, sudden weakening of the dollar could stifle fledgling European recovery. You have got in your forecast a forecast of 1¾% euro zone growth in 2004 which is higher than the European Central Bank's forecast, they have a wide range of 1.1 to 2.1 in 2004 and 1.9 to 2.9 in 2005. What is driving your forecast of a 6¼% growth in UK export markets?

Mr Cunliffe: The forecast for the euro zone we have is pretty much in line in this case with the consensus, around 1¾. What has happened over the past year is that although world growth has gone relative to our forecast at Budget time this year, and our forecast for this year and next is up, the balance has changed. There is more of it in the US, which is clearly making headway quickly where we see growth of around 4.2% next year, and in the euro zone we have written our growth forecast down to 1.7. Because the euro zone is important to the UK, nearly 60% of our trade goes in that direction, we have written down the growth in UK export markets both next year and the year ahead, the 6¾%. However, I would say growth of 1.7 in Europe is still below the euro zone, it is still below the trend rate of growth there. The confidence evidence over the last three or four months, the survey evidence, both industrial and consumer surveys, in the euro zone has suggested that those economies are about to pick up and the domestic demand is coming back and business confidence is coming back. In the third quarter, after two very bad quarters at the beginning of the year, we saw growth come back in the big economies in France, Italy and Germany, so there is some sign of that picking up. I am expecting that particularly as the US continues to grow very fast that will increase euro zone trade and will help the euro zone to come out. Around any forecast there are risks and clearly one of you mentioned the dollar, one of the risks in the forecast is around what might happen to the dollar. It is not a central case.

Q96 Mr Walter: What assumptions have you made? You pin quite a lot of hope on the US economy recovering but in terms of value to the UK economy that could be negated by a significant fall in the dollar, so what assumptions have you made?

Mr Cunliffe: The US economic recovery is more than hope now, I think there is some quite firm evidence that it is established and it is moving very quickly. There are significant imbalances in the world economy, which we go into a little bit in the PBR, which if they were to unwind quickly and in a disorderly way could move exchange rates in a fairly sharp way. It is important not to look at this question of how Europe will respond to the US in a simplistic exchange rate way. The European economy exports to the US. It benefits from an increase in US demand. The growth in US demand and the growth in the US economy are helping. On the other hand, the exchange rate, the price effect goes in the other direction. The effect is the net of those two and even though the euro has been strengthening against the dollar in the third quarter of this year, euro zone exports particularly to the US strengthen particularly in the third quarter. So you have to look at the volume effect and the price effect and they do offset each other.

Q97 Mr Walter: Perhaps I could move on to another topic in this section, again citing OECD, and look at comments about the UK economy. They have been suggesting that there are widespread fears that a potential source of instability could be a sharp retrenchment in the consumer sector triggered by a setback in the housing market. They have suggested

that large public sector deficits are adding to the risk here by putting upward pressure on interest rates. Given that the interest rate cycle, I think everybody agrees, certainly for the moment has turned upward, is there not an argument for cutting the UK fiscal deficits sooner rather than later?
Mr Cunliffe: I would say that over the last two years or so, probably over the last five years, fiscal policy has supported monetary policy and up to about 2000 it supported monetary policy by tightening. Then as we have seen the growth slow down it has supported monetary policy by loosening and I think the large amounts of public sector investment have helped maintain employment and helped to maintain confidence. I think on the housing market it is a bit different, different people take different views, but when you look at the increase in household debt, most of it is matched by an increase on the asset side, so it is not as if there has been borrowing for consumption. When you look at the debt service to income ratios, the amount of their income people are paying in mortgage payments or interest payments generally are low compared with the rates we saw at other times in the housing market of high house price increases in the late 1980s, early 1990s. If you look at the affordability, it is not clear to me that we are actually in a position where there will be a sharp break in confidence.

Q98 Mr Walter: There is a minority of households who are facing very high levels of income gearing on a regional basis. Have you done any work to look at the problems concerned with that?
Mr Cunliffe: Questions of how interest rate increases affect consumption, affect advance consumption, are really questions for the Bank of England because short run demand management of the economy is their job and not ours.

Q99 Mr Walter: They have signalled that as a problem?
Mr Cunliffe: The Bank of England has signalled it, as I understand it, as an issue, an issue that they are watching. Our forecasted model pretty much takes market interest rates and market expectations of interest rates going forward so what the market has built in on interest rates we have built in and, therefore, we have that effect on consumption in the forecasts.

Q100 John Mann: You told us in the spring that you were considering ways of plugging a gap in the official statistics when it comes to the health of pension funds. Could you update us on progress on that, please?
Mr Cunliffe: I am afraid you will have to remind me of the exact commitment.

Q101 John Mann: Yes. A quote from the Government response to the Committee's Seventh Report on the 2003 Budget, one of the action points was to consider whether a statistical digest or fact sheet could be produced bringing together all available pension statistics.
Mr Cunliffe: If I can let you have a note on that, I do not have that information with me.

Q102 John Mann: You have been very optimistic about business investment but pension fund deficits are a major problem. Have you been too complacent about company finances?
Mr Cunliffe: I would make a number of points. One, since Budget time the ONS revisions have given us a slightly different picture, in some cases a markedly different picture, of what happened in the past. The downturn in investment that we thought we had seen in 1992 with investment shrinking by over 11% has turned out to be much shallower because actually more real investment took place in the economy than we thought. I think the downturn in 2002 was around 4½ not 11½%. So the first point I would make is that looking backwards the investment downturn has been much shallower. The point I would make looking forwards is that clearly business investment is a very volatile series but it depends on corporate profits which have gone up this year, I think they are up about 8% on the same period last year. It depends on long term interest rates which are low, it depends on equity prices which have come back by about 20% since the Budget, and it depends on bond spreads which have narrowed and then it depends on prospects, it depends on prospects for the economy going forward and for exports. The pace of return that we have on business investment, I think we are forecasting three-quarters of a percentage of GDP this year, about 3½% next year going to somewhat around six the second year. That is quite low given the rates of increase in business investment that you have seen after previous slowdowns where it has been about 10% after two years. Annual investment rates have hit 18 to 20% figures so this is a very volatile series. I think there has been an effect from companies increasing their pension contributions and I think we have seen some of that in the lower wages and salaries and earnings that I mentioned earlier on because I think some of the earnings growth has gone into pension contributions rather than into wages and salaries. That is one of the things which have held down NICS. I do not think our figures for investment growth over the next two years compared with what has happened in the past are at all extraordinary and, as I said, we do take account of some of the higher pension contributions that have happened in the past.

Q103 John Mann: Can I just come back to my question. Do you actually have the information on pension fund deficits to be able to—
Mr Cunliffe: There is information on pension fund deficits. As I recall, it is not easy to compile an aggregate figure. There is also information on pension fund contributions, an increase in contributions, in the economy over the last year and we can let you have that but I am afraid I do not have them with me.

Q104 John Mann: The Lyons review is very welcome as a mechanism of social policy but is it not something of a distraction from the fact that you cannot really agree on an accurate way to measure both public and private sector productivity?
Mr Cunliffe: If I could say a word about the overall measurement of public sector productivity and inflation on public sector output and then perhaps my colleague, Mr Stephens, could say something on the Lyons review and possibly on—

Q105 Chairman: We are coming to productivity later on.
Mr Cunliffe: Shall we stick to the Lyons review.
Mr Stephens: The Lyons review is one part of a general concern across government to ensure that we secure value for money from the increased spending on public services. It is not only about increased efficiency but also about ensuring that growth is spread across the regions of the UK. As the Chancellor set out in the PBR, we expect to be on track to shift some 20,000 jobs out of London and the South East.

Q106 John Mann: Can I ask about government fixed investment. You have forecast in calendar year 2003 a sharp fall replaced by a large revision upwards in calendar year 2004. What is going on there?
Mr Stephens: Public sector net investment has been increasing substantially over recent years from four billion in 1999–2000 up to a planned figure of 18 billion for the current year 2003–04 and is planned to increase still further to 31 billion in 2007–08. We are expecting it to come in very slightly under forecast in the current year. Of course, public sector net investment is composed of a number of factors, not only central government investment but also local authority investment and other factors, but the reality still is that over recent years as a proportion of GDP public sector net investment has been increasing substantially.

Q107 John Mann: Do you expect a big surge in the final quarter of the financial year?
Mr Stephens: Traditionally there has been a surge in end year spending despite the increase in end year flexibility.

Q108 John Mann: Your estimates are suggesting that quite heavily this time.
Mr Stephens: Yes.

Q109 John Mann: Is that conducive to efficiency in the public sector?
Mr Stephens: Certainly we recognise the need to ensure that investment is planned and, with the introduction of 100% end year flexibility for departments, we have given departments and other delivery bodies the freedom to plan and manage their investment over time so that they are not constrained by the accounting year. Nonetheless, there remains the significant end year factor in investment spending and we are increasingly focused with departments on how they delegate in turn to their delivery bodies the end year flexibility and other freedoms that we give them.

Q110 John Mann: I thought we had now a three year planning of budgets?
Mr Stephens: We do. In the Spending Review we set three year plans and in the case of the Health Service five year plans. In the case of the Health Service, the NHS in turn delegates to local PCTs three year budgets. That is an approach which we want to see other departments and delivery bodies increasingly taking so that as we delegate freedom to departments that is passed on to front line delivery units.

Q111 John Mann: You have three year planning but there is this big surge in this final quarter. Have departments not yet caught up with this?
Mr Stephens: Of course, departments tend to want to retain an element of unallocated provision themselves to deal with contingencies that may arise in the year. Some of that is sensible and necessary. It may be that on occasions departments are being over-prudent and not delegating as much as they could do. We are investigating with departments the scope for further delegation of budgets and planning.

Q112 John Mann: Looking at the current account deficits in your forecast, is this sustainable?
Mr Cunliffe: I think the current account forecast that we have takes the current account to around $2\frac{1}{2}$% of GDP. I think that is a quite sustainable figure, yes.

Q113 Angela Eagle: When do you expect this cycle to end?
Mr Cunliffe: In the year 2005–06, financial year. I would say probably calendar 2005.

Q114 Angela Eagle: Will there be an announcement when it has ended?
Mr Cunliffe: The way in which we date the cycle is not a mystery.

Q115 Angela Eagle: I thought most of economics was a mystery.
Mr Cunliffe: I think the same sometimes. When we dated the start of the cycle we put out a Treasury publication explaining why we thought the cycle had actually started at that point and we will do the same when we date the end of the cycle. I should say the way in which we date the cycle is based on looking at a number of independent measures of capacity in the economy: wages, employment, fuel shortages, confidence and use of industrial capacity. We look at a wide range of measures that are, if you like, independent of our whole economic forecast to try and get a view as to when the economy is on trend. We will follow that methodology when we have to estimate the next on trend point, which will be the end of the cycle.

Q116 Angela Eagle: That is a transparent methodology which they will be able to assess when you make the announcement?
Mr Cunliffe: Our dating the start of this cycle in 1999 and estimating a short half cycle from 1997–99 was transparent. A number of the commentators, the IFS, the National Institute, commented on it and I expect there will be the same discussion and debate about the future trading of on trend points as there has been in the past, but it will be completely transparent.

Q117 Angela Eagle: I am not a cynic but there are those who say whether the Golden Rule is met or not rather depends on when the cycle ends.
Mr Cunliffe: No, I think the opposite is true actually. There is an argument that some commentators have made that rather than starting the cycle in 1999, this cycle, we should say that it started in 1997 and the previous cycle did not finish in 1999. If we had done that then the average annual surplus on the current budget would be higher than starting the cycle in 1999. If you like, we have taken a more cautious route. I should stress that is not one of our cautious assumptions, the cycle went from 1999 to the third quarter of 2001. We dated that on the best evidence that we had that the economy was on trend in 1999 and again in the third quarter of 2001 it was on trend.

Q118 Angela Eagle: Do you worry that in this cycle there was tightening at the beginning, loosening as the world economy slowed down, fiscally that is, and there will be fewer surpluses at the beginning of the next cycle? Do you worry about that in terms of the prospect of the Golden Rule being met next time?
Mr Cunliffe: At present we are forecasting going out past the end of the cycle that the economy goes to trend and stays on trend. You could say the best assumption we could make at this stage as to what happens at the beginning of the next cycle is almost that there is not a cycle, that the economy just grows at its trend rate. I am not worried that the last cycle started with surpluses when the economy was growing above trend and that some of those cautious balances that built up were run down when the economy was growing below trend because I think that is the object of the Golden Rule. Going forward we are starting to project surpluses again past the end of the current cycle, although I should make clear that past the end of the current cycle we are not showing a period of above trend growth, it is a more stylised assumption that the economy grows on trend.

Q119 Angela Eagle: Can you say something about the changes that the differences and different institutional arrangements for monetary policy and supported by fiscal policy have made to the extremity of the cycles past and present?
Mr Cunliffe: I think one of the clearest results of the decision to give the Bank of England operational independence is the way in which inflation expectations have come down to the Bank of England's target. You can see that in the figures markedly from 1997 onwards.

Q120 Angela Eagle: We have a much flatter cycle. You have taken the top and the bottom off the historic cycle.
Mr Cunliffe: As a result, the combination of more stable expectations going forward and then the combination of a forward looking policy setting framework for the Bank so they manage the economy looking ahead two years in a transparent way so people can understand what they are doing and why they are doing it, I think has taken down the amplitude of the cycle. The volatility that we saw in the British economic cycle over the period from 1970 onward changes, that volatility has clearly come out and cycles are less pronounced. In this economic cycle we are talking about a cycle around the trend rate of growth, we are not talking about a cycle around zero growth with a recession, with negative growth at the bottom of the cycle and positive growth at the top, which was the shape of the cycle over a long period before we made those changes. There are much smoother cycles going forward and positive growth, which I think we have seen for over 40 quarters now.

Q121 Angela Eagle: The previous Budget estimates were putting growth between 2 and 2½% and they were widely disbelieved by the so-called independent forecasters. Are you at least marginally satisfied that these growth rates have been hit?
Mr Cunliffe: Yes. It is the point I made before that our forecasting record has been quite robust. What has happened this year has tended to confirm that.

Q122 Angela Eagle: Do you think that as the world economy picks up and we have avoided recession that there needs to be a tightening of the fiscal stance now in order to shift the support away from consumer, retail and housing support to keep the economy going back into the private sector?
Mr Cunliffe: I think that tightening happens automatically through the operation of the automatic stabilisers. What they tend to do is as the economy grows in the same way as the economy grows at a rate below trend the automatic stabilisers lead to a loosening of fiscal policy that operates counter-cyclically. As the economy comes back and does above trend after 2005 one would expect the automatic stabilisers to operate in the same way and lead to a tightening of policy.

Q123 Angela Eagle: Can I just ask one question of Mr Stephens. You were talking about public sector productivity and output earlier. It seems to me, looking at measurements of public sector output, that we do not really have a very sensible way of measuring positive outcomes and much of what may be going on with the public sector investment is not being caught in the measures. For example, if you have a better educated workforce as a result of improvements in education, that is not caught in the

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way that public sector output is measured. Are you going to be doing any work to try to get a better handle on value for money for public sector expenditure so that we can make a better judgment of the value that we are getting for the substantial sums that are currently being invested?
Mr Stephens: Certainly you are right that this is a complex and difficult area because, of course, we do not have any prices to assign to government outputs. The ONS for some years has been working, and in many ways leading the field, in terms of developing output measures but, as you illustrate, there are a number of areas in which they do not capture in full government outcomes and there are areas, for example, in education where improved educational attainment, the increase in the achievement of national literacy standards, numeracy standards, at age 11, for example, is not captured and similarly on health and other areas of public services. Last week the Chancellor announced a review by Sir Tony Atkinson working to the National Statistician to look at the whole area of measures of government output and to report with a view to seeing what improvements can be made in the measures. Of course, in respect of securing value for money and efficiency in the delivery of public services this remains a government priority. Every department over the current Spending Review has had a value for money target and the independent review of efficiency in public services, led by Peter Gershon, established in Budget 2003, is working across public services with departments to ensure that as expenditure is increased efficiency is also secured. This will be a key factor that the Chancellor will set out in the approach to the next Spending Review setting plans forward to 2007–08.

Q124 Mr Plaskitt: Turning to revenues, can you explain why between 2002–03 and 2005–06 the growth of revenues from taxes on production will grow by 19% but social contributions will grow by 31%?
Mr Cunliffe: Can I ask which table you are looking at?

Q125 Mr Plaskitt: B21 on page 231.
Mr Cunliffe: It might be best to start explaining those figures starting with table B9 on page 217 because the groupings of taxes by economic category do not always come out in the taxes that we recognise.

Q126 Mr Plaskitt: Can I just interject ever so briefly, if I may. I am aware of what you are saying. My slight difficulty is that B9 runs out to 2004–05 whereas B21 runs out to 2005–06. Carry on.
Mr Cunliffe: Maybe if I say what we expect to be happening. In taxes on income of wealth you have got capital gains tax mixed into that category with income tax and they are behaving in different ways. If we start to look at the taxes on table B9, on the growth in income tax over the next year between 2003–04, which is from 118.8 to 128.3, about 9½ billion, we expect the bulk of that, around two-thirds, to come from average earnings growth to its long run average and wages and salaries. We expect some of that also to come from recovery in financial sector company profits linked to bonuses. Some of that will come from higher interest rates leading to higher tax on interest income. Finally, there is what is called fiscal drag in the equation. I think the same is pretty much true for social security contributions except that they are less subject to increases in the higher rate tax base and the bonus effect is not as strong there. I think also on the social security line there between 2003–04 and 2004–05, the increase from 72.6 to 78.4, there are some lagged effects of the National Insurance contribution increase from last year.

Q127 Mr Plaskitt: Okay. I understand what you say about the effect of fiscal drag and bonuses and so on in strengthening the line relating to income taxes, but if you go back to B21 the projected growth in taxes from income and wealth across that time sequence is 24% and yet, if I understand you rightly, the social contributions line, which has less of a buoyancy or fiscal drag effect on it, grows by 31%. Why does it grow more strongly in percentage terms than taxes from income and wealth? I would have thought the gearing would be about the same.
Mr Cunliffe: That growth from 74.1 to 83.1 on the social contributions line, which is an increase of about nine on 74—

Q128 Mr Plaskitt: Yes, but from outturn 2002–03 to your 2005–06 projection it is a 31% increase in cash revenue.
Mr Cunliffe: I think what you are seeing there is the National Insurance contribution increase, the one of 1% increase in spring 2003. You see the big jump between 2003 and 2004 is the National Insurance contribution which I think was costed around that level and then after that you are seeing a growth which is not quite the growth on the main income taxes, but there is in the increase between 2003–04 and 2004–05 a lagged effect from the National Insurance increase last year.

Q129 Mr Plaskitt: On your GDP growth assumptions relating to 2003–04, 2004–05, 2005–06, certainly in terms of the latter two, if I understand you correctly, you are working on the same assumptions about GDP growth.
Mr Cunliffe: We forecast the public finances on 3% real growth. The 3% is in calendar years and these are fiscal years, they are slightly different. You would add to that the GDP deflator because taxes are dealt with in a nominal sense, which would give you growth in money GDP of around about 5¾.

Q130 Mr Plaskitt: But you are not projecting any slowdown in growth 2005–06 over 2004–05, are you?

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Mr Cunliffe: GDP growth?

Q131 Mr Plaskitt: Yes.
Mr Cunliffe: We are projecting 3%, 3 to 3½, the same range.

Q132 Mr Plaskitt: The same range?
Mr Cunliffe: Yes.

Q133 Mr Plaskitt: In which case, can you just explain to me why the growth in revenue between 2003–04 and 2004–05 is 8% but between 2004–05 and 2005–06 is 7%?
Mr Cunliffe: There are a number of different effects happening here. The fiscal drag effect would tend to increase that revenue growth. At the same time we are making an assumption on corporation tax that it comes back to somewhere below its long run average as a percentage of GDP. It is about 2.3% now, the long-run average is three. We are projecting that will come back over two years but, of course, some of that coming back is sharper in the first year than in the second, so I would not necessarily expect the figure for 2005–06 to be higher than 2004–05.

Q134 Mr Plaskitt: Can I turn you back to B11 on page 220. This runs out over an even longer time frame, to 2008–09. Over the full course of that time frame, income tax revenues as a percentage of GDP grow by almost a full percentage point of GDP and yet despite the projected growth in the economy, and I assume that means growth in activity and turnover and traded goods and so forth, there is no increase at all in the take from VAT as a percentage of GDP. Why is that the case?
Mr Cunliffe: On income tax it grows by about 0.2 a year and 0.1 is normal fiscal drag, the rest is earnings growth is related to the growth of the economy generally. This is expressed as a proportion of a growing economy. As far as VAT is concerned, there is no growth in VAT because we use an audited assumption that the rate of VAT to consumer spending will decline by 0.05% a year. We use that assumption because when we set it in 2000 there was actually a decline in the ratio between consumer spending and VAT and over the following three years that decline continued, and indeed was a bit higher than the assumption. Last year it was reversed and the ratio of VAT to consumer spending climbed and recovered everything it had lost. We have not projected that forward because we are not fully sure of the reasons for it. We are doing a study which we hope the Comptroller and Auditor General will audit for the Budget. Generally we have used a cautious assumption on VAT and we have it on that declining path.

Q135 Mr Plaskitt: Finally, on the fiscal drag elements that push up this income tax take as a percentage of GDP, which are the major contributions to that fiscal drag? Is it predominantly the number of people moving up into the higher tax band as a result of growth in income levels? Is that the main contributor?
Mr Lewis: As Mr Cunliffe pointed out before, a real wage growth would tend to increase the overall effective rate of income tax. Essentially what that means is that more income is being paid at the higher rate than at basic rate in relative terms over time. The single biggest driver of that is the assumption we make about the return on income growth of higher rate tax paying individuals, particularly through things like city bonuses, which were a big feature of the late 1990s and were associated with the growth in financial company profits that we are now seeing coming through the outturn figures for financial company profits. It is largely driven by the proportion of income that is earned by people paying higher rate income tax.

Q136 Mr Plaskitt: What that line shows is that over the seven years of that table, without any changes in the level of income tax levied, income tax raises almost an additional £100 billion of revenue for the government.
Mr Lewis: We would say that on an annual basis fiscal drag would contribute about 0.1% of GDP for income tax receipts.

Q137 Mr Mudie: Without any effort I will lower the tone. Some of your lads were here yesterday so they will have given you fair warning of what I am going to ask. I notice Mr O'Donnell has not come back to answer the challenge. He flannelled me for two or three pages of verbatim report on revenues, but let us see where we are. What I find offensive is polite conversation of "It is within the forecasting error" etc, and when you put things in Budgets it is not just a bit of massaging it is downright offensive. For example, social security contributions were going to raise an additional £10 billion but they have not, they are down 20% in six months. You came here six months ago and you pulled them down to ten but now they are down to eight. I notice you have actually pulled from the Budget book the social security contribution as a separate contribution and married it with income tax. Can we have an explanation of why you have lost £2 billion on that? A specific explanation. You have had a warning of it. Where has the £2 billion gone? Why did you have it on the books six months ago?
Mr Cunliffe: What we do is we forecast the economy, we forecast the main elements of the economy that affect taxes. We are looking ahead, we are trying to work out how determinants will change, and then on the basis of those economic determinants we try and project taxes. In the case of social security contributions—

Q138 Mr Mudie: But this was a straightforward increase. This was the 1% as I understand it, which would bring in 10 billion.
Mr Cunliffe: It is a straightforward increase but it is an increase on the amount that people earn and the amount that people earn grows between years. What we have to do is we have to forecast how much that

amount will grow and we have to forecast how much wages and salaries will grow, and essentially they grew—

Q139 Mr Mudie: Twenty per cent in six months.
Mr Cunliffe: They grew at a lower rate.

Q140 Mr Mudie: So that is bad. Let us take the one I went through with Mr O'Donnell, which is income tax. I went back for each year and you went up, with fiscal drag included. In 2001 you went up between years four, four, it should have been another four, and then you shot up. At pre-Budget time you were going from 106 in one year to 110, then it was 114 for the year 2002–03 and for this year, 2003–04, you have projected a nine million increase. We pressed Mr O'Donnell on that and we just could not understand what he saw that we did not see. We have got two pages of flannel that he is not here to answer. We do not have all of your tools, etc., we just have your past record and the past figures but we have been proved to be correct and you have not because you have come down from 123 to 118. One of the questions I will ask you is are you sticking by the 118, so in six months' time when we come for the Budget I presume 118.8 will be the figure for income tax? You have only got three months to go and you have got your eye on the figures. In three months' time are you going to come to me and say "I know 123 was wrong", which was ludicrous to put forward in the first place, "but 118 we hold up our hands to and say that will be the final figure"? Let us deal with 123. When we look at the four, four, four, you only managed two last year. On trend it was four, four, two and suddenly you have got up to nine. Now you have brought it down to six but even that is a jump. Where do you get that 123 from and do you stick with 118.8? Remember, they are writing everything down. I think I will be here in six months, touch wood.
Mr Cunliffe: I think I will be here in six months as well. 118.8 is our best forecast of what the—

Q141 Mr Mudie: With three months to go?
Mr Cunliffe: It is a more robust forecast with three months to go than it was at the start of the year and clearly the further out you go—

Q142 Mr Mudie: Mr Cunliffe, with three months to go in a year are you telling me you are not going to stick by the 118?
Mr Cunliffe: It is the best forecast we could make, it is our central forecast for this period. You would expect with nine months of the year gone that that forecast should be pretty robust. If I could just put this—

Q143 Mr Mudie: We are pretty ordinary people. "Pretty robust" is no use to us. We are talking about one of the items in the Budget that went drastically wrong that dangerously increased the borrowing requirement. What does "pretty robust" mean? Do you stand by it or not?
Mr Cunliffe: Let me put this into context if I might. Our forecasting accuracy on revenues as a percentage a year ahead, not at the nine month point but a year ahead, how much the error is as a percentage of revenue, is about 2.6%.

Q144 Mr Mudie: Mr Cunliffe, Mr O'Donnell took me into percentages. A year ahead you told this Committee that you would raise 123 billion in income tax. A year later you come back and say you are only projecting with a pretty robust guess three-quarters of the year through that it will be 118.8.
Mr Cunliffe: I think a year ago we were giving you our best forecast.

Q145 Mr Mudie: Give me your best forecast now.
Mr Cunliffe: I am now doing exactly the same. It is 118.8. If you look at our forecasting record—

Q146 Mr Mudie: I do look at your forecasting record. For example, your forecasting record on current receipts in total went up six and then it was projected to go up nine, which has now subsequently gone back to 6.6. You projected a 30 billion increase between the years. We will give you 10 million of that was on this social security, which you demonstrably failed to bring in, so that went down. As we see it, you are saying between years you will go up from the increase you got last year, which was projected at nine at Budget time, it is down to 6.6 between years, and you are suggesting you will raise an additional 26.3 in total in current receipts. Let us just see where you were a year ago. You were suggesting that you would bring in 430 billion and a year later you are down to 422.8. Is that a pretty robust figure as well? Do you stick by this 428? It looks to me on trend that you are just kidding us with these figures, you are putting them in to suit some agenda rather than being a true assessment of where you should be.
Mr Cunliffe: These are our central projections.

Q147 Mr Mudie: Well, they are not very good.
Mr Cunliffe: The average error over 25 years on public finances has been about 1.1% of a GDP which is around £10 billion to £11 billion. Our forecasting record internationally on public finances as well as GDP compares pretty well and I can give you the evidence if you want.

Q148 Mr Mudie: Mr Cunliffe, just deal with this.
Mr Cunliffe: I explained earlier where the shortfall was.

Q149 Mr Mudie: Just deal with this and I will finish, I promise you. The last firm figure of an increase we have got in six months came down by about a third. You are projecting 26.3 between years additionally. Next year you are projecting a 33 billion increase. Those figures are so far out with a trend which has been running at about six billion, and we will add eight on for National Insurance so that brings you up to 14. You are projecting going up to 33 next year. That seems to be a very interesting figure. Would you defend that? Moreover, would you give

the Committee, because the book does not, a note, a detailed note, breaking down that 33 dated today so we know where we are starting from?
Mr Cunliffe: I would be happy to do that. I would say going forward one does not look at the trend by simply saying what the difference was between last year and this year, one looks at what is happening. One looks at the long run averages of these taxes as a percentage of GDP, we try to work out which ones are above and which ones are below. There have been a number of years, in fact more years than not, when we have under-forecast revenue and more revenue has come in than we forecast. It is trying to see those things which are behind that trend, so the extent to which profits come back, the extent to which earnings growth comes back. I am certainly happy to prepare that.

Q150 Mr Mudie: Tell me if I am being unfair to you. You have failed to specifically stand by the 118.8 income tax figure and say that will be the same when we meet in three months' time. What are you going to tell me about the current receipts figure? Is that a pretty robust estimate? Are you going to tell me that you will come in for income current receipts at 422.8?

Mr Cunliffe: I think exactly the same applies.

Q151 Mr Mudie: Which is, you are not going to tell me.
Mr Cunliffe: We are now nine months into the year. These are, I think, extremely robust forecasts.

Q152 Mr Mudie: What is that increase in percentage terms—pretty robust? Which percentage is it either way?
Mr Cunliffe: I think these will be well within the standard error for forecasts made in the autumn for the remainder of the year. Well within.

Q153 Chairman: A question which I think is germane to what George was asking is that, given that you have told us about the change in the relationship between growth and tax revenues over the past years, do you not think it would be helpful if you published more of your modelling work? You publish the economic model so why do you not publish the model of the flow of tax? That would help George and others? You do not do that.
Mr Cunliffe: We have published some work on particular taxes but we do not publish the public sector finance projections.

Q154 Chairman: Why do you not publish the model about the flow of tax? That helps with the point that George has made.
Mr Cunliffe: We publish the Treasury economic model, but as you can see different people use it to come up with very different results, and we do not actually publish the full Treasury economic model.

Q155 Chairman: Why do you not publish it? That is the question I am asking.
Mr Cunliffe: We would be very happy to explain how we do our forecasts and the like, but I would not publish the model because I think models are not, if you like, mechanical machines where you put in something at one end and it comes out the other end. They are a lot more complex than that.

Q156 Chairman: You publish the economic model and there is debate about the economic model, but at least people have the opportunity to use that and make their own projections. You do not have that for the flow of tax, and that is the point George was making.
Mr Cunliffe: We would be very happy to explain how we model particular taxes.

Chairman: You can, maybe, take that point back and come back.

Mr Mudie: You will notice we have been promised a note. Mr O'Donnell promised us it last year and it never turned up.

Chairman: He is coming back on Thursday.

Mr Mudie: I am hoping that the old promise will turn up this year.

Chairman: Could you tell Mr O'Donnell before Thursday?

Q157 Mr Beard: The IMF has warned in the spring that the sheer speed at which we are trying to spend in the public sector risks inefficiencies. Do you think that explains the 7.5% inflation rate in the public sector that we are suffering this year?
Mr Cunliffe: If I can just say, on the 7.5% implied inflation rate, as my colleague Mr Stephen said, in answer to an earlier question, we think there is a real issue here about the measurement of outputs in the public sector; about capturing quality increases in outputs, about capturing the full range of outputs and about capturing investment in future capability. So I think that 7.3% public sector deflator figure falls out of a measurement of public sector outputs that we do not think is accurate and around which we think there are significant problems and that is why the review under Tony Atkinson has been set up, reporting to the national statistician. I do not know if you want to say something about efficiency.
Mr Stephens: In terms of planned spending increases, these have been carefully planned and they derive from the work done in the Spending Review 2002. In the case of the Health Service they were based upon the report done by Derek Wanless published at the time of Budget 2002, which looked at what needed to be done to bring health spending and health services up to the European average, and looked specifically at the issue of what was an acceptable rate of growth in spend. The levels of spending increase set for the health service, in particular, reflected the conclusions of the evidence

that Derek Wanless looked at. Clearly, it remains important that departments plan their spending efficiently and use this productively and in a value-for-money way. We have a number of measures including the PSA targets to ensure that that discipline remains on departments.

Q158 Mr Beard: If you do not accept 7.5% as the public sector inflation rate, what sort of inflation rate do you believe the public sector is being subjected to?
Mr Cunliffe: I think that is the reason why we set up this review under Tony Atkinson to look at this issue. It is, as Mr Stephens said, quite a complex issue. A number of countries do not try to measure public sector outputs, what they simply do is take real inputs and assume that real inputs represent real outputs. This is work which, if you like, is at the forefront of statistical measurement. I do not think I have an answer to that question.

Q159 Mr Beard: It is also at the forefront of policy, because if the inflation rate is at this sort of level the implication is that the pressure on fiscal policy is not due to a surge in real spending but due to a surge in internal inflation.
Mr Cunliffe: I agree entirely that the increased spending in public services or the investment in public services, particularly health and education where these problems of measurement are most manifest, means it is a priority to get this review done and to get a better understanding of this issue. I think we know enough about the way outputs are measured to produce that 7.3 figure to know that there are areas of significant measurement error. We drew attention to some of them actually in the PBR document.

Q160 Mr Beard: The Treasury is predicting growth in nominal government spending of 10.5% this year, but real growth of 3.25%. If, as the Treasury seem to believe, the level of cost inflation in the public sector is overestimated, which is what you are implying by what you have replied, does that not mean that the real rate of government spending is being underestimated?
Mr Cunliffe: Yes. The rate of spending is a nominal concept, but the real outputs for that nominal spending is being underestimated, yes.

Q161 Mr Beard: If the real rate of growth in the public sector has been underestimated to any substantial extent, which is the implication of what you are saying, that must have an impact in the larger picture on the output gap, must it not?
Mr Cunliffe: Yes. This year we are assuming that the contribution from government consumption and investment to growth is around 1%. We are looking at 1% next year and, I think, $\frac{3}{4}$% the year after (and those are in real terms). So to the extent that real outputs are higher, that would affect the growth of the economy.

Q162 Mr Beard: Is this not a maggot at the centre of the fiscal apple, that the whole thing is in doubt as a presentation of the present fiscal position, while that big uncertainty in the inflation rate and the rate of growth of public spending is there?
Mr Cunliffe: I think you have to look, to some extent, at the gearing here. If that rate of real output was higher or significantly higher, the impact it will have on GDP growth, I do not think, would be such to throw out our calculations of the output gap in a material way.

Q163 Mr Beard: With the public finances in the present situation, how easily are you going to control public spending growth in the next year, or in the forthcoming Spending Review? There is a lot of vagueness about it.
Mr Stephens: As you know, we have published fixed three-year plans for departmental spending—the DEL limits; we forecast AME spending twice-yearly and we published a fresh, revised forecast in the PBR. That reflects our plans and our forecasts for public spending, and we are confident that we expect to deliver on those plans.

Q164 Mr Beard: Even though you do not know whether the plans are variable to 7.5% or 5% inflation?
Mr Stephens: The departmental plans are set in cash terms, effectively, so that they can set a nominal amount and departments are expected to meet those nominal budgets.

Q165 Mr Beard: They will not be able to if the public sector inflation is high; they will be less able to meet what they are intending to do than if the inflation is low, will they not?
Mr Stephens: Departments are expected to manage within those budgets and to deal with pressures, including cost pressures within those budgets, to take action to manage down those pressures and to ensure that in, for example, the way that they procure goods and services they are doing so in the most cost-efficient and value-for-money way. We believe that fixed three-year budgets provide an important incentive to departments to manage their resources efficiently.

Q166 Mr Beard: What you are saying is that they will keep to their nominal budgets but you are not quite sure what they will get from it when they have spent it, because the inflation rate will change what exactly they are getting?
Mr Stephens: We have also set clear outcome and output targets for departments. One of the issues around the measurement of government output that we were highlighting earlier is that a lot of those positive outcomes in terms of improvement in the quality of public services that the Government is setting out to achieve and has set departments' targets to achieve are not actually reflected in the global measures of government output, but we have very specific targets for departments to achieve in terms of public service outcomes, in terms of health,

in terms of improved health outcomes, in terms of improved patient experience, in terms of improved educational attainment, and the Government puts in a great deal of effort and publishes full information on the achievement against those targets, so that the public can see and judge where the money is going and what performance is secured for it.

Q167 Mr Beard: Given that you have got an average 7.1% growth in health spending in the coming years, and expected growth of 6% in real terms in education spending, what sort of constraints have been placed on other departments that are not so well-endowed?
Mr Stephens: Well, the average rate of increase across all departments is, I believe, of the order of just under 5%. That historically is a very high level of increase for all departments. The Government has clearly signalled, not surprisingly, that health and education are its priority areas, but in the current Spending Review period through to 2005–06 the Government's prudent management of the economy and public finances earlier has allowed significant increases for other priority and other departments as well.

Q168 Mr Beard: So what are the projected rates of growth of departments like Transport or Social Security?
Mr Stephens: Transport, I believe, from memory, is projected to grow at a significant rate of around 7-8%. I do not have the figure to hand on Social Security, and that is indeed managed in the AME area on an annually managed basis.

Q169 Mr Beard: Where is the low growth going to come, if you are saying Transport is going to grow at the same rate as the health service?
Mr Stephens: In other area of public services growth is closer to trend. All of this reflects the priorities and political choices of the Government, as you would expect, rather than just projecting all increases forward at an equal level.

Q170 Mr Beard: The Institute of Public Policy Research has suggested that some spending commitments, such as help given to local authorities next year, are not included in the spending figures for 2004–05. So will the spending figures be subject to an almost inevitable drift upwards, as these figures start getting factored in as we approach the Budget?
Mr Stephens: I am not aware of what specifically they might be referring to there. Over the past year the Government has given significant additions to local authorities. It announced further additions, I think, amounting to about £420 million in the PBR on top of additions announced in the summer, and both of those are factored into forward forecasts.

Q171 Mr Beard: Finally, the Budget is nine months past but the Treasury has virtually emptied all of the annually managed expenditure margin for both next year and the year after. It is set at zero. What is going to provide a buffer if demands increases as rapidly as you are expecting?
Mr Stephens: The AME margin is set for exactly that purpose.

Q172 Mr Beard: But it is not there anymore.
Mr Stephens: Indeed. It has been drawn down. In that sense, it is fulfilling its purpose.

Q173 Mr Beard: But you have two years to go. These are the margins for next year and the year after.
Mr Stephens: Yes, but we have also factored in the cautious assumptions that others have referred to in the public finances, and of course we will be reviewing the forecasts, reviewing the assumptions and the way in which they are managed, again, in the Budget.

Q174 Chairman: How can you factor in something from nothing? There is nothing left, so how can you factor in things from nothing?
Mr Stephens: That is exactly the purpose of the margin—to be there to be used up.

Q175 Mr Fallon: Mr Stephens, any reallocation from current account to capital account helps the Government meet its golden rule, does it not?
Mr Stephens: The golden rule is scored against current spending, yes.

Q176 Mr Fallon: Can you answer my question: any reallocation that might happen from the current account to the capital account will help the Government meet its golden rule?
Mr Stephens: Indeed. The golden rule is scored against current spending.

Q177 Mr Fallon: What attempts are you aware of to reallocate from the current account to the capital account?
Mr Stephens: The allocation of spending to the national accounts aggregates are, in the end, determined according to national accounts principles and decided ultimately by the Office of National Statistics, independent of the Government. So it is not a matter for the Government to choose to switch the classification of a particular item of spending from current to capital. There are switches that go on on a regular basis that reflect changes in substance in the nature of the spend or changes in the view that professional statisticians take of that spend. That is something which goes on all the time, but it is not something where the Government can choose, on its own authority, simply to reclassify one area of spend.

Q178 Mr Fallon: Have you read the Annual Charges Review published by the Office of the Rail Regulator this month?
Mr Stephens: I have not read the full review. I am aware of the publication of that review.

Q179 Mr Fallon: Are you aware of paragraph 18 of that review?
Mr Stephens: I think I know what you are referring to.

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Q180 Mr Fallon: Let me help you here. I quote: "Ten days before the publication of this document, the Department for Transport and the Strategic Rail Authority made a joint submission to the Regulator in which they explained for accounting reasons it would be desirable for the SRA, in future, to increase the amount of money it pays in grant to Network Rail, allowing access charges to be set at a lower level than in Table 3." Is that right?
Mr Stephens: Yes. The issue here is that the Rail Regulator, in setting the budget for Network Rail, recognises that a substantial increase in capital expenditure by Network Rail is required. Because of the nature of the financial flows within the rail industry Network Rail is funded through a mixture of network grant, which is a capital grant from the Government, from the SRA, and track access charges paid by the train operating companies which, because of the nature of the guarantees given by the Government in the case of increases, are also 100% funded by the Government. The Regulator is saying that what he is setting requires a substantial increase in capital expenditure by Network Rail; the issue here is whether the accounting form follows the substance of the expenditure, and it is clearly desirable that the accounting form should follow the substance. The substance is capital expenditure, and it is desirable that that is scored and recognised as such, but whether it is or whether it is not is the subject of examination not by one but two independent authorities: first of all, the Rail Regulator himself, who is independent and who needs, first of all, to classify this as capital expenditure, and agree the arrangements for the financial flows, and, secondly, it needs to be recognised as—in the case of an increase in the network grant—a capital grant by the national accounts authorities, the ONS.

Q181 Mr Fallon: Why was it then, that just 10 days before his review was to be published the Department for Transport made this emergency demand that they actually increase the amount of money that they pay to Network Rail in grant? That was, surely, simply to help the Treasury meet its golden rule? You asked them to fiddle the figures just before it was published. If they had not done that it would all have appeared on the current side and your golden rule would have been in more danger of being breached. Is that not right?
Mr Stephens: The Rail Regulator's review was published after the PBR, so I should be clear that it is not factored into the figures, although the Government is committed to meeting its financial commitments as a result of the Regulator's review. The Regulator's review has been a long and complex review which he has conducted independently and the conclusions of which were unclear until the late stages. All the representations from the DfT and the SRA have been concerned with are to ensure that, given the conclusion by the Rail Regulator, significant additional capital expenditure is required by Network Rail and, given that this is going to be funded by the Government, that the correct accounting form is attached to the substance of that treatment. I should be clear; there are a number of areas, in respect for example of single use military equipment, where that is, for example, scored as current expenditure in the national accounts although, on commercial principles, it would count as capital expenditure. We are simply trying to apply national accounts principles in a principled and consistent way here.

Q182 Mr Fallon: Was the Treasury aware of this last-minute submission?
Mr Stephens: We have been, as you would expect, involved throughout the Rail Regulator's review and involved with the Department for Transport.

Q183 Mr Fallon: Did you ask the Department for Transport to make this change?
Mr Stephens: As I say, we have been involved throughout the review, working with the Department for Transport and, obviously, rightly concerned to ensure that the substance of the planned increased in capital expenditure that the Regulator considers necessary is reflected in the correct accounting form.

Q184 Mr Fallon: So it was you. Finally, just clear up this issue of publishing the whole of Government accounts. Is it true you have delayed it for another year?
Mr Stephens: Yes, it has been delayed for a year. That is primarily due to extra work that is required to take into account the impact of the new prudential regime from local authorities' borrowing.

Q185 Mr Fallon: The effect of that will be to defer the inclusion of Network Rail's debts. Is that right or not? Is that right or not?
Mr Stephens: The issue of Network Rail's debts and the Government's fiscal position turns on national accounts. The Government's fiscal position is judged on national accounts. It is well-known that for the purposes of national accounts the ONS has judged that Network Rail is in the private sector and, therefore, the debts do not count for the purpose of national accounts. Equally, applying commercial GAAP principles, the Comptroller and Auditor General judged that they were an element of the SRA's balance sheet, and if we continue to apply those principles to the production of whole of government accounts then at that point they would be consolidated into whole of government accounts. There will, of course, continue to be, because they are produced on different principles, a number of differences between whole of government accounts and national accounts, but the Government has said that it expects to continue to set its fiscal rules and to be judged in terms of its fiscal performance against national accounts which are the internationally accepted norm for these purposes.

Q186 Mr Fallon: I just want to be clear that the Network Rail borrowing, which the Comptroller has said must appear on public accounts, will not

now appear on public accounts for a further year and will not appear until 2006–07. That is the position, is it not?

Mr Stephens: They appear on the SRA accounts, which are published and available. The whole of government accounts is an important and complex development which we hope will improve the transparency of public accounts generally, but as I say they will not be the basis on which the Government's performance in public finances and its fiscal position is judged, which will continue to be on national accounts principles.

Q187 Mr Cousins: I wonder if I could ask Mr Lewis when he expects the Government to reach a conclusion on Real Estate Investment Trusts and on the changes in tax liability for domiciles?

Mr Lewis: On Real Estate Investment Trusts we said, when the timetable was kicked off in the Budget this year, we were interested in looking at measures to improve the efficiency and liquidity of the property investment market, and since then we have had a number of representations and information provided by the industry and others. That coincided with the interim report of the Barker Review, which, in parallel with the work we have been doing, made a recommendation that this proposal was one that should be given some consideration by the Treasury. So bringing those together, we are now saying in the pre-Budget report that we are in a position to be able to move forward to a formal consultation process beginning in the Budget. Those consultation processes, under Cabinet Office rules, we run for 13 weeks and then ministers beyond that—there is no firm timetable—can make a decision based on the information that has been generated from the consultation process. On the residence and domicile review, that is also progressing well. We issued a background document in the Budget and we have been holding a number of sessions with individuals with an interest or who may be directly affected by changes in the rules. We give a very brief report in the document here about the progress that is going on on the back of that document. As you know, it raises some very fundamental questions about the nature of the Income Tax regime in a world in which labour markets are becoming more internationalised, where there is greater mobility of labour, particularly into particular sectors of the economy, and it also looked at how the principles of fairness can be applied to people who may not be domiciled in the UK but may be resident for a long period of time. It raised these issues alongside some international comparisons of how similar principles are dealt with in other countries. So it is a rather complex issue. We have had a number of sessions with interested parties, and what we have said in the Pre-Budget Report is that we will move forward for a formal consultation on specific options when that process is complete.

Q188 Mr Cunliffe: Do forgive me. That is all very helpful, but I did actually ask you when, and I am no clearer.

Mr Lewis: I do not want to pre-empt when ministers will come to a judgment on the back of information that is provided through the consultation process. I think in both of the reviews that you have mentioned what we have set out is a timetable for the publication of information for transparency and the principles on which the Government is investigating the issue. Ultimately, then, once that is done it is a matter for ministers to take decisions in the context of the normal Budget process, consistent with a timetable that would allow them to do that, but that is a matter for future Budget judgments.

Q189 Mr Cousins: There is a suggestion that the proposed changes in the taxation of pension funds (by "pension funds" I am here referring to individual pension funds not collective pension funds) means that people will be able to put buy-to-let properties into a pension wrapper from April 2005. Is that correct?

Mr Lewis: There are proposals in the Pre-Budget Report for changes to the regulatory environment for pension funds. Then there are also the proposals for the simplification of the pensions tax regime, where there is a similar timetable of consultations.

Q190 Mr Cousins: So what is the answer to my question?

Mr Lewis: I am sorry, the question on—

Q191 Mr Cousins: Will it be possible for people to put buy-to-let properties in an individual pension fund pension wrapper by April 2005?

Mr Holgate: I do not know, is the answer to that. We will have to come back to you on that.

Q192 Mr Cousins: That is helpful. Mr Holgate, I wonder if I could turn to you. Flat-rate local housing allowances particularly figured in the Pre-Budget Report. How much do you propose to save in public spending by the introduction of flat-rate local housing allowances?

Mr Holgate: I do not think there is any proposition that we should be saving money through those allowances.

Q193 Mr Cousins: What will the variation be in terms of your own policy thinking about flat-rate local housing allowances? What will the acceptable variation be across the country?

Mr Holgate: That is the sort of thing which the pilots which are starting in both the private sector and, in due course, the social sector will help us judge. Essentially, I think, what you are driving at is that if we simplify the system there may be some disparities between areas that are brought into one new area if a local housing allowance spreads across a broader area than currently, and that is the sort of thing which we are having to see how that works as these pilots roll out.

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Q194 Mr Cousins: You have two pilots already, one in Blackpool and one in Lewisham. What is the variation in the flat-rate of housing allowance between Blackpool and Lewisham?
Mr Holgate: Those are a long way apart so it is very unlikely that there will be a national local housing allowance; they will be in different areas.

Q195 Mr Cousins: Indeed, there will be flat-rate local housing allowances in different areas. You are unable to give me any guidance on what the projected differential might be. I am now asking you specifically, in the case of the two pilots which are up and running, one in Blackpool, one in Lewisham, what is the difference between the flat-rate housing allowance in each location?
Mr Holgate: I do not know what the local housing allowances are pertaining on each occasion, but they will have been drawn from the rents prevailing in both those locations.

Q196 Mr Cousins: I know how they will have been drawn, I am asking you what the difference is between Blackpool and Lewisham.
Mr Holgate: I do not know.

Q197 Mr Cousins: Could you tell me at a later date?
Mr Holgate: Sure.

Q198 Mr Cousins: Mr Stephens, yesterday we had some discussion on the fact that in terms of public sector costs and their rising it is the non-labour component of costs which appears to be rising most rapidly. Is that an analysis you would accept?
Mr Stephens: I think this comes back, I think, to issues of measuring government output, which we have looked at recently. As a proportion of government spending, the proportion on non-pay costs has risen—you are correct.

Q199 Mr Cousins: Thank you. That would be entirely unsurprisingly and hardly worth asking a question about. I am asking you, do you accept the analysis that has been given to us by other people that it is the non-labour component of pubic sector costs that has been rising particularly rapidly, compared to the labour cost component of public spending?
Mr Cunliffe: If you are referring to the Goldman Sachs article—I know you saw David Walton—which we have looked at, I do not think we do accept that analysis. What Goldmans did was a comparison of cost increases, private sector to public sector, deriving them from different points. What I find difficult with that analysis—and I have read it very carefully because I have a great deal of respect for both Walton and Broadbent—is that it does not tell you what the outputs were.

Q200 Mr Cousins: I am not asking you about outputs—the Committee has had a rehearsal of the issue of outputs—I am simply asking about the build-up of cost. Do you accept that it is the non-labour component of public sector costs that is rising more rapidly than the labour component of costs?
Mr Cunliffe: My initial interpretation of that work is actually that the thing they have which they call "non-labour costs" is simply a residual, and if you had better measurement of outputs you would be able to understand better what was going on.

Q201 Mr Cousins: Obviously there is no point in pursuing this now but would you be kind enough to give us your more technical thoughts on that issue? The Lyons Review. I do not know who amongst you deals with the Lyons Review. Mr Stephens. What view do you take about the interim report of the Lyons Review?
Mr Stephens: As the Chancellor set out in the PBR, he believes that that has demonstrated that we are on track on achieve what he set as a target of moving 20,000 jobs from London and the South East, and that there may be further opportunities to move more jobs and enhance public service delivery and regional growth.

Q202 Mr Cousins: Are you aware that in the Lyons Review the largest government department that has no employment presence outside London and the South East is, in fact, the Treasury?
Mr Stephens: Yes.

Q203 Mr Cousins: You admitted it from your reply to my earlier question. That was a shame. What are you going to do about it?
Mr Stephens: I should make it clear that amongst the Chancellor's departments as a whole they have significant areas of employment outside London and the South East.

Q204 Mr Cousins: I did not ask you about the Chancellor's departments, I asked you about the Treasury.
Mr Stephens: The Treasury has committed staff to support regional offices. It is reviewing its own position. It is by the nature of the Treasury a central, strategic department, supporting the centre of government and supporting ministers. That does imply a number of constraints on its own position.

Q205 Mr Cousins: So you are not going to move anyone?
Mr Stephens: I did not say that.

Q206 Mr Cousins: Because you are a central, strategic department you are not going to move outside London?
Mr Stephens: I did not say that. I said that we are reviewing our own position, as we are expecting all departments to do.

Q207 Mr Cousins: How much cheaper would you all be if you were relocated to Hartlepool?

Mr Stephens: I do not know the answer to that.

Q208 Mr Cousins: Do you not? You are going to institute all these local pay scales; you must have some idea how much cheaper you would be if you were relocated in Hartlepool.
Mr Stephens: The Treasury is not responsible for setting local pay rates. The point is that that calculation requires not only taking into account pay rates but, also, the additional costs that might come from whatever was necessary to ensure that the Treasury continued to deliver what it is there to do and to support ministers.

Q209 Mr Cousins: So in the case of moving the Treasury, you would not save any money. You are unique amongst departments. Not only are you the largest department with no presence outside London and the South East, but it would actually cost money to move you because you are so important. Do I understand you correctly?
Mr Stephens: No, I did not say that. This is something that we keep under review and are considering. I do not have to-hand the specific cost figures that you want, I am afraid.

Q210 Mr Cousins: Could you do an exercise for us and tell us how much cheaper you would be if you were relocated to Hartlepool?
Mr Cunliffe: If I could interject on one point, here. The Treasury as a department is relatively small, I think at about 1,000, compared to the rest of Whitehall.

Q211 Mr Cousins: In the Lyons Review the figure is just a little short of 8,000 people.
Mr Cunliffe: For the central Treasury?

Q212 Mr Cousins: Yes. That is the Lyons Review figure. One of the things, perhaps, you ought to keep under review is what your reviews are producing.
Mr Cunliffe: The point I was going to make, though, was that in order to decide whether it is cheaper to go somewhere or to stay where you are, I think we will do what other departments do which is not just look at the cost of accommodation but look at the costs of the operation if we move part of the operation outside. My point is that it is more to do with the overall costs of the business operating with part of it out of London than it is simply to do with the cost of accommodation in different places.

Q213 Mr Cousins: That is very, very disappointing. Why were the reductions in ISA allowances not more clearly recorded in the Pre-Budget Report?
Mr Holgate: You are referring now to Chapter 5 where we have a paragraph on ISAs.

Q214 Mr Cousins: You do. But it is not obvious from that paragraph you are actually reducing the allowances.
Mr Holgate: The proposed reduction in allowances was announced a long time ago, and it is not news.

Q215 Mr Cousins: So it was not worth repeating in the context of a section that actually deals with ISA allowances?
Mr Holgate: The section that deals with Individual Savings Accounts comes under "Promoting Saving and Assess Ownership", and it explains that ISAs are doing certain things that we would want them to do—

Q216 Mr Cousins: So they are doing so well there ought to be less of them in the future?
Mr Holgate: No, they are doing moderately well but we do not have to set the limits where they currently are for them to carry on doing what they are doing moderately well.

Q217 Mr Cousins: So not only are they doing so well there ought to be less of them in future but in the future there will be a stronger bias towards equities. Mr Holgate, is this part of your financial advice—that we should all be in equities?
Mr Holgate: You are referring back to my evidence on the Child Trust Fund where, as you rightly say, we have a presumption that the majority of investors would want to invest in equity vehicles. That is right.

Q218 Mr Cousins: In fact, in ISAs the majority of people do not invest in equity vehicles.
Mr Holgate: There is a spread between cash and equities.

Q219 Mr Cousins: And the cash is bigger, is it not? That is the bit you are cutting, is it not?
Mr Holgate: Well, if the ISA limit is down to £1,000 for cash, then that is still a reasonable sum of money and it is still more than many, many people have in liquid savings anyway.

Q220 Mr Cousins: Is it the case that the biggest component of ISAs is the cash ISA, and that is the one you are choosing to cut?
Mr Holgate: It is certainly the one that most people use, yes.

Q221 Mr Cousins: And that is the one you are choosing to cut.
Mr Holgate: Yes.

Q222 Mr Cousins: So in the Budget Report you tell us what a success ISAs are but you do not tell us that the component of ISAs that is most successful is the one you are going to cut.
Mr Holgate: It is a question of what is the limit that you need to set in order to help people to save what they can afford to save.

Q223 Mr Cousins: So we should accept the Treasury's judgment on these matters rather than the judgment of individuals?
Mr Holgate: No, individuals should choose to save as much as they want to. The question is to what extent a tax privilege should attach to that saving.

Q224 Mr Cousins: So the tax privileges should be all geared towards equities and reduced for cash.
Mr Holgate: Not necessarily, no. As you say, there is both a cash and an equity vehicle.

Q225 Mr Cousins: Why did you not make it clearer in the Pre-Budget Report that you were freezing the Child Tax Credit allowances that are for families with income?
Mr Holgate: Well, we published a full table of the new Tax Credit rates.

Q226 Mr Cousins: Can you tell me where that is and how it is explained?
Mr Holgate: On page 5 of one of our press notices. Press notice 2, page 5 of 8.

Q227 Mr Cousins: I wonder if you could pause a moment while the rest of us catch up. Down in this jungle, it is very hard to follow these things. So you would have to go to press notice 2 accompanying the Pre-Budget Report to work out that some important components of the Child Tax Credit are being frozen.
Mr Holgate: You would have had some warning of precisely that from the Budget document in April.

Q228 Mr Cousins: Really. What form would that warning have taken?
Mr Holgate: We set out on page 203 of the Budget document in April which elements we were assuming indexation at various levels in the baselines going forward. So we said there that various elements of the Working Tax Credit would be linked to the RPI.

Q229 Mr Cousins: That one is actually in the Pre-Budget Report?
Mr Holgate: Yes, and the per child element of the Child Tax Credit would be linked to earnings. For the purposes of Tax Credit those were the two specific things that we mention there.

Q230 Mr Cousins: I am sorry, that does not answer my question of why it is not clear to us all that these very important components of the Child Tax Credit, which particularly affect people on middle incomes, are being frozen.
Mr Holgate: I suppose I would have to dispute your contention that it is not clear. We have never said—

Q231 Mr Cousins: Could you tell me where it is clear then?
Mr Holgate: We have never said that we were doing anything else. Second, we have set it out in an attachment to a press notice, which a peculiar place to put something if you wish to hush it up.

Q232 Mr Cousins: Can you tell me how it is flagged in the press notice? I have now got the advantage of having the press notice in front of me.
Mr Holgate: Excellent. On page 5 we set out the components of the Working and Child Tax Credits.

Q233 Mr Cousins: But that is numbers. You have to infer it from the numbers.
Mr Holgate: You have to look at the change column where there is a plus or a zero.

Q234 Mr Cousins: What is the distributional effect of these changes in Child Tax Credit? How much money does freezing those allowances save the Government?
Mr Holgate: If we were to increase the family element by the rate of inflation, which we take as 2.8%, then it would be of the order of £85 million, I think.

Q235 Mr Cousins: In a full year?
Mr Holgate: In a full year.

Q236 Mr Cousins: And the other component?
Mr Holgate: I do not think I have got a costing for each and every one but there is a tax ready reckoner document that we also produce—at the risk of further confusion—which sets out the costs of indexation for quite a wide variety of taxes, tax reliefs and so on, and includes on Table 4 the direct effects of illustrative changes in most of the Working and Child Tax Credit elements. So my calculation for the family element, which you asked for, leads me to conclude that it would have cost £85 million.

Q237 Mr Cousins: Do you think this is a satisfactory way of reporting to the public and to Parliament—bearing in mind Child Tax Credits is one of the Government's flagship projects—how one important component of that is actually being frozen, not indexed and saving the Government a considerable sum of money?
Mr Holgate: As I have set out, we have specified what assumptions about indexation were included for various parts of the Child and Working Tax Credits in the Budget and we have also set out, I think quite clearly, what is happening to each of those elements in the press notice accompanying the PBR.

Q238 Mr Cousins: I do not know whether my colleagues on the Committee would appreciate this but I would appreciate all these bits of paper being brought together so that we could actually see where they are distributed across this incredible quantity of paper that accompanied this year's Pre-Budget Report—goodness only knows how many forests were demolished to produce it—and where we can actually find out that some of these important components to people on middle incomes of the Child Tax Credit were actually being frozen.
Mr Holgate: As I say, it was released in the press notice.

Q239 Mr Cousins: Could you put all those bits together so we can see how we could have followed it through?

Mr Holgate: I do not think I have anything to add to what I have said already, which is that we set out what was happening to the Working and Child Tax Credits—

Q240 Mr Cousins: What are the distributional effects of that change in the Child Tax Credit between deciles of income? Who loses from that particular freezing?
Mr Holgate: If you take account of increases—

Q241 Mr Cousins: It is people on middle incomes, is it not?
Mr Holgate: It is people on incomes, broadly—depending on the size of their family—between £35,000 and £58,000.

Q242 Mr Cousins: No, it is the fourth and fifth deciles of income.[1]
Mr Holgate: Yes. What they have lost by us not indexing—

Q243 Mr Cousins: And it is household income we are talking about?
Mr Holgate: That is right. What they have lost is 2.8% of £545 in a year. So they are getting exactly the same amount in nominal terms as they got last year, if their income remains the same. Had we put the Family element up by 2.8% then over the year as a whole they might have expected £15 more.

Q244 Mr Mudie: Could I just ask where on page 203 Mr Cousins might be expected to start this off? According to you, it is explained on page 203 of the Budget, which I cannot find. I can find page 203 but then there is the press notice. Could you point me to the specific words that would enable Mr Cousins to have picked this up last Budget time?
Mr Holgate: On that page we set out what is happening—

Q245 Mr Mudie: Where? The reference to Child Tax Credit is: "The Child Tax Credit will rise in line with the annual increase in average earnings for the lifetime of this Parliament." That is the one specific reference to Child Tax Credit. Where else is it then?
Mr Holgate: That is the only place it needs to be for people to know that there are certain things which the Government is firmly intending to do, which is in the baseline, and that is increasing the per child element of—

Q246 Mr Cousins: We have to infer that change by the fact that there is no explicit endorsement in here of the fact that the family element is being indexed. That is the only way we know—because it is not mentioned. Because something is not mentioned we say "Aha".
Mr Holgate: No. I think that is an unreasonable way of putting it.

Q247 Mr Cousins: Come on. Page 203. Where is it?
Mr Holgate: The point is that we set out on page 203 the things which do have specific promises attached to them. For the ones that are not there there are not specific promises attached to them. Then we explain in the press notice—

Q248 Mr Cousins: Exactly. The only way we work it out is because it is not there.
Mr Holgate: Yes. Then, in the press notice, we explain exactly what is and what is not happening, as we are obliged to do, so that the Inland Revenue can get its systems right for next year. All of the Working and Child Tax Credit elements are set out here.

Q249 Mr Cousins: Now that the Government has introduced these extraordinarily complex pieces of tax credit architecture, and they are at the heart of the Government's policy for redistribution, do you not think it is important that the hand is properly declared about this so that we can see the distributional impact of it and we can see where the Government is hoping to tweak things to save money?
Mr Holgate: I think when it is a question of £15 in a year, then setting out all the elements in the Child and Working Tax Credit in the second press notice that accompanies the PBR and the other major documents is not disproportionate.

Q250 Mr Cousins: Mr Holgate, that is only the first year, is it not?
Mr Holgate: Yes. That is an assertion rather than a question.

Q251 Mr Cousins: That is right. That is the first year. The £15 is the first year.
Mr Holgate: The first year.

Q252 Mr Cousins: And it continues in future years if you do not index it, it gets bigger, does it not?
Mr Holgate: Again, you are sort of making my point for me, which is to say that there are certain parts of the Child and Working Tax Credits which have clear trajectories attached to them and there are other parts which do not, and the Family element is one that does not.

Q253 Chairman: I have got a couple of questions to tie the event up. The Chancellor has informed the Public Sector Pay Review Boards that the new inflation target is 2%. Looking at wage negotiations generally, are employees not likely to feel that they are being asked to take a sizeable wage cut if Consumer Price Index inflation is used by employers in pay discussions while the gap between the two measures is so large?
Mr Cunliffe: Are you talking about the public sector?

[1] Further analysis demonstrates that there are few if any households in the fourth and fifth deciles whose tax credits would decline in value in real terms between 2003–04 and 2004–05. Such households would instead be found mainly between the seventh and ninth deciles.

Q254 Chairman: He has informed the boards.
Mr Cunliffe: Or pay bargaining generally?

Q255 Chairman: Yes.
Mr Cunliffe: If I can take the general point, I think we have made the change now to the CPI at the lower target for the Bank of England. That, I imagine, will be taken into account in pay negotiations going forward. However, the way in which that happens, I think, will depend on how quickly the new target is established and my own view is that I would imagine that there will be some negotiation around inflation, as there already is in pay settlements, and around the change in the target before it settles down. We have not, for the economy as a whole, made a general assumption about how the change to the CPI will be taken into pay negotiations. I do not know whether you want to say a word on the public sector specifically?
Mr Stephens: The Government has submitted its evidence to all the Pay Review Bodies, the Chancellor has written as a courtesy to the Pay Review Bodies to let them know of the change in the inflation target, so that is one of a number of factors which they can take into account in their recommendations, but the overwhelming issue for Pay Review Bodies is the need to recruit, retain and motivate workers in the appropriate sectors, and that is the key issue which the Government is directing the Pay Review Bodies to consider.

Q256 Chairman: In terms of Treasury forecasts, you have forecast no net rise in the savings ratio from its current variable levels. Is a savings ratio below 5% a healthy position for the British economy?
Mr Cunliffe: I think you have to look at that in a historical perspective and you also have to look at why people might want to save more than the current savings ratio. It is certainly true that in 1980s and early 1990s the savings ratio was higher than that. I think a number of things have changed: the amount of macro-economic stability in the economy has meant that people will feel they need to hold lower levels of so-called precautionary savings; the amount of credit constraint—the fact that households now have much more access to credit—has meant, again, that the amount of precautionary savings probably needs to be lower, and then I think the shift in expectations about interest rates and the volatility of the economy have also had that effect. It is quite interesting that, if you look back to the early 1960s, for example, you find the savings ratio over that period fluctuated around 6%, touched levels of 4.5, 4.6 (roughly where we are now) and it was really only when we got into the high inflation period of the late-1960s and 1970s that those precautionary savings ratios shot up. So if you are saying can the economy function with a savings ratio of 4.8% or something of that order, it is not to me obvious that savings of that order is wrong and we should go back to the average of, say, the 1980s and 1990s.

Q257 Chairman: My last question is about achieving the golden rule, which was mentioned earlier. In discussing the standard cautious case, you state: "The average surplus in the current Budget in the cautious case is no longer positive, although the Government is on track to meet its golden rule." Does this statement actually mean that the Government is not on track to meet the golden rule on the cautious case?
Mr Cunliffe: I think we need to be clear. The golden rule is and has, since the establishment of the framework, been set at the average annual surplus of GDP over the cycle. We made that quite clear when we reported on the golden rule, for example, in Budget 2000. The test of the golden rule is whether the average annual surplus, as a percentage of GDP, over the years of the cycle is positive and that the cyclical element of the golden rule, which is to borrow only to invest over the cycle, by looking specifically over all the years of the cycle and then dividing the surplus as a percentage of GDP by the number of years in the cycle. That has not changed. There are two ways in which we apply caution in the public finances. One is through the use of cautious assumptions, like setting the public finances on a growth rate of $\frac{1}{4}$% below our central estimate, and the other is a stress test to the public finances which is to assume that the relationship of the economy to its trend level is lower than we thought, so that more of a surplus would be cyclical and more of a deficit would be structural. That latter stress test is the cautious case. The cautious case has never been part of the framework of meeting the golden rule.

Q258 Chairman: On the stress test element then, your figures suggest that without policy changes the golden rule, if it applied, would be broken if growth emerges in line with the cautious case. Are you suggesting that in these circumstances the golden rule would be disregarded?
Mr Cunliffe: No. The cautious case does not affect the amount of growth, the cautious case affects the amount of growth which is deemed to be cyclical and the amount of growth which is deemed to structural. It is a stress test that assumes that you have got the cyclical position of the economy wrong. So the golden rule will be met if, at the end of the cycle, we have an annual surplus, as a percentage of GDP. The way we use the cautious case is, really, to say (and this is over the cycle and we are doing policy planning) "If we have mis-forecast the economy so that more of the surpluses we are getting are cyclical, and they will disappear, or more of the deficits are structural, and they will persist, how will that position look because we will not build up the surpluses over the cycle that we will need to deal with the downturn?" We are now, on our estimation, two years or so away from the end of the cycle. I think the cautious case is a very useful stress test that has enabled us to build up surpluses and to adjust policy, but it is not a way of meeting the golden rule one way or the other because it deals with a cyclically adjusted current budget, whereas the golden rule is on the current budget.

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Q259 Chairman: You say the golden rule will terminate in 2005, but if you report in March 2005 as opposed to October 2005 there could be quite a material difference there.
Mr Cunliffe: I think we will measure the golden rule when we come to the end of the cycle. I do not know exactly when that will be.

Q260 Chairman: When you are going to announce the end of the cycle?
Mr Cunliffe: We will do work on measures of capacity in the economy, and when they show that, on a very broad range of capacity measures, the economy seems to be on trend, then I think we will announce that.

Q261 Mr Fallon: The Sub-Committee of this Committee has oversight over Customs revenue and we expect to start work soon on the O'Donnell Review. What has happened to that?
Mr Cunliffe: We expect the O'Donnell Review to come out in the New Year.

Q262 Mr Fallon: Can you help us a bit more on that? I thought it was supposed to come out with the PBR.
Mr Cunliffe: The O'Donnell Review is dealing with a range of complex issues, and I think I expect it to come out in the New Year.

Chairman: Again, if you could have some further information on that on Thursday that would be useful to us. Thanks for your time this morning.

Thursday 18 December 2003

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard	Mr George Mudie
Angela Eagle	Mr James Plaskitt
Mr Michael Fallon	Mr David Ruffley
John Mann	Mr Robert Walter

Witnesses: **Rt Hon Gordon Brown,** a Member of the House, Chancellor of the Exchequer, **Mr Ed Balls,** Chief Economic Adviser, **Mr John Cunliffe,** Managing Director, Macroeconomic Policy and International Finance, **Mr Nicholas Holgate,** Director, Welfare Reform, **Mr Andrew Lewis,** Head of Tax Policy Team, and **Mr Jonathan Stephens,** Director, Public Spending, HM Treasury, examined.

Q263 Chairman: May I open the meeting by welcoming you, Chancellor, to the Committee. Chancellor, your Pre-Budget Report presented a generally very upbeat view of the outlook for the economy, but as the MPC and the Governor of the Bank of England always remind us when we see them, forecasts are all about assessing risk and probabilities. What are the main risks you forecast for the future?
Mr Brown: As I think I said when I gave the Pre-Budget Report, which was only a few days ago, there are clearly risks associated with both currency movement and imbalances in the world economy, it is too early to judge what the pace of the US recovery is going to be over the next period of time, and there has been a disappointment about the rate of growth in the euro area. Therefore, as before, there are considerable economic uncertainties. Equally, there are geopolitical uncertainties, which we all know about, particularly since 11 September. That is why we will always be vigilant in what we do and that is why, as I think you will see when we go through it this morning, the statements and the forecasts we make are made on cautious assumptions.

Q264 Chairman: Do you think there are any risks in the imbalances in the domestic economy?
Mr Brown: I think there is greater balance in the economy now than at the time of the Budget; house price rises and consumer demand, as again I said in the Pre-Budget Report, are moderating and we have always expected that, while consumer demand and public investment had to be important motives of economic growth during the period when, first of all, world trade had virtually stalled and therefore export markets were very difficult for every economy and when of course there was very little growth in the world economy as a whole and manufacturing and industrial production was affected, having gone through that period, we can now see consumer demand and house prices moderating, and we see the economy being able to sustain more balanced growth. You can see in our projections for the coming year that business investment, which is already rising, rising even faster; manufacturing output, which is already rising, rising even faster; industrial output as a whole rising faster; consumer spending moderating but still at a reasonable level; and house price growth moderating. That is the picture of greater balance than we presented to the House of Commons last week.

Q265 Chairman: With regard to the housing market, do you think there is going to be a soft landing?
Mr Brown: I have never used these phrases. The most important thing I can see is that we have said in the Pre-Budget Report that we expect house price growth to moderate, and there are pretty good signs that that is exactly what has been happening.

Q266 Chairman: There has been a much sharper rise than expected in public borrowing this year. Your official, Jon Cunliffe, said when he was here this week that it was "within the standard error for fiscal forecasting". Is that not a very weak and lame excuse for the £10 billion overshoot?
Mr Brown: I do not think so because what we have seen in the last few months is a rise in the amount of money we have had to spend on Iraq, and indeed more widely on anti-terrorist activities. It could hardly be foreseen two years ago, or even one year ago, that the commitment to Iraq would have to be so big. Equally, what you have seen is average earnings on the revenue side growing at a slower rate than we had expected. I think you will find that the final figures for last year and this year are coming in at something of the order of 3.5% or 3.6% compared with what had been previous forecast at around 4.5%. The rise in borrowing is completely explicable. Equally, I think you have to look around the world and you have to take a proper international perspective on what is happening. Our deficit, at its highest in the figures that we announced last week, is 3.4%. The deficits in Germany and France are above 4%; ours is 3.4%; the German deficit is above 4%; the American deficit rises to 5%; the Japanese deficit is at 7%. In fact, if you look for the next few years, the American deficit remains at 5%, the Japanese deficit remains above 5%, and our deficit goes from 3.4% and comes down, whereas these deficits remain very high. I think you have also got to look at this historically. In every previous economic cycle the figures that have been recorded at the

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worst points for borrowing in the cycle are: in the early Nineties it was 8%, not 3.4%, and in the Sixties, Seventies and Eighties the figures being recorded were 6 and 7%. In historical terms, to have fiscal policy supporting monetary policy during a period when there has been a world downturn and to have a borrowing requirement of 3.4% is perfectly affordable, and indeed our plans are perfectly affordable.

Q267 Mr Walter: Chancellor, in your statement to the House, and I think quite correctly, you said that we have had the longest period of peace time growth since 1870. However, the Governor of the Bank of England has argued that it would be unwise to expect that remarkable performance of recent years to continue. He has pointed to the fact that the large margin of spare capacity that we had in the early 1990s has now largely gone and that the exchange rate trend is particularly unhelpful. It is almost inevitable, and I am quoting his word, that there will be more volatility in both output and inflation in the figure. Do you agree with the Governor?
Mr Brown: He is talking about the very things I was talking about at the beginning, that there are global uncertainties and currency imbalances to which we have been subject. Since 1997, we have had: an Asian Crisis; a Russian crisis; an oil shock where the oil price when to $35; we then had an IT bubble that essentially was a bubble that burst and caused huge problems for us; we had an American recession with all of its effects throughout the whole of the world; we had the spill-over in economic terms from the disastrous events of September 11th. We have shown, as a British economy, that, even with these things happening, we have been able to maintain growth. What the Governor was referring to was the likelihood that there will be continued and perhaps, in some cases on the currency issues, more pressures upon us in the years to come. I do not think anybody who studies economics or politics can take anything other than a view that you have got to be vigilant in the face of both unexpected and perhaps also unpredictable events facing your economy. The question, however, is: are we operating the correct monetary and fiscal policy to deal with these potential issues, and I think we are.

Q268 Mr Walter: Just looking at your growth forecasts, they tend to be higher than most others. You are looking for 2004 at 3 to 3.5% growth and for 2005 at 3 to 3.5% growth. The Bank is below you, the OECD is below you, the consensus is below you, all at below 3%. If we look at your forecasts for the world economy, you are talking about 6.25% growth in UK export markets, whilst at the same time indicating that eurozone growth is only going to be 1.75%, and this is for next year. Given that 59% of our exports go to the eurozone, how do you account for the difference?
Mr Brown: First, on the forecasts of growth, if we had been, as indeed we were, meeting here just after the Budget and I had exactly the same questions about the British growth rate for this year and you or your colleagues—not you because I do not think you were at that meeting—were repeating what the independent forecasters were saying, what everybody else was saying about what was likely to happen to the British economy over the year, and it is true to say that this Committee and some of its members were sceptical about what we said about British growth this year, in comparison with the forecast in the Budget and the reality now, people know that our forecast that growth would be 2 to 2.5% has been met. Equally, we are confident that, as we look round the world at what is happening as people move out of one of protracted period of low world growth, there is going to be growth in the world economy. On the question of exports, what has actually happened in the last two years to trade I think has been one of the most interesting features of this downturn, and therefore I think is quite important to look at what happens as a result of this stalling of trade afterwards. Even in the early 1990s when the world economy was in recession, world trade continued to grow. Over the last two years, world trade has failed to grow in one of the years, and then in 2002 grew for the first part of the year and then stalled in the second part of the year, and so we have had a period of low world trade growth. We think world trade growth will come back relatively quickly. As far as the exchange rate with the euro is concerned, I think we are in a better position than we were a few years ago and therefore I do not think it is an unrealistic estimate. I think the 6.75%, by the way, is volume, but I stand to be corrected on that.

Q269 Mr Walter: Let us look at it again and perhaps you could confirm whether or not that is volume. It says that there is a percentage change on a year earlier but we are still looking at eurozone growth in your forecast of 1.75%, which is considerably more than that of the European Central Bank, and a growth in UK export markets of 6.15%. Given the decline in the dollar, that surely must have some effect on the difference between 1.75% and 6.15%. What sort of assumptions are you making about the dollar exchange rate?
Mr Brown: I will ask Mr Cunliffe to come in on the dollar exchange rate. I do not think we publish these assumptions at all. I do not think it would be wise to do so. As far as the euro growth rate is concerned, there are a number of people who think the euro area will grow faster than 1.75% next year, and I have seen a number of forecasts that suggest that euro area growth could be higher than that, I think at 1.75%. Given that we have had 0.4% growth this year in the euro area, people do expect there to be greater growth next year and it is not an unrealistic forecast for next year. As I say, as far as trade is concerned, we expect trade to be a

bigger feature of the recovery. Our exchange rate in relation to the euro area has improved since the position we were in a few years ago.
Mr Cunliffe That figure is for growth in the UK export markets. The figure that we have in the PBR this year for 2003 is 3.75% and that is growth in UK export markets at a time when the euro area has been very depressed. If we think the euro area growth is going to go from 0.5% to 1.75%, and remember this is UK export markets worldwide, it is not unreasonable to think that the UK export markets might grow by 6.5 to 7% next year.

Q270 Mr Walter: What you are predicting is an increase in our exports to the eurozone?
Mr Balls: We actually have world trade growth overall rising by 4% this year and then 7.75% next year. We have UK export market rising by 3.15% this year and 6.15% next year. It is clearly the case on our numbers that UK export markets are growing less fast then world trade overall. If you come back to our budget numbers, we actually had world trade and UK export markets rising at the same rate. That would suggest, as you say, that the fact that we have a slightly slower growth path for the euro this year and next is likely to mean that UK export markets are rising less fast than world trade overall. Despite that, we are still seeing a recovery in exports, as in the budget forecast. I think in a sense your point about the slower path of euro growth is reflected in a slightly slower path for UK export markets relative to world trade. The key number is world trade recovering by 7.75% next year. By historical standards, that is the kind of growth rate we would expect to see.
Mr Brown: I do not think 7.75% is an unreasonable figure, again looking back on past history, and particularly since world trade did stall for virtually two years.

Q271 Mr Walter: Can I move on to a different tack? The recent mix of record borrowing, slower spending and the savings ratio—
Mr Brown: Can I just correct you? It is not record borrowing. That is a complete myth.

Q272 Chairman: Answer the question.
Mr Brown: I thought that was the question.

Q273 Mr Walter: There has been talk of a £27 billion savings gap in the UK. Do you think that there is a major savings gap in the UK economy and could you quantify it? Secondly, could I ask you this? You did not make the announcement in your PBR publicly that you had reduced the cash ISA allowance to just £1,000. Do you think that is a good way of encouraging the less well-off to save?
Mr Brown: I think what we have done cumulatively on savings is an encouragement to the less well-off to save. I think the introduction of the Baby Bond is a good way forward. The work we are doing on piloting a savings gateway for people on low incomes is very important for this. I do not accept the £27 billion figure. I think it is an ABI figure but it is not an official government figure. I do not accept it.

Q274 Mr Walter: Would you place a figure on it?
Mr Brown: No, I would not place a figure on it and I think these figures change so much from time to time, dependent on a number of things that are going on in the economy. If you look at what has happened since 1997, millions of people have taken out ISAs; there is a very considerable amount of money. I think someone can give me the exact figure that has been deposited in ISAs, and they have been successful. At the same time, household wealth has grown by 50% since 1997, mainly as a result of the increased valuation of people's homes, but wealth has grown very substantially since 1997. I will say that the ratio, by the way, is not the lowest it has been but it is higher than it was in the late 1980s and is rising; the money deposited in ISAs is £120 billion, so it is a considerable amount. The issue of course that has worried us all and on which we are trying to reach a consensus is pensions.

Q275 Mr Walter: Why did you reduce the cash ISA allowance and why did you actually not make that public that you were reducing it?
Mr Brown: I will ask Mr Holgate to report on that.
Mr Holgate: I think the interest in this has arisen from an observation alongside another announcement that the ISA limits are expected to come down from £7,000 and £3,000 to £5,000 and £1,000. There is no new announcement on this. That expectation was set out some years ago, and this is merely continuing to be the assumption as set out when the ISAs were first increased to £7,000, I think. There is nothing new about that at all.

Q276 Mr Walter: So we can anticipate that ISAs will disappear in a matter of three or four years?
Mr Holgate: I do not think that follows, not least because they were given a 10-year pledge when introduced, so I think they will still be here for some considerable time to come.
Mr Brown: I am happy to give you a note on this showing that this was known information in the public arena before the Pre-Budget Report. I will send the Committee a note on this.

Q277 John Mann: On capital spending in the public sector, forecasting in the final quarter a major surge in year-end spending, is it not about time that Treasury got on top of more recalcitrant, antiquated government departments that do not plan their spending properly?
Mr Brown: Are you wanting us to spend more? Are you insisting that more is spent on capital spending?

Q278 John Mann: What I am suggesting is that the planning out of capital spending is yet again being weighted to the year-end, which is an efficient way for you to plan spending.

Mr Brown: Because we now have three-year spending plans, we believe that we are finding a better way of getting round what was this end of year, last minute dash to get spending in before a particular date in February and March. I think we are dealing with that. The truth is that public investment has been very low for a long period of years and departments were used to a situation where, even when public spending on investment had been announced, it would probably be cancelled at the next annual spending round. I think we are now getting to the situation where we are taking a more long-termist view of this; I think public investment has risen very substantially. The contribution public investment is making to the economy is now recognised and we are talking to departments all the time about how they can make sure that their investment plans go according to plan. I think your point about departments getting it right is taken on board and I am sure every member of the Select Committee is monitoring that individual departments are saying exactly that to them.

Q279 John Mann: On pensions and company fund deficits, the Committee were led to believe that because of the identified data about the health of corporate pension funds there would be a report coming. When I asked Treasury officials about this on Tuesday, they appeared to be rather mystified. I wondered what the progress was on reporting on this.
Mr Brown: Mr Holgate has done some work on your question. He is able to bring you up to date on our question on Tuesday.
Mr Holgate: We will add this to the note that we owe the Committee from its Tuesday hearing. I have learnt that there is a Pensions Statistics Review Committee that comprises industry experts and officials from various government departments. They have an action plan, you will be pleased to know, and one of the action points is to consider whether, and if so how, a statistical digest or fact sheet could be produced, bringing together all the available pensions statistics. That is being taken forward.

Q280 John Mann: We look forward to receiving that. In my own constituency we are approaching full employment. Indeed the identified problem is going to be that for the first time in 40 years there will be a general labour shortage. In identifying what the levers are to growth, it would appear that the major issues are land, labour market flexibility, planning and transport infrastructure. We tend to measure what is measurable. What intention do you have to try to begin to identify how we measure these levers of growth so that in any short-term downturn we can look to what to do to ensure that we remain at full employment?
Mr Brown: At a local and regional level, the encouragement we are giving to the Regional Development Agencies and to local employment services to look at the local labour markets, to look at the problems that are likely to exist over a period of time and to try to deal with them is very important. In other words, it is not simply a national employment policy that we are pursuing; it is also a local and regional employment policy that is going to be important. As far as the barriers to growth are concerned and how they can be overcome for the longer term so that we can have a higher rate in each region of sustainable growth, you are absolutely right to identify planning as an issue. Perhaps the Committee may wish to go into this in some detail at a later stage but there are major reforms that the Treasury and the Department of the Deputy Prime Minister are involved in that are trying to make the planning system more flexible, more able to respond, and of course business planning districts are available in your constituency and in other areas where you can have fast-track, physical planning decisions that can actually help speed up economic growth. In addition, we have these 2,000 enterprise areas. The one issue you did not mention in terms of both growth and the labour market is skills. I do think this is an increasingly important issue for the British economy. We published the Skills White Paper in the summer. We now know that there are five million adults without literacy skills and a larger number of adults without numeracy skills. We have a number of initiatives to try and help those people who are unqualified to become qualified. The rate of unemployment for unqualified adult males of working age with no skills whatever is very high indeed, and so we have got to do something about that. The employer training pilots that we have innovated, the modern apprenticeships that are now expanding, the direct learning of the University for Industry, all these things are available, including the work of the Employment Service, to help people gain the skills that are necessary. I think that all these initiatives are going to be important to your constituents.

Q281 John Mann: You have used fiscal incentives, Chancellor, and I would suggest very successfully. I have had the largest fall in unemployment in my constituency over the last year of any constituency in Britain.
Mr Brown: I think that is due to the quality of the MP!

Q282 John Mann: We have also had the lowest intervention by the Small Business Service. Should we not be weighting far more towards fiscal incentives and far less towards this rather old style public sector intervention in terms of generating jobs and growth?
Mr Brown: I think what you are saying about the importance of small business creation is recognised by the Government, more so than under the previous government, if I may say so. The encouragement that we are trying to give to small business creation in areas that have traditionally been high unemployment areas can be seen through the 2,000 enterprise areas. The encouragement we

are giving to local authorities to involve themselves in helping small business creation I think is also very important. You may have seen the growth incentive where a local authority that is involved in helping create new businesses in its area will get some return from the National Business Rate where previously there was no tax incentive for that local authority to be involved in that business or small company creation. All these things are increasingly important. I think any constituency that has high unemployment ought to look at the differential rate of small business creation because that is one of the important barometers as to whether they can increase jobs in the constituency in the years to come.

Q283 John Mann: I have two final questions. On the North Sea, do we not risk a premature and unnecessary sharp decline in exploration from the existing players since the proposal is for new players in the market?
Mr Brown: I think the incentives for existing players that we increased a year ago are very high indeed now. We increased the capital allowances available to exiting companies in the North Sea, and that is mainly the large companies, to develop new fields. We increased the overall tax rate in the North Sea on corporation tax, but we put much of that money back by increasing the investment allowances available in the North Sea. As far as new companies coming into the North Sea are concerned, we are conscious that to exploit some of the remaining reserves in the North Sea may require, indeed interest, a different type of company from some of the big major players. It is to encourage them to come into the North Sea as new companies in the North Sea that we are offering to give them some incentive that would help cover the cost of their exploration activities. It is an incentive to persuade new companies to come into the North Sea, but clearly there were big incentives already available for existing companies in the North Sea.

Q284 John Mann: My final question is about an industry that is in major financial crisis at the moment, and that is the Scottish and English football industry, which warranted eleven very important words in your pre-Budget statement. Is it your intention to come up with some proposals in your consultation over football supporters trusts to allow us to say what is, after all, a very important potential exporting earnings sector in the British economy?
Mr Brown: As for the state of the football industry, obviously a number of decisions have just been made in the last few days about the access to broadcasting and football matches, and that will affect the economics of football in the years to come. As far as what we as a government can do, there are some questions about the Inland Revenue treatment of football supporters' trusts that we have to look at. There have been some questions raised about football clubs when they go into liquidation and their treatment by the public authorities. We will look initially at football supporters' trusts. We are not against doing further work. We have been quite influenced by the work of this All-Party Football Committee in the House of Commons, which has taken evidence from a large number of people. That has revealed that there are some problems. We believe that football clubs are very much part of the local community. We are sad when we see a number of football clubs, either through over-extending themselves or for other reasons, getting into huge difficulties, and that affects community spirit and community activity. We are conscious that this issue of football supporters' trusts should be looked at first, and that is what we are going to do.

Q285 Chairman: Chancellor, I would like to ask you about the output gap. The Treasury's optimism of both growth and fiscal policy resets heavily on an estimate of the output gap, which is at the top of the range of estimates. When we on this Committee asked the experts, they were all over the place as to what the output gap is. Is there not a danger that the policy is now resting too heavily on that estimate?
Mr Brown: I do not think we are over-optimistic about the output gap at all. I will ask Mr Balls, as the Chief Economic Adviser to the Treasury, to give us some information about Treasury thinking on the output gap.
Mr Balls: The output gap we estimate to be around the same profile as at budget time, which is what you would expect because we have the same profile for GDP for next year as at budget time. We have not really changed the overall shape of our economic forecast. It is an output gap which, for the public finances, is based upon a cautious view of the trend growth of the economy at 2.5%. We use 3.75 for our overall economic forecast for just 2.5%. There has been new information, which has arisen in the last few months as a result of the ONS revisions to the national accounts in the summer. That showed, as we set out in box 2.4 in the Per-Budget Report, that over the period 1997–2001, the actual trend of output growth in the UK economy was not 2.6%, as we thought at the time of the budget, but actually 2.94%, with stronger productivity growth in that period than we had expected. We could have decided, on the basis of that history of 2.9%, to revise up our view of the trend growth, and therefore that would have led to a larger output gap. We decided not to do that but to stay with our central view at 2.75, lower than 2.9, and also to stay with 2.5% for further public finances, lower than 2.9. We made a deliberate decision to ignore, if you like, the stronger evidence from the past and to stick with a more cautious view. That is why we ended up with this same path for the output gap and going forward. It is quite conceivable, on the basis of the past and these trends continuing, that it will turn out that growth will be stronger in future trend terms and therefore it may well be that we are being pessimistic about the output gap rather than optimistic, but we

judged it would be imprudent and incautious to take that view at this time. There is a long discussion in Annex A, which looks in detail at the labour market, as to why, in the end, looking at the range of factors, what has been happening to average earnings, to employment, to unemployment, to capacity indicators, we were led to believe that the right judgment was to stay with the output gap path we have. There is clearly an output gap at the moment; it has closed steadily up to the period at the beginning of 2006. That is what underpins our forecast of 3.5%. Some people might describe that as optimistic but I think, on the basis of the data, you could actually equally make the case that it is pessimistic. We decided to continue to take a cautious view.

Mr Brown: May I just repeat the reference to box 2.4 on the National Accounts and trend growth? I think this has relevance to the fiscal position as well. While trend growth in the period 1997–2001 was 2.94, our assumption is 2.75, but our fiscal projects are based on 2.5, and indeed for 2007–09 our fiscal projections are based on 2.15%. I do not think we can be said to be anything other than cautious about our projections for growth and how we then build these into the fiscal figures.

Mr Balls: May I just say one other thing, with your permission, Chairman? Until 1997, government in the UK did not publish estimates of the output gap and they did not publish estimates therefore of the cyclically-adjusted fiscal balances, and so it was not possible to reach a judgment as to where you were in the cycle and what, adjusted for the economic cycle, the fiscal position was. We made a decision in 1997 to move to a new framework. We have kept with the same fiscal rules now for six and a half years. Throughout that period we have published estimates of the output gap and also our full estimates for the first time, which allow people to judge, adjusted for the economic cycle, the underlying structural fiscal position. I do not think it is true to say that we rely more than in the past on the output gap or give the impression that that is somehow an imprudent thing to do. In fact, it is a far more transparent and open thing to do to provide people with the information. It is not possible to run a fiscal policy which adjusts for the cycle and gives you an underlying structural view unless you produce in detail estimates of the output gap. It has never ever been done before. If you look back to the late 1980s, the debate at that time was whether you should revise the trend growth rate of the economy in 1987, 1988 and 1989 from then 2.5% up to 3, 4 even 5%. That was a non-transparent debate, which was not reflected in the budget documentation because there was no obligation at that time to publish estimates of trend. It is a strength of the system in the UK that there is now an open public debate about the trend growth rate, the level of the output gap, when the cycle started, when the cycle ended. It is a more educated analytical and transparent approach to fiscal policy, which leads to these debates, so I think that you should see it as strength rather than any sign of weakness.

Q286 Chairman: Moving on to fiscal policy, in November, the OECD talked of the danger of the UK fiscal arithmetic needing, as they says, a "destabilising adjustment later on" in the absence of corrective action through the upswing. How do you respond to those comments?

Mr Brown: We are meeting our fiscal rules and will continue to meet our fiscal rules. I think a lot of this debate, if I may say so, has been quite insular, partly because people are not focusing on levels of borrowing that genuinely are taking place in other countries, and the deficits in European countries are now quite high; the deficit in America is indeed a great deal higher and will continue to be a lot higher for some years to come. First, from the international perspective, people should see the British position as being both sustainable and prudent. Equally, at the same time, you need only look at our figures in the historical context to see that at this point in the cycle they are relatively low. I think part of the problem in this debate is that other governments in the past have held to a balanced budget rule; in other words, they expect either every year or over the cycle the budget to be totally in balance or in surplus. A lot of the debate in this country appears to start from the assumption that it is somehow wrong to borrow at all. Our two rules are the golden rule, which is that current expenditure is covered by revenues over the cycle, and the sustainable investment rule that with a low level of debt—and our debt is lower than most countries—it is prudent to borrow for justifiable investment expenditures. Therefore, to record figures where you do borrow is part of our policy because we wish to invest properly in the infrastructure of this country. There was a period when governments committed themselves to a balanced budget, then towards a balanced budget, then to balanced budget over the cycle, then towards a balanced budget over the cycle, then towards a medium-term balanced budget. Each government that did that failed to meet their own rules. The interesting thing about what we have done and what we are able to report is that we continue to meet our rules, and we do so on the basis of what I think is a prudent approach to fiscal policy for the medium term.

Q287 Mr Fallon: Let us go back to your own failure, Chancellor, and the mess you have made of public sector borrowing. Perhaps you would just correct what you told the Chairman a few moments ago when you tried to explain away your £10 billion error on what happened a year ago, that the forecast of £27 billion was actually made in April when the war had already started, not before it began. Would you also then confirm that Table 13 shows that the interest payments on your £10 billion mistake will be £0.5 billion this year, £1.6 billion next year and £1.0 billion the year after, and so a total of £3.1 billion for your £10 billion mistake?

Mr Brown: I do not accept that for a minute. You are telling me—

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Q288 Mr Fallon: You do not accept that you made a mistake between £27 billion and £37 billion?
Mr Brown: I do not accept that I made a mistake. You are telling me that we could have anticipated everything that was to happen in Iraq at the point at which we prepared the budget in March and April. I can tell you that the costs of the operations on terrorism, which are not simply Iraq but anti-terrorism expenditure, have been higher than we would have anticipated, higher than probably you would have anticipated, even with the gift of hindsight. I believe that we are justified in reporting to the House that the overall bill over two years for Iraq and for terrorism is substantially higher. I think we are also right to point out, as I did, that one of the reasons why the other side of the equation, that is revenues, have been lower—spending has been higher because of these things but revenues have been lower—is because of what has happened to average earnings. As far as debt interest payments are concerned, I think you would be the first to acknowledge that we have the lowest share of debt interest payments as a percentage of GDP since 1915 but the figure is around 2% of GDP. The previous government that you represented was paying more out in debt interest payments than they were putting into education as a result of running such a high borrowing requirement over a period of years and such a high level of national debt. We have rectified that situation where I think, for each of the three or four years that we are reporting, debt interest payments are around 2%. I just give the Committee the figures: 2001–02, £2.19 billion; 2002–03 £1.98 billion; 2003–04 £2.02 billion; 2004–05 £2.11 billion, 2005–06, £2.04 billion, and of course the higher percentage reflects also estimates about what are the likely interest rates in that period. I would compare that with the 5%s and 4%s that were being recorded in previous years under your own government. I think our position on debt interest payments is one of a high level of prudence.

Q289 Mr Fallon: Will you also confirm, Chancellor, that the average forecast that the Treasury has published this morning for next year's borrowing is £36.9 billion against your own forecast of £31 billion?
Mr Brown: No, I do not accept that. Whose average forecast is that?

Q290 Mr Fallon: The average economic independent forecast that the Treasury published this morning—*Forecast for the UK Economy*—for next year's borrowing is £36.9 billion, whereas you forecast that as only £31 billion. Are you wrong again?
Mr Brown: I think these may have been published yesterday actually. When you look at the cautious assumptions that we make about borrowing, then I would have thought that people will come closer to our figure over the coming months.

Q291 Mr Fallon: Do you recall a document, Chancellor, called *Planning Sustainable Public Spending: Lessons from Previous Policy experience*, which you published in November 2000, three years ago?
Mr Brown: I am not sure that I wrote every paragraph of that myself but I do recall that there was such a document,

Q292 Mr Fallon: You will recall the sentence: "By requiring policy to pass this 'stress test' the chances of repeating earlier errors are reduced accordingly."
Mr Brown: Absolutely, and we have not repeated past errors. If you want me to explain the difference between past errors and the present situation—

Q293 Mr Fallon: No. I want you to confirm that that is what you said about the cautious case. I want to draw your attention to 2.74 of your own Pre-Budget Report for this last week where you say: "Drawing on this margin means the average surplus on the current budget in the cautious case is no longer positive . . ." That means you are in danger of breaking your rule, does it not?
Mr Brown: Our rule is the golden rule, Mr Fallon, and we are meeting our golden rule and we are meeting our golden rule as reported in the PBR. We are not breaking our golden rule. I saw some of the questioning that was taking place earlier this week and I really ought to explain to the Committee that the golden rule is achieved based on cautious assumptions. What are these cautious assumptions that I believe the Committee should take into account? First, as Mr Balls was saying, we assume for fiscal purposes that the growth rate is 2.5% and, as I said, in future years, after 2007, 2.15%. Whereas we have evidence about growth trends of 2.9, and we have an audited assumption of a trend growth rate of 2.75, we are actually only assuming for fiscal purposes 2.5% and then, later in the year, 2.15%. In addition to that and because our fiscal projects are prudent and based on a cautious set of assumptions, we do not include an allowance for higher employment. Although there are 1.7 million extra jobs in this economy, we have not taken into account in any one of our projections since 1997 the extra revenue we will get or the lesser amounts of social security benefit that we have to pay. Our oil price assumption is $24.90 over the course of the year. The oil price at the moment is $29-$30, and of course that has a considerable bearing on North Sea oil revenues. We do not make any assumptions about indirect benefits from our spend-to-save programmes. We have a pretty cautious VAT assumption where the VAT income as a proportion of spending falls by 0.5% a year and we do not take into account privatisation revenues that are not actually out there and explained as something that is likely to happen. We have brought this from the past experience, we have brought it from the projections that were made in the past. That is why you cannot make a comparison with the 8% deficit of the early Nineties for two years when you are

talking about a 3.4 deficit in Britain, which is very considerably lower than other countries at the moment and it is based on cautious assumptions. The cautious case is looking even more at what might happen if, for example, we have misjudged the output gap, but we need the golden rule. We need the golden rule on cautious assumptions. Our requirement is to meet the golden rule.

Q294 Mr Fallon: But the surplus that you are forecasting to meet the golden rule is now, you will confirm, within the official margin of forecasting error. It is also only possible, is it not, Chancellor, because you have actually—and you have not told anybody this—changed the way you have added up the surplus; you count current surpluses and deficits as a percentage of GDP this year and you are putting them in cash terms in 2005–06, which conveniently gives you a larger number.
Mr Brown: That is absolute nonsense. You really have to be better informed. That is nonsense. I know that this was stated in the IFS report to you.

Q295 Mr Fallon: We took evidence on it
Mr Brown: And they also made an assumption about the numbers of top-rate taxpayers that was totally false, and I hope the Committee will get an apology from them for giving you completely wrong figures. But equally on this question of the 0.2% of GDP, which is the margin, it is stated in all our publications that this is the way we will calculate it over a period of time. Perhaps I should ask Mr Balls to read out the publications that state this.
Mr Balls: There are two different places, as we reference in the Pre-Budget Report. It may well be that you do not always read the footnotes, but if you read the footnote 8 on page 34 and if the IFS had read those footnotes, they also would have spotted these references. First of all, on page 24, in Budget 2000, when we assess the golden rule over the cycle between 1997 and 1999, we set out that the average annual surplus on the current budget was 0.7% of GDP. Then in the book the Treasury published two or three years ago on pages 162 and 164 we set out performance against the golden rule since the early 1970s. In that document we stated that in each of the last two full economic cycles to 1997 current spending consistently exceeded current revenue by an amount averaging over 1.5% of GDP. The only time so far where we have assessed the golden rule over a cycle in Budget 2000, we used the method of looking at the average surplus as a percentage of GDP and then in the book we publish where we set out how the framework operates, going back over 30 years, we also use that methodology. The accusation that we have changed our methodology is just untrue. It is clearly referenced in the document for people who want to read it on page 34. The other point is just to explain the cautious case, paragraphs 2.73 and 2.74, which you set out to explain exactly why we have done what we have done and why, in the public spending document, you reference that we talked about the cautious margin. Through the first phase of the economic cycle, when our rule was to meet the golden rule adjusted for the cycle, we have deliberately over-achieved in the early phase the golden rule. We did that by instituting a cautious case, which was put in to ensure that in the early phase of the cycle, when you did not know the path to output and the revenue, you over-achieved. During that period, we were regularly criticised for building up a war chest, for using cautious assumptions. The reason why we did that and ran I think the first run of three surpluses on net borrowing since the 1960s was precisely so that over the whole cycle we could build up a margin in the early years so that if the world changed in the way that people did not expect, a global downturn, global patterns of tax revenue, you had built up a margin for caution so that you could still meet your fiscal rules. The reason why past governments have never been able, over the cycle, to meet their fiscal rules is because they did not take that deliberately cautious approach. What we are now doing in the fiscal finances set out here is showing that post-2005 we again build up that margin, so that by the end of the forecast period we again meet the golden rule on the cautious case. It is not something that you do after the fact; it is something you do in advance in order to build up a prudent margin. Those paragraphs explain exactly why, having done that, you can then meet the golden rule in the cycle, which is what we are doing.

Q296 Mr Fallon: Chancellor, were you aware that your officials confirmed to us on Tuesday that government officials, for accounting reasons, asked the Rail Regulator at the last moment to switch rail funding from the current to the capital account in order to help you meet your rule and that because the Auditor General has now ruled that Network Rail's debts have to be shown in the whole government accounts, officials have confirmed to us that you have now postponed publication of those whole government accounts from 2005–06 to 2006–07 when a future Chancellor presumably will have to meet the bill?
Mr Brown: But you know perfectly well on the first case, Mr Fallon, that the decisions about the funding of Network Rail are a matter for the Regulator. We are not in a position to interfere with eth regulator.

Q297 Mr Fallon: He says he was approached by officials.
Mr Brown: There is obviously dialogue between the Regulator and other bodies before he makes his decisions, but you know perfectly well that these are decisions that are made by the Regulator. As for the fact that he has allocated or suggested an allocation for capital expenditure, this has been happening since 2001 that capital expenditure is regarded as important when looking at the requirements of Network Rail. There is nothing sinister about this at all. It is also completely untrue of course that the whole government accounts have

been delayed because of the railway issue. We said we would publish whole government accounts based on a series of pilots, and we hope to do so in 2005. That was the statement that we made. In the Pre-Budget Report we said that, having looked at all the difficulties facing us, in particular the issue of the prudential borrowing requirements of local authorities, we propose now to do that in 2006. I do not think there is anything sinister about that either. You may wish to look for conspiracy theories, but the Regulator has the power to make his announcements independent of government, and that was how he was set up. Equally, the whole government accounts (a) are going to be published for the first time and (b) are going to be based on the best information available to us by getting the prudential borrowing requirements of local authorities included in them. That is the proper explanation for what has happened.

Q298 Mr Fallon: We are not looking for conspiracy charges. What we are looking for is more transparency, the answer to all these different fiddles, rather than you selecting assumptions that you want audited by the NAO is to allow the National Audit Office free rein to audit any of the assumption in your PBR that it chooses to do so. Why will you not let the inspectors into the Treasury to sort this out and improve the credibility of the way you draw up these accounts?
Mr Brown: Mr Fallon, when we introduced our new monetary and fiscal regime, you opposed our new regime. Our regime was the first time that the National Audit Office was brought in to audit the assumptions. I have just gone through the major assumptions audited by the National Audit Office.

Q299 Mr Fallon: You chose those.
Mr Brown: They are: the trend growth rate, employment, the oil price, indirect savings and VAT assumptions. These are major issues that the National Audit Office now report to us. None of this was ever done under the previous government. That is one of the reasons why, of course, the deficits went so high in the early 1990s, because assumptions were built into the figures that were never actually realistic assumptions. I think, when you look at our assumptions on both growth, employment, oil price, VAT and privatisation, these are realistic assumptions and we have innovated by using the National Audit Office. Of course we can review this from time to time but I think it would be unfair of the Committee not to welcome the advance in transparency that this Government has made for the first time in dealing with monetary and fiscal policy.
Chairman: Chancellor, I see that the IFS has been in contact with us and they have changed their figures for higher rate taxpayers from six million to four million with apologies for any confusion. I wonder if you could give us relatively brief answers. I want to finish by 11.20 because we have Treasury Questions.

Q300 Mr Ruffley: Projections for public finances are on the assumption that tax allowances and thresholds are indexed in line with inflation, as you know. Would you agree that typically earnings rise by more than inflation?
Mr Brown: We are following exactly the policy that was followed by the previous government, and in fact the policy that has been followed since 1976. I thought there was an all-party consensus on that policy.

Q301 Mr Ruffley: Yes, but—
Mr Brown: There is an all-party consensus, thank you.

Q302 Mr Ruffley: Your doing this in a spectacular way means actually that a higher proportion of people's earnings fall into the higher tax bracket over the period covered by your Red Book for the PBR. What was the income tax gross of tax credits as a share of GDP last year?
Mr Brown: I think there are figures available that Mr Holgate can give you.

Q303 Mr Ruffley: Do you know, Chancellor, for 2003–04?
Mr Brown: There are figures available that Mr Holgate is just going to give you.

Q304 Mr Ruffley: Are you familiar with the contents of the table?
Mr Brown: I am familiar that there are figures in the Pre-Budget Report that we are just about to read to you.

Q305 Mr Ruffley: These should be at your fingertips.
Mr Brown: I think Mr Holgate has these at his fingertips.

Q306 Mr Ruffley: So they are at his fingertips and not at your fingertips? That is very reassuring.
Mr Brown: The percentage of income tax as a proportion of national income, is that it?
Mr Holgate: It was 10.7% in 2002–03.

Q307 Mr Ruffley: Yes, and it goes all the way up to 2008–09 in this table to 11.6. The significance of that figure is that there is quite a lot of fiscal drag in that and the longer fiscal-drag continues, the greater the impact each year as the higher rate threshold, and I quote from the IFS, "moves down into the more densely populated parts of the income distribution". That is true, is it not?
Mr Brown: There is fiscal-drag. Fiscal drag is something that happens under every government. It is not something that is unique to the Labour Government.
Mr Ruffley: Let me tell you why it is different, Chancellor. You make a point that it is a very important question, thanks to fiscal-drag and the freezing of the personal allowance this year, for which you are responsible. The effective higher rate threshold, the basic rate plus the personal

allowance in nominal terms this year, is £35,115; it has actually fallen from 161% of average earnings when we were in power, 1996–97, and it is biting down to lower paid people to 143% in 2003–04 in income distribution. How many higher income taxpayers were there in 1996–97?

Q308 Chairman: Let us get the sense of the question. Chancellor, that does not mean the Select Committee has been in power.
Mr Brown: I think Mr Ruffley is describing a situation where—

Q309 Mr Ruffley: In 1996–97, how many higher rate taxpayers were there?
Mr Brown: I think Mr Ruffley is describing a situation where people are better off under this Government, and therefore they are earning more. The rate of increase in the average household income has been 3% in real terms. If I am right, the figure was 2.1 million.

Q310 Mr Ruffley: How many higher rate taxpayers were there in 1996?
Mr Brown: I think I have got the figures.

Mr Ruffley: You should know this. Tax is a big issue for people. You do not know.
Mr Holgate: Households on average are £825 per year better off.

Q311 Mr Ruffley: Mr Holgate, (a) I did not ask you and (b) that is not the question. I asked the Chancellor a question and I want to know how many higher rate taxpayers—
Mr Brown: You will be pleased to know, Mr Ruffley, I was absolutely right; the figure is 2.1 million, as I said.

Q312 Mr Ruffley: What is it this year, estimated from the Inland Revenue?
Mr Brown: The figure for 2002–03, which was the latest figure that we have, is estimated to be 3 million.

Q313 Mr Ruffley: The figure is 3 million for last year, not this year?
Mr Brown: We have estimates for 2002–03, but I cannot be sure that that will be the outturn.

Q314 Mr Ruffley: What is the estimate?
Mr Brown: I would prefer to stick with the estimate for 2002–03 as 3 million. That is a reflection, of course, of the rise in people's standard of living under this Government, and it could only have happened if people were seeing a real rise in household income of about 3% on average a year, and so you should be congratulating us on the fact that more people are earning more and have been earning more consistently every year under this Government.

Q315 Mr Ruffley: The House of Commons Library has done some research that I commissioned on cautious assumptions about fiscal-drag. Starting with 2003–04, the effective higher rate threshold is £35,115. Using your tax benefit reference manual for 2003–04, next year's threshold, 2004–05, will be £36,130. Extrapolating that on a 2% real earnings growth, which everyone would consider to be a reasonable assumption, and we know why you do not publish those going forward, that gets in 2008–09, to the end of the period covered by your Red Book, to £39,881. What I want to know is how this affects people in the real world. You have a heavily advertised interest in public sector workers, do you not, Chancellor? Tell me: does a sergeant this year, with four years' service completed, pay the top rate of tax this year?
Mr Brown: First of all, you are wrong about average earnings, Mr Ruffley. Let us get back to real facts. You are assuming, and want to continue to assume, a 2% above inflation rise in average earnings each year, but the fact of the matter is that average earnings rose last year by 3.6% and this year by 3.5%, only 1% above inflation in real terms. These forecasts that you are trying to base all your figures on are completely speculative and I am afraid you are just repeating the mistakes that the IFS made and appearing to present them as House of Commons figures. These are exactly the figures that the IFS gave.

Q316 Mr Ruffley: I will make these figures available at the end of this meeting. Let us just talk about this year. I am referring to the Tax Benefit Reference Manual because the threshold is, as I say, £36,130, for 2004–05, your own figures, no-one else's assumptions. Is a police sergeant with four years' completed service paying top-rate tax or not?
Mr Brown: I think it is difficult to tell what the rise in earnings is.
Mr Ruffley: It is standard rate published—
Chairman: We have a question and answer session here. We do not interrupt one another. Chancellor, you answer the question. If you have any problem, see me.

Q317 Mr Ruffley: Is that sergeant paying top-rate tax or not?
Mr Brown: You are talking about 2004–05. I do not know what the rise in earnings of that sergeant is going to be between now and 2004–05. Now you want to look at 2003–04.

Q318 Mr Ruffley: That is because you are not answering the question, and so I am just going to have to try another way.
Mr Brown: Mr Ruffley, your case is collapsing because it is based on a whole series of assumptions in the Institution of Fiscal Studies report when they tried to suggest that there were six million people who were going to be in the top rate tax bracket.

Q319 Mr Ruffley: We have already heard that that correction has been made.

Mr Brown: Mr Ruffley, you endorsed the IFS report with quotes in the *Daily Mail* saying how terrible it was that this was about to happen. We now find that the figure was not six million that the IFS wanted to put to this Committee; they wanted to put a figure of four million.

Q320 Mr Ruffley: That has been corrected, and you know that.
Mr Brown: Mr Ruffley, I think you have got to doubt whether the four million figure is accurate as well. Look at the components of income tax. You wish to suggest that there is only one reason that income tax revenue is going to rise.

Q321 Mr Ruffley: I did not say it was all fiscal drag, and the record will show that.
Mr Brown: Can I finish my answer and then Mr Ruffley can say exactly what he wants to say? The reasons that income tax revenue will rise are not simply fiscal drag; they depend on what is likely to happen to bonuses; they depend on the numbers of people likely to be in work; they depend on the interest that is paid and the tax receipts from interest that is paid. It is a wholly erroneous assumption that is made, both by the IFS and by Mr Ruffley that there was one cause and one cause alone of—
Mr Ruffley: I did not say that and the record will show that. You are making it up, as usual.

Q322 Chairman: Chancellor, can you finish?
Mr Brown: There are many reasons why these figures for income tax revenue are high but I think this Committee should now be very cautious, having been misled earlier this week, about how many people are likely to be top rate tax payers—

Q323 Mr Ruffley: Corrected.
Mr Brown: Having been misled earlier this week, they should be cautious about making forecasts about years ahead which depend on a whole series of assumptions, including about average earnings but were certainly not true last year and are certainly not true this year.

Q324 Mr Ruffley: A teacher, upper pay scale, UPS5, is that teacher now paying top rate tax in 2003–04?
Mr Brown: There are many different rates of earnings for teachers, depending on performance related pay, depending on whether they work in London or elsewhere.

Q325 Mr Ruffley: Non London, no bonus.
Mr Brown: Each of these conditions have got to be taken into account before you can make a judgment about these figures.

Q326 Mr Ruffley: You do not know that either. Okay.
Mr Brown: We have now got to a situation, Chairman, where he has had to withdraw his allegations about future years—

Q327 Mr Ruffley: I am not withdrawing anything.
Mr Brown: He cannot sustain his allegations about the present year.

Q328 Mr Ruffley: The question is you do not know anything about public sector pay, you do not know what sergeants earn, you do not know what UPS5 earns. Final question: can you tell me what the net taxes and social security contributions as a share of GDP, the tax burden, was in 2002–03, what was that figure?
Mr Brown: I think the figure that we are reporting is 35.9%.

Q329 Mr Ruffley: What does it rise to by 2008–09 in your own table, B11?
Mr Brown: As the country becomes more prosperous.—

Q330 Mr Ruffley: Ah, so you are not taxing them through the teeth then?
Mr Brown: As the country rises more prosperously it is 38.2, which is lower than it was—

Q331 Mr Ruffley: It is higher than the one you inherited and you know it.
Mr Brown: Chairman, let me just finish, lower than the peak figure reached by the Conservatives and it is very difficult for them to complain about a 38.2 figure when they went to 38.9.
Chairman: Chancellor, this is a non-partisan Committee.

Q332 Mr Ruffley: On income tax as a share of GDP, on the prudent assumptions which have been made by the IFS, in your own table, B11, on the national tax burden, does it not show that this is a tax time bomb that is ticking away for middle England? Tax is going up and more people are being dragged into the higher rate threshold?
Mr Brown: Mr Ruffley, I can only refer you to—

Q333 Mr Ruffley: You are denying that, are you?
Mr Brown: I can only refer you to the last Budget statement of the previous Conservative Government when they predicted that tax as a share of GDP under their policies would rise—

Q334 Mr Ruffley: What did you inherit in 1996–97?
Mr Brown:—would rise to 37.9% on one measure and 39.3%.

Q335 Mr Ruffley: What tax did you inherit in 1996–97? You probably do not know that either.
Mr Brown: What I am telling you, Mr Ruffley, is not only did we inherit a big deficit but the projection that was made by the previous Government was not—

Q336 Mr Ruffley: What was the tax bill that was inherited? Was it under 36%?

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Mr Brown: You are very interested in projections.

Q337 Mr Ruffley: I think you will find it was.
Mr Brown: You are very interested in projections, that the projection would rise to 39.3% on one measure and 37.9% on another measure. The last Conservative Government was predicting an equal rise—

Q338 Mr Ruffley: I think B11 speaks for itself, Chancellor.
Mr Brown:—in the tax take as a percentage of GDP.
Mr Ruffley: You are condemned by your own figures.
Chairman: Angela, over to you. It is Christmas.

Q339 Angela Eagle: The employment record has been remarkable to date with 1.7 million new jobs. You made an interesting announcement, Chancellor, in the Pre-Budget Report about your view of the future of the New Deal and how it is going to help deepen and broaden the commitment to full employment. Could you say a bit about how you see changes to the New Deal achieving that in the future and obviously let us know what would happen if the New Deal was abolished?
Mr Brown: The New Deal, I am pleased to say, has been one of the most successful employment programmes that any Government has been involved in. There are two million people who have had the benefit of the New Deal and there are one million people already in jobs as a result of the New Deal. We believe that looking forward the New Deal will have to move in two directions. One, it will have to be more flexible to deal with local employment conditions that Mr Mann raised a few minutes ago. Secondly, it will have to do more to concentrate on the level of skills that persons who are unemployed or people in work indeed can obtain to meet the needs of a modern economy. So we see, first of all, more discretion given to the local employment service so that where there are local labour market needs, whether it is in the travel to work problems that people have in rural areas or whether it is in the particular skills mix of a local economy, they could intervene and use their discretion to help create better facilities and better opportunities for people to get to work. Then we wish to build upon the New Deal this greater element where a person who is unemployed is checked for the skills that they have, given assistance, there is to be a work and skills focus, interviews and courses which will enable people to acquire skills that they need and, therefore, we deal with the situation in our economy where one of the reasons that people are unemployed and cannot get jobs is that they do not have any literacy or numeracy skills. The New Deal would become more sophisticated, more local and flexible and more orientated towards giving people the skills that are necessary for their employment future.

Q340 Angela Eagle: Now my colleague, John Mann, was talking earlier about how in his area he was pretty close to full employment. In areas like mine up in Wallasey we still have a persistent rump of people who are finding it very difficult to get a job. One of the things I certainly see as I talk to people and come across them is that NVQ level 2 is a good start but it does not always equip people to get into more meaningful employment and up the employment level. It has always seemed a weakness to me of the New Deal that we do not have higher levels of qualifications as possibilities in it. Are your changes going to allow this to come into the system?
Mr Brown: The Skills White Paper when it came out in July said that while the concentration of the Government is ensuring that people who do not have any functional literacy and numeracy skills can get to NVQ 2, we will also help people get to skills level 3 and quite a lot of our skills budget is devoted to that. I think as things develop over time we will want to concentrate on getting people not just basic skills but getting people better skills than that. I think you will be interested in not just the New Deal attempts to help people get skills but the employer training pilots that are going successfully and they are mainly helping people who have left school at 15 or 16 who have no skills of their own who are, therefore, for the first time acquiring skills through the workplace. That is another mechanism by which people while still in work can get the skills that perhaps enable them to get a better job.

Q341 Angela Eagle: Can you explain a conundrum that I think if I had been arriving from Mars on the day after the Pre-Budget Report with only a general view of economics might have puzzled me and that is all of the comments on the deficit and yet this seeming contradiction that at the same time as having a deficit you were finding an extra one billion pounds to assist both child-care and children in general?
Mr Brown: I think that is because we believe that our plans are affordable and it was right to honour our promise that we would reduce child poverty by 25% by 2004 and by investing in the child element—and by the way, so you can be sure about this, every one of the figures was announced on the day and there was no dubiety about that—by raising the child element we were able to do more about the position of lower and middle income families and seven million children benefited from it. It is because we believe our borrowing is affordable and the right thing to do at this particular point in the cycle and we feel that it is part of our commitment as a Government to tackle the problems of child poverty that we inherited that we put this extra billion pounds also into tackling the problems of child poverty.

Q342 Angela Eagle: Are you confident that this extra money will get you to your target of getting rid of 25% of child poverty in the next two or three years?

Mr Brown: We have got to do this by 2004, the 25%, and we are looking at how we can cut poverty by 50% amongst children by 2010. There is an issue about the calculation involved of child poverty. Before housing costs there is absolutely no doubt in our view that we meet the 25% cut in poverty since we set the target to be achieved by 2004. I think it is true to say that many of the pressure groups involved in this who have done an enormous amount of work over the years have welcomed the announcement we made as the contribution towards meeting that target.

Q343 Angela Eagle: Can I just move on to public expenditure and we have these figures quoted by sceptics—who try to argue that increases in public expenditure are always wasteful—about the 47% volume growth that we have seen in public expenditure in the last few years but output measures of only 15.5% increase in the output that we get for the 47% volume growth. This is used as an argument then to say that somehow value for money is not being achieved. I know you have instigated a review to see how output is measured but I worry that public sector output, particularly, for example, children being higher qualified or health being better are not really revealed in economic measurements of output. Do you share the same worry and what can you do to try to get a handle on how much value we are getting for the extra money that is going into the public services?
Mr Brown: It is clear that the existing indicators which have been used for years do not reflect properly the quality improvements which are taking place. If a fall in class sizes reduces productivity, by definition that is a problem because the quality of teaching is undoubtedly likely to be higher. The same problems arise in relation to the health service and that is why Tony Atkinson, the Professor who is an expert in these matters, has been asked to conduct an inquiry into public sector productivity and I believe that will give us a better measure that we can debate. The report will be published and we can debate about public sector productivity.

Q344 Mr Beard: Following on from that, the Pre-Budget Report says on page 182: "Real Government spending on current goods and services as measured in the national accounts has accelerated a lot less than nominal spending over the recent past". Then Goldman Sachs echo the same message saying: "The bulk of the increase in cash spending has been eaten up by a significant rise in public sector costs. Over the last five years public sector costs have risen by 6% a year compared with a rise of 1.5% a year in the private sector". Should we take these predictions of high levels of inflation in the public sector seriously and what is being done to ensure that we get value for money for the increased public expenditure?
Mr Brown: This is the issue and the importance that we attach to reform as we make investment. It does say in that same paragraph, if I may say so: "Measurement difficulties mean that the real measure is almost certainly highly misleading". I think we can get a consensus on that but it is unlikely that the measurements which are used at the moment can pick up all the improvements which would be taking place in the quality of the service. I have looked carefully at the National Health Service and if you look at what has been happening overall, outpatient attendances have risen from 11.5 million to 13 million; elective admissions from 4½ million to 5½ million and emergency admissions to 4 million and finished consultant episodes have risen from 11.6 million to 12.8 million. Of course the other things which are happening in the health service is by being able to treat people in GP surgeries rather than hospitals and by being able to conduct operations at the same time on a day basis and not having to have people staying in the hospital for a long period of time, our productivity figures do not pick up this very substantial increase in the quality of service that is available to people. I have a number of other figures in the health service if people would want them.

Q345 Mr Beard: Goldman Sachs go on to say that labour costs are not the main problem, less than one half is due to the combined effect of faster growth of average pay and lower growth of labour productivity. The rest reflects an acceleration in non labour costs. Is this because with the bulk of things that are now being contracted for there is so much competition for, say, the building industry that that is driving costs up?
Mr Brown: I think when you are dealing with issues in the health service, for example the drugs bill has gone up by more than 10% in the last year, that is, however, a reflection of people's demand for the highest quality drugs. We are looking at that and what we might be able to do about it. Equally at the same time, if I can just give you one example, the number of statins, which is the anti-cholesterol drug that is available to adults, has risen from six million in 1997, the number prescribed, to 19 million today. It is hardly surprising that a drug which avoids illness and keeps people out of hospital is a costly one for the National Health Service. There have been issues in relation to that. On PFI I think perhaps the Committee may wish to look at this in more detail later. All the evidence of the projects in building hospitals is that they have come in as better value for money than was achieved under the old regime. I would not say that was contributory to higher inflation.
Mr Balls: If I can give you just one example on the education side. In the national accounts at the moment education output is measured by pupil years, the number of pupils you teach per year, so if you have more classroom assistants or smaller class sizes that does not show up in any way as an increase in output or productivity. That counts as just higher costs. If you have better test results and better success that does not come in. Also, on your point about non wage costs, if you take all of the

improvements in school buildings all around the country in the last six or seven years, all those new buildings do not count as output either because it does not affect the number of pupils who are in the schools. The fact the schools are better equipped, they have got facilities, are safe to be in and clean, that does not count at the moment in the way in which output is measured. It is clearly a pretty perverse way of measuring the output of education. What we are trying to do with this review is independently to get to a better measure of output rather than all those things which we know are real improvements simply being counted as inflation which is just a ridiculous way to go about it.
Mr Brown: I hope the Committee will be able to take an interest in the progress of this review. It is clearly important, whatever the partisan nature of the politics, to have the best measures possible in public sector productivity.

Q346 Mr Beard: The planned increase in spending of the National Health Service is 7.1% and in education 6%. How is that going to affect the increase in spending in other departments? How will it affect or constrain spending on transport or defence if those are to persist?
Mr Brown: The settlement that we made last year when we raised National Insurance to pay for the National Health Service was that health service expenditure would rise by 7.5% in real terms each year to 2008 and that is built in to all the figures that we have produced for this Committee today in the Pre-Budget Report. The assumption on which the spending review is based for other services than health is 2.5% growth in current expenditure and that will form the basis of the discussions around the spending review. We have given the cash figures now.

Q347 Mr Beard: Is it, as we move towards the end of the cycle, becoming more and more difficult to control public expenditure than it was?
Mr Brown: I think it is always an issue that you want to have the best controls over public expenditure. I think having broken from the annual cycle, which was a very disparate set of relationships between Treasury and departments in the past where departments tried to spend money in the last month of the year simply to use up the money, and where annual spending arrangements were made which in capital investment terms were never really kept because people did not believe from one year to the next that if a roads project was agreed it would happen because something would come in in the middle which would say that this had to be cancelled in favour of spending on defence or the health service or some other issue which arose, we have kept fairly well to our three year plans with departments. I think the pressures on the reserve have been mainly issues relating to overseas matters and to the fight against terrorism and I think our investment plans—and we had this conversation with Mr Mann earlier on about that—are now moving ahead, although there had been a culture in departments which did not expect that if you announced an investment it would actually necessarily happen. That has changed and I think we are moving forward now.

Q348 Mr Beard: Chancellor, moving to the PSA targets, on page 144 of the Pre-Budget Report it says: "This Pre-Budget Report announces the abolition of service delivery agreements for the 2004 spending review removing over 500 lower level input and output and process targets". Does that mean that there are fewer national targets or fewer targets overall?
Mr Brown: There are fewer targets overall. The general move was after a period in which it was essential, if we were going to break from what people used to call postcode lotteries that we set national standards. We want to give local managers, as we said, increased flexibility to determine outcomes and be accountable at a local level. Certainly input and process targets that we have for a period of time, actually mainly not the Treasury had but departments had for a period of time, are of less relevance as you move forward with these public investment proposals and the greater flexibility for local managers will be a feature of the spending review when it comes out in the next few months.

Q349 Mr Beard: Does this greater flexibility for local managers not mean that they will be setting local targets and, therefore, they will have to be monitored and there will be more people doing the monitoring at local level than now?
Mr Brown: That may or may not be the case. I think what is going to happen is there is going to be a greater demand for more information to be published at a local level so that people can see for themselves what is happening to a local service. I think a lot of people have been influenced by the experience in New York where real time accountability takes place, where police results are published almost on a weekly basis and on such a regular basis that people can see at first hand what is happening in terms of results and outputs and everything else. I think increasingly people will look at the local hospital and the local education authority and want to see in real time what is actually going on and what results have been achieved. It was necessary for the first stage of our public investment programme that people saw that we were breaking from the postcode lottery syndrome of the past but clearly the more local flexibility and the more local accountability there is the better it is for everyone.

Q350 Mr Beard: Chancellor, why in your view is now the right time to switch both the measure and the target for inflation?
Mr Brown: The reason that we are switching the inflation target is that we believe the new target is a better measure of inflation. We said in 1997, funnily enough, that we would consider this but thought that while the new Bank of England arrangement

was being established we should stick at that time with the measure which was known and well understood. We always said in 1997 that we reserve the right to come back and look again at what the inflation target should be. Now there are distinct advantages to us in having an internationally comparable measure but there are also distinct advantages to us in having a measure that is far more comprehensive in the way it includes different groups who spend money in the British economy and it takes into account the real spending patterns of people rather than the theoretical spending patterns of people, so what is called the geometric rather than arithmetic measure is a better means of judging inflation as we move forward.

Q351 Mr Plaskitt: There is the argument about which is the better measure but why change it now, why not last year or why not next year?
Mr Brown: Since 1997 we have always said that we would look at changing this inflation measure. I think if I am right to the House of Commons in October 1997 when I brought the first report on the euro I said we were considering changing the inflation measure for good reasons of British economic policy as well as an interest in having the same inflation measure as the euro area.

Q352 Mr Plaskitt: There is always an argument for having a better measure of inflation and the more accurate measure of inflation but you had the choice of when to make the change.
Mr Brown: Yes.

Q353 Mr Plaskitt: You have chosen to make the change now. Was there something in particular about the latter end of 2003 which made this the right time to make that change?
Mr Brown: It was that we said at the beginning in 1997 we should give the new system with the Bank of England, running an independent assessment of interest rates based on inflation targets set by the Government, time to bed in, establish credibility. I do not think anybody now is in any doubt that that has been a good system for Britain. It has established a legitimacy and credibility that is widely respected and, given that we had considered in 1997 moving to a new inflation target but thought it was better not to disrupt at that time the existing arrangements, this is as good a time as any to move to the new inflation target.

Q354 Mr Plaskitt: The CPI itself is likely to be reformed in the way it is calculated shortly. Was there not a case for waiting until that reform was completed?
Mr Brown: I think that is a very interesting point and I am grateful to you for raising it to give me the chance to deal with that. It is clear that internationally people have found difficulty in measuring for inflation purposes the effects of housing and the costs of mortgages. What has been sought for in the euro area but also more generally is an acceptable and incredible way of measuring that. The truth is that the retail price measures that we have in Britain were not good ways of measuring that. The truth also is that they are finding it very difficult to get to a solution. I cannot give you the date on which they are going to reach a solution on this and, therefore, simply to delay in the hope there would be a new announcement in two or three years' time or one year's time would not have been appropriate.

Q355 Mr Plaskitt: At the point where you made the change on the old measure, RPI, inflation was at or slightly above target. At the point where you made the change to the new measure it produced an inflation rate considerably below the target. Does not the change in the measure and the target amount to a loosening of monetary policy?
Mr Brown: I think you have to look at the position not as it is today in terms of the difference between the CPI and the RPIX today, you have got to look as the Bank of England will tell you, as they reported in the previous inflation report, that the relevant comparison is what will be happening two years ahead. They will be setting interest rates based on their assessment of what is the likely level of inflation two years ahead. Interestingly enough, the 2% of the CPI and the 2.5% of the RPIX come together so two years ahead CPI is expected to be 2% and RPI is expected to be 2.5%.

Q356 Mr Plaskitt: Nevertheless it was still the case that on the day the switch was made the Bank was driving towards one target and was bang on it and then suddenly it was driving to another target and it was off it. Will that not have an impact on the decisions the Bank makes over the next few months about the appropriate interest rate to deliver the now 2% target?
Mr Brown: I think that is for the Bank to comment on but it is a perfectly manageable process as Professor King, the Governor of the Bank of England, has said. It has the added advantage that it is an internationally recognised measure of inflation.

Q357 Mr Plaskitt: The Bank has commented on it. Mr King says you have moved the goalposts.
Mr Brown: No. He did not actually say that and I think that was corrected by Mr Healey, our Minister, when this was debated in the House of Commons. What he said was he had to deal with the perception that people may feel that the goalposts have been changed, he did not himself believe that. Remember, so we are dealing with this in a way that the people will understand, the Bank of England looks two years ahead, that is how they say they look at things, and two years ahead both the CPI and the RPIX are on target. It is hardly a disruptive element for monetary policy making if that is the case at the moment.

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Q358 Mr Plaskitt: I am afraid it is back to football because Mr King was reported in August as saying "When defending a free kick from David Beckham you do not expect someone behind you to move the goalposts".
Mr Brown: What he actually said was it will not make very much difference to monetary policy at present because looking ahead two years we will see the difference between the two measures around half a point, two to 2.5%, which is the sort of order of magnitude of the change in target that many of you discussed. I think the Committee's feeling is looking ahead two years or so a change in the target is not likely to be a big factor in setting monetary policy. I repeat what he said about football—and of course he is a very big supporter of Aston Villa football team so he knows about what happens between the goalposts, usually, goals being scored against that team—

Q359 Mr Ruffley: They won last night.
Mr Brown: They won last night and they are through to the semi final, if I am right, in the Carling Cup. The fact of the matter is that he was talking about the perception then, not about the realities.

Q360 Mr Ruffley: It is an issue.
Mr Brown: I think it is true to say that Aston Villa are second bottom of the league.

Q361 Mr Plaskitt: In Benefits Agencies up and down the country you have staff administering changes in the rates of benefit being paid and they are working to RPI, as you said in your Pre-Budget statement. You are expecting the wage negotiators in the unions to be looking at CPI not RPI. Will that work, having the two rates of inflation going at the same time?
Mr Brown: We were intent not to disrupt the way pensioners saw the social security benefits or the pension rise and so it is on the same basis. There is no doubt if we think the better measure of inflation in the economy is CPI at 2% then it is right for us to inform people throughout the wage bargaining system that we believe that is a better measure of the inflation that is happening in the economy.

Q362 Mr Plaskitt: Do you hope that by switching to CPI you can slow the rate of wage growth in the public sector?
Mr Brown: I think when we made our decisions that led to the Bank of England becoming independent, one of the problems that we had seen in the British economy—I do not think there should be any party difference on this—was that what used to happen in the British economy which was the cause of the extreme cycles that we had was you would have a burst of inflation for one reason or another and then people would try to catch up with that so you would then have a second burst of inflation through wage negotiations when people did not expect that inflation would be 2.5% a few years down the line, they expected it was going to be 5%, and negotiated according to that basis. We had this British problem where inflation rose, wage negotiators got it into their head that inflation was going to rise even more and wage negotiators negotiated far higher rates of inflation than were even existing in the economy at that time. Since 1997 people's expectation of inflation is 2.5% under the RPIX so people think that the Bank of England will meet its inflation target and I think that is the major difference affecting wage negotiators since 1997. Whereas forecast five years on for inflation before the Bank of England was made independent, whether even with a 2.5% or less target, inflation was actually going to be 4.5% five years down the line, now people see that inflation with a 2% target, as it will be, will actually be inflation hitting 2% down the line. I think that is what should influence people as they look at wages. Now of course pay is set to recruit, retain, motivate and these are factors which have to be taken into account but I think when wage negotiators know that an inflation target of 2% is a target which will be met then some of the problems that have bedevilled the British economy in the past, people trying to catch up thinking that inflation is going to be much higher than even that reported at the time, can melt away.

Q363 Mr Plaskitt: A final one. Of course the expectation is important but if the expectation moves down from 2.5 to two, does it not follow, and are you anticipating, that the nominal level of wage settlements, certainly in the public sector, will also take a step down?
Mr Brown: Let us wait and see because I am not being prescriptive in announcing a pay policy. What I am saying, however, is that the best measure of inflation that we have got and we are working to is one which suggests that working to an inflation target of 2% and achieving an inflation target of 2% is what is good for Britain.

Q364 Mr Mudie: Chancellor, the big question for me today is where the hell is Gus O'Donnell because I had looked forward to meeting him today because we had a spirited discussion on your revenue forecast last year and he pinned himself to certain figures that proved wrong and I was looking forward to meeting him. Where is he? He is otherwise engaged, is he?
Mr Brown: He is running the Treasury. He is Permanent Secretary. I am sure that if you have specific questions for him to answer he will be very happy to answer them.

Q365 Mr Mudie: I am sure he will but I just want an assurance from you. I had a similarly spirited discussion with Mr Cunliffe and Mr Lewis.
Mr Brown: They have returned.

Q366 Mr Mudie: They have pinned themselves to figures and I have promised to see them in three months if God spares us all. Can I have your assurance they will be here?

Mr Brown: If you demand it, Mr Mudie, they will be here.

Q367 Mr Mudie: I shall demand. I would like to go through something. When you were last before us we both got into hot water because I raised foundation hospitals, which was not well received in some quarters, so I thought I would be uncontroversial today and have a trawl through university finance but I have given that a go today.
Mr Brown: You will disappoint your admirers.

Q368 Mr Mudie: Pardon?
Mr Brown: I am joking.

Q369 Mr Mudie: Child poverty. I think that is a great target and I think we are going well with it. I would just like to go through with you in terms of how do you compare, if you like, your strategy with child poverty, in other words helping with the poorest child and targeting that with the sort of approach you have done with pensioners where you have specifically targeted the poorest for the first six years and it has had an amazing effect? I am not sure I detect the same specific targeting. I see a great deal of money going into child poverty but not necessarily targeted as specifically as you do at pensioners.
Mr Brown: I think the principle underlining our approach to children is that every child should be recognised in the tax and benefit system and, therefore, we should have a decent level of child benefit and, therefore, there is a minimum that is universal below which nobody should fall. In addition to that universal minimum we should have more money available for those who need it most and when they need it. I think you will find that the two elements of our policy, certainly where there are lower income families, are we are able to provide more in terms of the child tax credit but equally at the time that considerable expense is having to be laid out for the first time when the child is an infant, nought to one, there is more money available then as well. So there are two elements of the children's policy as far as getting money to people who need it most, it is more money for those people who are poorer and equally more money for those when they need it most which is at that very young age. If you look at the actual figures, the child benefit is just over £16 a week, I am right to say. With the family element and the child tax credit, most families, five million or so, nearly six million, will be getting £27 or more. Then the poorest child, that is the mother of the poorest child, she will be receiving £54 for that child, so not £16 or £27 but £54 and for a child, nought to one, in that first group with all the maternity allowances and the help, the maternity grant that is available as well, it could be as much as £100 a week for the first year for that child. It is a policy which recognises the needs of poorer families but also recognises the needs of people who are very young.

Q370 Mr Mudie: When you say maternity, that implies one of the parents at least is in work.
Mr Brown: No.

Q371 Mr Mudie: They tend not to be the children in severest poverty, those are usually ones where no parent is in work.
Mr Brown: Can I just come in to correct that. You are right, maternity pay can only be paid to those people who have been in work but the maternity grant, the £500, is paid to any mother irrespective of whether she has been in work or not. It is a one-off payment which is worth about £10 a week.

Q372 Mr Mudie: I just want to take you away to just see your thoughts and where you are going on it. You see with pensioners I think there is no alternative, I do not see, other than you rescuing proper pensioners from poverty because certainly as they grow older, the work opportunities, the physical opportunities, mean that they have to look to you for help. One of the things which worries me is should we be giving—I am not saying we should not be giving—there is a choice in terms of how to move children out of poverty and one of the choices is how do we spend the money, do we give it to a parent or do we transform that into enabling that parent to move themselves out of poverty off benefit and a different lifestyle?
Mr Brown: Absolutely.

Q373 Mr Mudie: You put a billion quid into this. Did any debate take place within Whitehall as to whether it should have gone in as an increased tax benefit or would it have been better targeting maybe even more funds into the New Deal for unmarried mothers or single parents, etc?
Mr Brown: It is getting that balance right. You are absolutely right we have got to get that balance right because in the end what we want to ensure is we have families where someone or in some cases two people are earning sufficient money that they are able to bear the costs of bringing up the children with the support of the state but not really dependent on the Government. We are encouraging more people to move into jobs. There are 200,000 lone parents who have moved into work since we came into power and half of them have benefited, as I understand it, and would not have gone into work had it not been for the New Deal for lone parents. If that lone parent goes into work, even if they are working part-time, that is 16 hours or just over 16 hours, they could be £50 to £100 a week better off so the rewards for work are higher than they have ever been as a result of the integration of tax challenges.

Q374 Mr Mudie: Chancellor, was consideration given to using that million rather than giving it as a tax benefit to pump priming policies and initiatives to persuade them?

18 December 2003 Rt Hon Gordon Brown MP, Mr Ed Balls, Mr John Cunliffe, Mr Nicholas Holgate, Mr Andrew Lewis and Mr Jonathan Stephens

Mr Brown: We are doing both, if I may say so. In the Budget we announced that we would have a new scheme to help lone parents get into work where for the first year they are at work in certain circumstances we pay them an extra £40 a week. So we are giving them an incentive to get back into work and giving them extra money and we are paying for that money from the New Deal. Equally from last week I was able to announce on child care, which matters to that group of people who want to get into work but are worried about whether they can meet their responsibilities to their children at the time they are working, an initiative on child care grant. An employer can give £50 a week free of tax and the individual who receives the £50 does not have to pay tax on it as well if it is used for registered child care. At each point we are looking at the relative balance between the incentives for work that we can give and the help. I believe we have got a duty to every child in the country.

Q375 Mr Mudie: I understand all that and I applaud all that but I am specifically coming back to the institutional point. We used to believe in joined up government, it seems to have disappeared from our recovery in the last two or three years. Is there a committee set up operating across departments which deals with children's issues?
Mr Brown: Yes.

Q376 Mr Mudie: So that there is a pooling of money, pooling of ideas, pooling of initiatives, an integration of ideas and which department takes the lead on that?
Mr Brown: There is a committee on children which you may or may not agree is the right thing to do that I chair. I work with David Blunkett at the Home Office who has also taken a very big interest in this.

Q377 Mr Mudie: Keep him away from it.
Mr Brown: Equally the key departments are the Department of Work and Pensions and the Department for Education and Skills. The new strategy for children, there was a Green Paper on children's services, is trying to integrate many of the services available to children. Child care is increasingly an important part of this but so too are the children centres that we have announced and the very fact that we could have every young child of three and four in nursery education now is a considerable advance because all the evidence is that what happens in the early years of a child's life is going to have more influence on the potential being realised than what happens later.

Q378 Mr Mudie: This is a question you will probably not answer but did you take your suggested child tax benefit, a billion quid, to that committee and have any discussion about priorities? Did anybody dare argue that they could use it better or did you just decide?
Mr Brown: There is a regular exchange of views but on this we were all committed as a Government to meeting that target in child poverty. It was not a question of us having to decide whether or not to meet the target, we wanted to meet the target and that was a decision of Government collectively.

Q379 Mr Mudie: Can I go on to housing now. In your very first sentence to the Chairman you mentioned about house prices moderating. I just want to know what exactly you mean by moderating. I want you to tie it to Kate Barker's "Sharp house prices in almost all parts of the UK fuel concerns about affordability" Can you just say a few words about the definition of moderating in the context and also her view on affordability? Are they in different time contexts?
Mr Brown: We are talking about what happens over the next year or two and we are talking about house prices, when we say moderating, the growth rate slowing down. We do not make predictions about particular percentages here. What Ms Barker is talking about is the long term challenge of the housing market where demand outstrips supply and she is talking about a real terms rise in house prices over 30 years, under all governments, over these 30 years of three times as much as Germany and France. House prices have risen faster in Britain. There has been more volatility in house prices in Britain and there is a problem about both supply and perhaps, as Professor Miles is looking at, the nature of the mortgage market as well. She has identified a number of issues already in her interim report on the planning side and we talked about that earlier. She identified also a gap in the private rented market and we said in the Pre-Budget Report we would look at this question of whether the tax incentives available to individuals should also be available to real investment on property development investment trusts. She will report finally in the Budget. It is undoubtedly the case that a lot of the stop-go problems that the economy has had over the last 40 years have been influenced by what has been happening in the housing sector and we really want to get to the bottom of some of these issues.

Q380 Mr Mudie: A man with a wonderfully Scottish name, Tom McPhail, you will remember the great Celtic player of that name, from Hargreaves Lansdown, I would like to quote what he said. "It is hard to reconcile the Chancellor's stated ambition of controlling the housing market's disproportionate influence on the economy with a proposal that will allow billions of pounds of pension fund money to wash into the housing market". The question arising from that is does this move not risk reigniting house price inflation?
Mr Brown: I think that is wrong, actually.

Q381 Mr Mudie: Mr McPhail is wrong, is he?

Mr Brown: Yes, despite his name. What I think we are looking at is a very particular issue that the private rented sector in Britain is very low, it is far lower than in Germany, France or America. To some extent what happened a century ago the private rented sector was very big, there has been a century in which it has declined I think to less than 10% of housing. We are looking at how you can get more money. In fact, there is a broad consensus. In fact, Shelter, I think, has issued a report saying it is necessary to get more incentives into the private rented market so that we can have more private rented housing available and we are looking at how it can be done. We have not committed ourselves either to billions of pounds of incentives or to expecting there will be billions of pounds of property investment by pension fund companies.

Q382 Chairman: Two questions, Chancellor, before we wind up. Just to add to the one by George on the housing market. You have attached a high priority to reforming the UK housing market. Given the rate at which people switch mortgages how long will it take in your opinion for a substantial move to fixed rate mortgages in the UK? The second point on that is how long do you expect it to be before any reform produces a detectable difference in terms of smoothing the operation of the macro economy?
Mr Brown: These are very big questions. The reason I cannot give you a full answer is we have asked Ms Barker and Professor Miles to look at these issues and report to us. I am hoping that we will have quite detailed reports by the time of the Budget and I hope the Committee, which has obviously taken an interest in the credit card market, may wish also to take an interest in the mortgage market. Professor Miles' report will be available for people to look at.

Q383 Chairman: Okay.
Mr Brown: I am not going to draw conclusions at the moment but I think the Committee will want to look at what will be quite interesting reports.

Q384 Chairman: You will be spending on your credit card over Christmas?
Mr Brown: I am very prudent in all things.

Q385 Chairman: Okay. Chancellor, you may know that the Committee will commence an inquiry into regional productivity in the New Year.
Mr Brown: Yes.

Q386 Chairman: Our experts have told us that the productivity gap between the UK's best and worst performing regions is similar to that between West Germany and East Germany and the UK has the greatest variation in regional productivity in the EU with productivity accounting for 60% of these differences. How important is it to narrow that gap?
Mr Brown: It is and we have a document on regional productivity that was published in 2001, perhaps the Committee may wish to look at that and interview some of the people who did that report and are now building on the work. It is important, of course, if we are going to have balanced economic growth in this country, that every region works to its fullest potential. I think some regions with the help of Regional Development Agencies and with the help of new policies could achieve more.

Q387 Chairman: Our advisors say that the UK has the greatest variation in regional prosperity in the EU. Do you recognise that?
Mr Brown: I think that was in our document.
Mr Balls: In the 2001 document we showed that if you move from the level of the region to the sub-region, which is called NUTS 2 in classification terms, we have greater variation at that level in the UK than in any other country in the whole of the European Union of the 15. It is in our document of 2001 that there is greater sub-regional variation in the UK than anywhere else, including Italy.

Q388 Chairman: Okay. Can I thank you, Chancellor, for your appearance this morning and say to my colleagues and yourself and the public have a Merry Christmas.
Mr Brown: Thank you very much. I hope you all have a Happy Christmas.

Written evidence

Memorandum submitted by the CBI

(A) THE PRE-BUDGET REPORT IN ISOLATION

Tax initiatives

1. The CBI welcomes the following measures or potential measures:

— Extension of the R&D tax credit to include the direct costs of software and power.

The following measures to improve conditions facing SMEs and entrepreneurs:

- — New Enterprise Capital Funds, to tackle the equity gap for investments of up to £2 million.
- — The increase in the number of firms eligible for enhanced first year capital allowances.
- — Enhanced income tax relief for Venture Capital Trusts and higher annual investment limits for both these and for the Enterprise Investment Scheme.
- — The review of the Small Firms' Loan Guarantee Scheme.
- — Lower rates for the VAT flat rate scheme, and simplified administration, for start-ups.
- — The increase in the statutory audit threshold.
- — The publication of proposals to simplify pension schemes, and the decision to invite the National Audit Office to look into the effect of the proposed £1.4 million lifetime cap.

The following measures in the environmental tax area:

- — Extension of the scope of the climate change levy discount.
- — The 80% discount in Northern Ireland from the aggregates levy, until 2012.
- — Confirmation of consultation on how landfill tax revenues will be recycled to business.
- — The three year "certainty period" for "alternative fuels"' enjoying a duty differential (though the CBI would have preferred a five year period).

Enhanced tax relief for new companies engaging in North Sea exploration.

— The ability of local authorities to share in additional business rate income, potentially rewarding "business-friendly" councils.

— The employee and employer tax relief for employer-funded childcare.

— The new 100% capital allowance for renovation of vacant commercial premises in the 2000 Enterprise Areas.

— The possible introduction in future of "real estate investment trusts", following the publication of Kate Barker's report on housing supply.

2. The CBI is, however, concerned about the following issues:

— The threat that, if the NAO finds "against" the Chancellor on the lifetime cap, the whole pensions simplification project would be abandoned.

— The application of transfer pricing rules to within-UK transactions on same basis as international transactions. This will result in significant additional administration costs for business.

— The surprise re-emergence of the proposal for a spirits industry stamping scheme. If enacted, this is likely to add significantly to the legitimate industry's costs. A voluntary approach to tackling fraud should be attainable and would be far preferable.

— The possibility of a change in the basis on which dividend income is taxed, in the case of owner-managers of small incorporated businesses.

— Other measures described as "protecting tax revenues" (eg rules relating to VAT and to the Construction Industry Scheme). The CBI of course fully supports the Government's efforts to clamp down on evasion, fraud and other clear abuses. We will nevertheless wish to examine what is proposed in detail, to make sure that unintended consequences for genuine, legitimate business activity are kept to a minimum.

3. We also believe that the PBR was a missed opportunity in some respects. On what is probably the most pressing issue of the day, we would have liked to have seen an indication of a more fundamental change of approach to pension provision, with consideration given to greater fiscal incentives and/or reduced disincentives. Reduction or elimination of insurance premium tax, in the case of businesses' insurance policies, is also clearly justified on grounds of economic principle, as well as making a small but welcome dent in the high cost of cover. And for SMEs, the CBI is again disappointed at the lack of action on: the unfair rules governing the corporation tax treatment of "associated companies"; the unfair tax treatment

of the incidental costs of raising equity finance; and the tax treatment of equity investments in smaller quoted companies, which are generally disadvantaged compared with their unquoted counterparts. Extension of the 100% ICT allowance, beyond 31 March, would also have been beneficial.

Spending allocations and initiatives

4. The CBI welcomes the following initiatives:

In the area of spending reform and efficiency:

- The review of procurement processes, to be headed by Alan Wood of Siemens.
- The new framework for the achievement of cost savings in transaction services, back office services and procurement processes.
- The abolition of many targets.
- The proposed relocation of 20,000 civil service jobs from London and the South East.

The extension of the employer training pilots to a third of the country.

Economic forecasts and the public finances

5. The Chancellor's forecast for GDP growth is very close to the CBI's (2.0%) for 2003, but is a little optimistic for 2004 and 2005 compared with ours (2.8% and 2.7%).

6. On government borrowing, the Treasury's projections are more realistic than previously, though borrowing still falls a little more sharply than in the CBI forecast (CBI: 2.9% of GDP in 2004–05 and 2.7% in 2005–06). We believe that the Treasury is quite right at this point in the economic cycle to avoid major tax increases, and instead allow borrowing to take the strain. However, we note that the policy stance has changed significantly in recent years: the latest forecast of a £37 billion deficit can be clearly contrasted with the forecast deficit of just £1 billion when the Treasury projection for the current fiscal year was first made five years ago. And we believe that it is far more likely than not that a sizeable discretionary fiscal tightening will be required in due course—if not in the present economic cycle (or in the present parliament), then in the next.

Other initiatives

7. On the change in the inflation target, HICP has some advantages and some disadvantages compared with RPIX. We would, however, be concerned if the timing of the move added to the difficulties faced by the MPC in setting and explaining their interest policy over the coming months and years.

8. We also note that the change amounts to a slight relaxation of the inflation target, of perhaps 0.2 percentage points. In the short term, this may allow the MPC to set interest rates marginally lower than they otherwise would. But there is no reason to believe that the change of target will in itself affect the "neutral" level of real interest rates. Over the very long-term, the average level of real interest rates can be expected to be no different under the new regime, so inflation and nominal interest rates will average some 0.2 percentage points higher than they otherwise would. As the tax system does not allow fully for the effects of inflation (with eg income tax levied on nominal interest payments, and inflation allowed to erode the real value of capital allowances), the Exchequer should ultimately gain from the move, even if benefit payments and tax thresholds continue to rise in line with the RPI.

9. On housing, we welcome the Barker Review which recognises the problem of housing supply and the part played in that by planning restrictions, and hope that appropriate policy action will result. We also welcome the possibility of "real estate investment trusts". But we hope that neither the Barker nor the Miles review will result in any new tax on the property sector, nor in any unnecessary regulatory intervention in the markets.

10. Following the Allsopp report on statistics, we hope that a set of useful regional statistics can be developed, and that these can be used amongst other things to help in the drive for greater pay flexibility in the public sector. But it is vital that any resulting compliance cost for business is not disproportionate.

(B) Views on the Direction of Fiscal Policy

The overall approach to spending, borrowing and taxation in the current parliament

11. The CBI has welcomed the extra government spending allocated to the transport infrastructure, training, education, scientific research and other expenditures improving the economy's long-term growth and competitiveness.

12. Otherwise, we have some concerns about the increasing share of government spending in GDP, or more precisely, the consequences for the wider economy of the need to finance that policy:

- The increase in the overall tax burden already seen will be hindering UK competitiveness and may be curbing the incentives to work and save.

— The increases in spending on means-tested benefits and tax credits may be further undermining these incentives.

— The obvious possibility of further tax increases at some point in future is a threat to consumer and business confidence today.

— The increase in the government's share of activity and employment necessarily means a smaller share for the market-driven private sector. To the extent that the latter is potentially more productive, average productivity across the economy will be held back.

— "Crowding out" of productive business investment could also become an issue as the global and UK recoveries gather pace, though for the time being there are many other factors holding back this investment.

The increase in business taxation since 1997

13. A significant proportion of the net tax increase caused by Budget action since 1997 has fallen on the business sector, including investors in business. We believe that this is not justified:

— On a long-term view, as taxes levied on business are likely to impact disproportionately on investment rather than consumption, and can distort decisions about the production process.

— Especially over the past few years, when the industrial sector was being fiercely squeezed by other factors, while households' ability to borrow and spend grew rapidly. The shape of tax policy has, in other words, exacerbated the imbalances in the UK economy.

The general shape of business tax policy

14. In the most recent years, the focus of business taxation has shifted away from taxes on profits, towards taxes unrelated to profits and thereby adding to the business cost base (eg employers' national insurance, and transport, "green" and property taxes). This is a concern because taxes unrelated to profits can:

— make some otherwise viable businesses and activities unviable; and

— be more economically distortive than taxes directly related to profits.

The increased use of targeted tax incentives and disincentives to achieve specific policy goals

15. Tax policy under the present Government has been marked by the much greater use of fiscal policy to achieve specific policy goals, aside from simply raising more revenue to pay for public spending programmes. Key examples include:

(i) Tax incentives as part of the "meeting the productivity challenge" policy agenda.

(ii) Tax disincentives to achieve environmental policy goals.

(iii) Tax credits to reward and help workers in low-paid jobs.

(iv) Tax credits to help with the cost of children and childcare.

(v) New benefits and means-tested tax credits to help low-income pensioners.

16. Of these, (i) and (ii) have the most bearing on business. In principle, the CBI accepts that tax incentives and disincentives may be the best way to achieve some policy goals; we are by no means opposed to them per se. We would however stress the following points:

(i) The government should not neglect other, ultimately complementary, objectives.

(ii) Tax policy should be based on the principle of "neutrality": the system should not favour one type of activity over another, except to correct a clear "market failure".

(iii) The government should maintain a tax system that is relatively stable, does not add unnecessarily to complexity or compliance costs, and confers certainty on all affected.

(iv) Tax policy should be consistent, both in its objectives and in its implementation.

Attention to other, ultimately complementary, objectives

17. Improving UK productivity will require, amongst other things, greater investment in fixed and intangible assets. But that requires:

— An adequate incentive to invest, in turn provided by after-tax profitability.

— Ultimately, sufficient funds at the national level, in turn dependent on business, household and government saving (although in the short term net overseas investment into the UK can make up for a domestic savings shortfall).

18. And this in turn means that:

— Any tax adding to business costs, or any other policy reducing after-tax profitability, can work against the objective of raising UK productivity, unless the revenues are specifically returned to business or otherwise used for investment purposes. By the same token, tax cuts partially reversing

recent increases in business costs—such as employer pension provision or insurance—should not necessarily be viewed as a "worse use" of Treasury funds than tax cuts more obviously related to the productivity goal.

— The same principles apply to fiscal measures affecting the reward to save. In general, policy has reduced the reward for saving in recent years (abolition of dividend tax credits, extension of means-tested state retirement benefits, proposed lifetime cap on pension funds, widening of the inheritance tax net, etc). A reversal of this policy direction would be welcome, even if it "used up" revenues otherwise available for alternative tax reductions.

The principle of "neutrality"

19. The "default" tax system should involve a wide tax base with no "special" allowances, while also being even, with no specific activities or expenditures penalised. By minimising distortions in the choice of activity, this simple system would be entirely consistent with the goal of maximising economy-wide productivity. "Targeted tax incentives", as well as taxes on specific activities, are departures from this framework and so need to be clearly and objectively justified.

20. By and large, the CBI believes that the targeted incentives introduced by the Government so far can be justified objectively:

— The case for R&D tax credits is based on the clear economic rationale that without a policy incentive, the return to the developer would fall short of the return to society as a whole, leaving "too little" R&D to be carried out. Cash flow considerations, and the fact that most other countries have positive R&D incentives, provide further justification.

— Cash flow considerations can justify what might otherwise be regarded as "concessions" for SMEs.

21. However, one clear danger with this approach is that the greater the number of targeted tax incentives, the more likely it is that misjudgements will be made, resulting in inefficient activities being positively encouraged over more efficient alternatives.

Stability, certainty, complexity and compliance costs

22. The second danger with the Government's approach, of shaping and reshaping the tax system to achieve various policy goals, is that it complicates the tax system, adds to administrative costs and renders the environment for undertaking business less certain. CBI members have become increasingly concerned about these policy effects in recent years.

23. Where targeted tax incentives are introduced, the Government must be clear not only that the change is justified on the grounds of economic principle, but also that the benefit will clearly offset all related costs, including the cost of complexity and compliance. We hope that the Government will continue to carry forward the model of consultation.

Inconsistency in policy

24. One further, but crucial, concern is the apparently inconsistent approach of the Government as it reshapes the tax system. While it has recognised the case for specific tax incentives in some areas, to offset "market failure", it insists on maintaining and even extending specific tax disincentives in other areas, even where these are themselves a cause of "market failure".

25. Here, we note the increased dependence on various stamp duties, culminating in the recent rise in duty on leased business property. We do not understand why the Government accepts that a rise in productivity resulting from extra research spending is worthwhile and deserves to be encouraged by policy, yet apparently believes that the same rise in productivity resulting from relocation within the UK is not so worthwhile and deserves to attract a specific tax penalty.

26. The Government's approach to savings is also difficult to understand. The policy of successively reducing the reward for saving not only runs counter to the stated goal of increasing private saving, it is also at odds with economic principle. "Neutrality" in savings is achieved by a "pure" version of the traditional UK approach to pensions, with savings made out of pre-tax income and returns building up within the fund free of all tax, but tax levied on the final value when it is withdrawn. The "pure" approach to ISAs, where savings are made out of after-tax income but all returns are tax-free, also achieves "neutrality". It is therefore incorrect to view the Government's approach as one of removing "unwarranted tax breaks". Policy has, rather, been to move away from "neutrality", back towards the "double taxation" of saved income.

December 2003

Memorandum submitted by Mr Robert Chote, Institute for Fiscal Studies

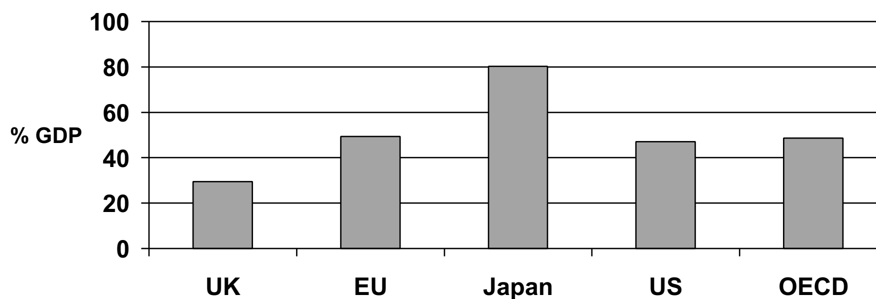
THE PBR AND THE PUBLIC FINANCES: A PRELIMINARY REACTION

Gordon Brown conceded in his Pre-Budget Report that government borrowing would be around £10 billion higher this year than he predicted in April's Budget, even though economic growth is roughly in line with the forecasts he made then. Adjusting public sector net borrowing for the state of the economy, the underlying fiscal position in 2003–04 looks weaker than at any time since Mr Brown became Chancellor.

But even without explicit tax raising measures or reductions in spending plans, the Treasury expects the structural position to improve significantly over the next five years. It argues therefore that Mr Brown's fiscal rules are met over the current economic cycle and that he is on course to meet them over the following cycle. It is reasonable to ask if this is a prudent judgement to make.

It is worth stating at the outset that in no fundamental sense is there a crisis in the public finances. By international and historical standards, public sector net debt is modest and not increasing explosively. Financial markets are not concerned by the prospect of default or of resort to inflation to reduce the burden of the debt.

General government net debt (2003)



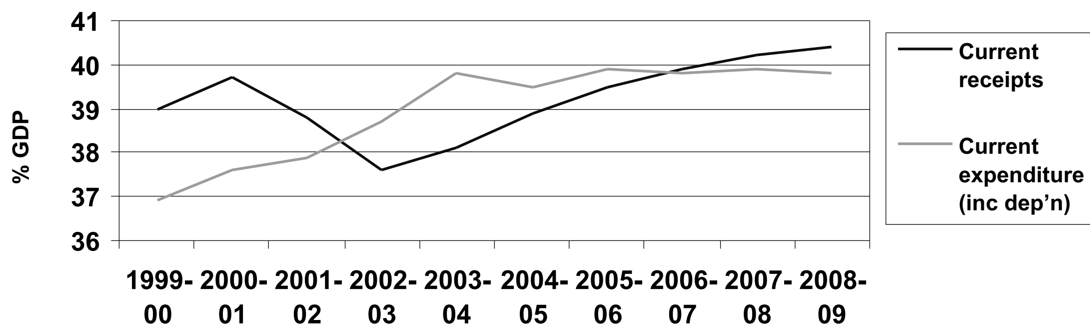
But we also have to assess the public finances against the more stringent benchmark of the rules that Mr Brown set himself under the Code for Fiscal Stability in 1998:

— The golden rule states that the government should only borrow to invest. This implies that tax revenues should equal or exceed current (or non-investment) spending. Sensibly, the rule does not have to be met every year, only on average over the ups and downs of the economic cycle.

— The sustainable investment rule states that public sector net debt should be kept at a "stable and prudent" level, currently defined (pretty arbitrarily) as no more than 40% of national income. This constrains the debt-financed investment the government can undertake, although it can also sponsor investment through the Private Finance Initiative without adding to net debt.

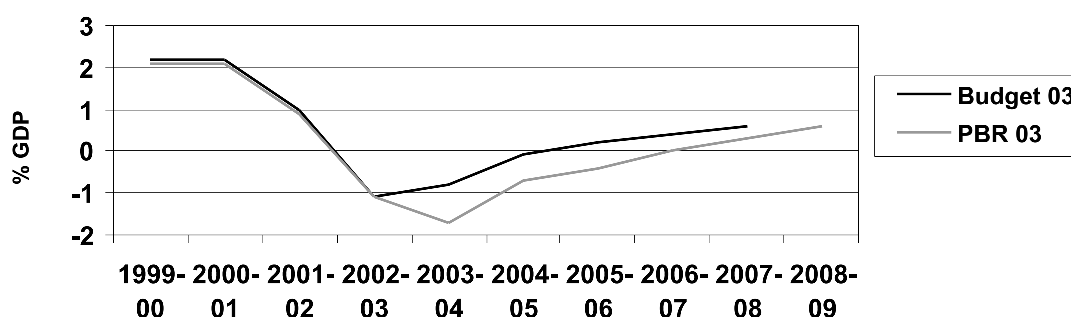
With public sector net debt currently below 33% of national income and public sector net investment planned to only to rise to 2.2% of national income in the medium term, the golden rule currently appears the more binding.

Current expenditure and receipts

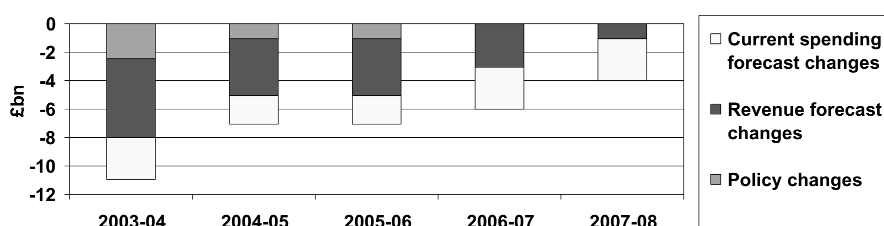


We calculate the current budget balance by deducting current expenditure and depreciation from current receipts. In the Budget the chancellor predicted that the current budget deficit would be at its deepest in 2002–03 at £11.7 billion, recovering steadily thereafter. But rather than shrinking by 30% to £8.4 billion this year as he predicted in April, over the first seven months of the current financial year the current budget

deficit has been running at double last year's levels. The Treasury expects the deterioration to be less severe during the remaining five months, but it still expects the deficit for the year as a whole to be almost 65% up on last year at £19.3 billion.



The predicted deterioration in the current budget balance this year and over the remainder of the forecast period reflects a combination of deliberate policy changes announced in the PBR and other changes in forecasts of revenues and spending.



During the current financial year the main policy change is £2.5 billion in extra spending on Britain's commitments in Iraq (comprising £2 billion carried forward from the previous financial year plus £500 million of extra resources announced in the PBR). In later financial years the main changes are extra spending on the child tax credit and measures to boost productivity, offset by extra revenues from tackling tax evasion and avoidance.

NET IMPACT OF DISCRETIONARY POLICY MEASURES ANNOUNCED IN THE PBR

£ million	*2003–04*	*2004–05*	*2005–06*
Iraq etc	−£2,500	−£300	0
Child tax credit increase	0	−£885	−£925
Anti tax evasion	0	+£370	+£560
Other	−£20	−£155	−£290
Total	−£2,520	−£970	−£655

In addition to the impact of deliberate policy measures, forecasts for current spending have been raised by £2–3 billion a year over the forecast period. The main contributing factors are higher-than-expected take-up of the child and working tax credits, higher expected debt interest payments, higher social security benefit spending (reflecting higher RPI inflation following the move to the new inflation target, partially offset by a lower assumption for future unemployment) and accounting adjustments.

Again excluding the impact of deliberate policy measures, the main changes to the Treasury's forecasts for current revenue over the next few years are:

— an upward revision reflecting the fact that equity prices have risen by 20% since the Budget, not merely in line with money GDP as assumed. (This boosts expected future receipts from stamp duty and capital taxes);

— a downward revision reflecting the fact that wages and salaries have grown less quickly than the Treasury expected, reducing current and future expected receipts from income tax and national insurance;

— a downward revision reflecting the fact that consumer spending has grown less quickly than expected, reducing VAT and excise duty receipts (although VAT receipts per pound of consumer spending have been coming in unexpectedly strongly this year after a number of years of unexpected weakness).

— A downward revision from other factors, including lower housing transactions (affecting stamp duty) and lower-than expected oil production.

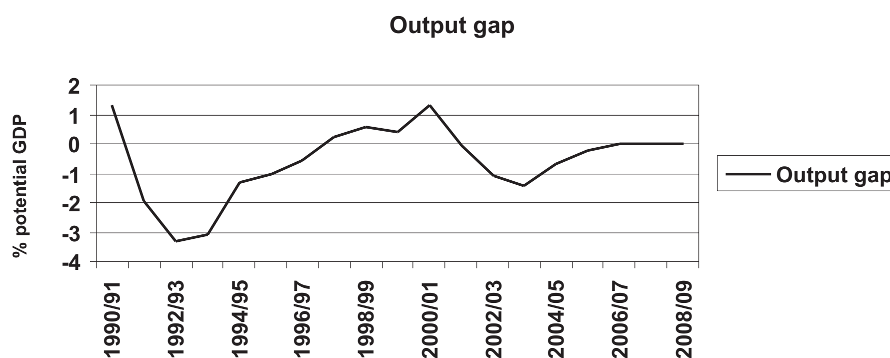
NON-POLICY RELATED CHANGES IN CURRENT REVENUE FORECASTS

£ billion	*2003–04*	*2004–05*	*2005–06*	*2006–07*	*2007–08*
Stock market	+£0.5	+£1	+£1.5	+£1.5	+£1.5
Low wage growth	−£3.5	−£4	−£4	−£3.5	−£3
Weak consumer spending	−£0.5	−£0.5	−£1	−£1	−£0.5
Other	−£2	−£0.5	−£1	0	+£1
Total	−£5.5	−£4	−£4	−£3	−£1

So what do the revisions imply for the Treasury's chances of meeting the golden rule?

The Treasury focuses on performance over what it thinks of as the current economic cycle. As at the time of the Budget, it believes that this began when the economy was running at its sustainable level in 1999–2000. Output then moved above trend briefly and returned to its sustainable level in 2002–03. In the current financial year the economy is thought to be running 1.4% below capacity (a negative "output gap"). The gap is expected to shrink over the next three years until the economy is back at its trend level in 2006–07. We can therefore think of the current cycle as the seven financial years running from 1999–2000 to 2005–06.

The pattern of the output gap is virtually the same as published in the Budget, despite significant upward revisions to estimates of GDP over the summer. This has been accomplished by raising the estimated trend rate of growth in the economy in the period 1997H1 to 2001Q3 from 2.61% a year to 2.94% a year. But the Treasury has left its projection of trend growth between 2001Q3 to 2006Q4 at 2.75%—and continues to assume 2.5% for projecting the public finances.



NB: Financial year averages, so mini-cycle prior to 1999–2000 not visible.

The golden rule implies that the aggregate current budget balance over the seven years of the economic cycle should be in balance or in surplus. In recent Budget and Pre-Budget Report speeches, Mr Brown has quantified the government's room for manoeuvre by aggregating the past and forecast cash values of the current budget over the cycle. So in his 2003 Budget speech, for example, he noted that:

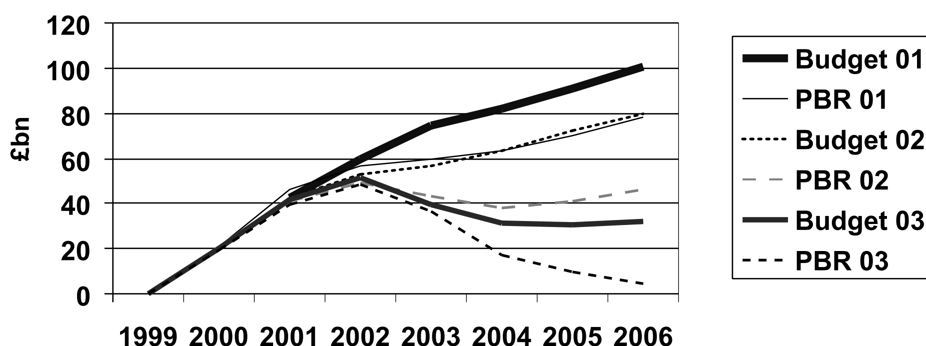
> "We meet our golden rule over the cycle—not just achieving a balance but with an estimated surplus at £32 billions."

As a result of the increased borrowing forecast for this and the next two financial years, the predicted aggregate surplus has since declined. As the Pre-Budget Report noted:

> "By 2005–06, when the current cycle ends under the assumptions used in these projections, the accumulated total surplus over the economic cycle will be £4½ billion." (Para B37).

The forecast over-achievement of the golden rule in the current cycle has declined even more over the past two-and-a-half years. In Budget 2001—two years into the seven year cycle—the Treasury projected a cumulative surplus of £100 billion between 1999–2000 and 2005–06.

Projecting over-achievement by such a large amount early in the cycle could be regarded as prudent, given the considerable uncertainty in forecasting the path of the public finances over the following five-year period. But there is no reason for the Treasury to seek to have over-achieved the golden rule ex post by a significant amount, unless public debt were at or near the 40% of national income ceiling and the government wished to create room for more investment. It is therefore reasonable that the forecast over-achievement of the golden rule should decline as the end of the cycle draws nearer and as the uncertainties surrounding the outturn over the remainder of the cycle diminish. However, with the forecast cumulative surplus having been reduced from £100 billion in Budget 2001 to £4.5 billion in PBR 2003, it is reasonable to ask whether it is prudent to have exhausted almost all the room for manoeuvre with two-and-a-half years of the cycle still to run.



Note: Figures show cumulative surplus at the end of financial year in March.

In this context it is also worth bearing in mind that the "AME margin"—the contingency reserve within Annually Managed Expenditure—has now been reduced to £0.3 billion in 2003–04 and to zero in the two following years. In the Budget, the AME margin is typically restored to £1 billion, £2 billion and £3 billion over the following three years to provide scope for unexpected spending needs. To do the same in the forthcoming Budget would require the chancellor to find a net £2.7 billion to restore the AME margin over the remainder of the current cycle (£1 billion in 2004–05 plus £2 billion in 2005–06 less the £0.3 billion remaining in 2003–04). Unless this was offset by savings or tax increases elsewhere, this would further eat into the remaining £4.5 billion cushion.

Assessing the rule on this basis was complicated in the PBR speech this year because the chancellor changed the basis on which he calculates the forecast cumulative surplus without explaining clearly at the time that he was doing it. This method involves adding up the annual current surpluses and deficits as percentages of GDP in the relevant years and then expressing the total in cash terms in 2005–06. This is a more sensible way of assessing the rule, because a pound at the beginning of the cycle is worth more than a pound at the end of it.

Conveniently, it also happens to give a larger number. As the chancellor said in the PBR speech:

> ". . . we have an average annual surplus over the whole cycle of around 0.2% of GDP—meeting our first rule in this cycle by a margin of £14 billion".

The degree of overachievement forecast in earlier Budget and PBRs would also have been larger if the calculations had been carried out on this basis.

Whichever way you calculate the likely over-achievement, the figure is relatively modest when you consider that the average error in forecasting public sector net borrowing (the current budget balance plus public sector net investment) one year ahead has in recent years been 1% of GDP or £10 billion in today's prices.

Perhaps worryingly for the Treasury, the direction of its one-year ahead forecast errors has moved in a negative direction since the beginning of this economic cycle. The forecast was around 2% of GDP too pessimistic for 1999–2000, 1% of GDP too pessimistic in 2000–01, 0.5% of GDP too optimistic in 2001–02 and 1% of GDP too optimistic in 2002–03. If the PBR forecast is correct, the one-year ahead forecast for this financial year will again have been around 1% of GDP too optimistic.

In past Budgets and Pre-Budget Reports the Treasury has also underlined its room for manoeuvre in meeting the golden rule by asserting that it would be met if the level of trend output were 1% lower than is assumed in the central case. (This would reduce the structural current budget balance by around 0.7% of GDP each year and also affect the timing of the cycle.) The PBR indicates that the golden rule is no longer met on this basis (and the sharp-eyed will note that in Chart B2 it has started shading the area beneath the central case rather than beneath the cautious one).

But, as the PBR points out, in principle it is reasonable to reduce the caution you seek as you get closer to the end of the cycle, if you believe it is less likely that you will have to revise your assessment of trend output. Whether recent GDP revisions mean we are in fact more confident about the size of the output gap is open to debate. The current Treasury estimate appears relatively large by the standards of other forecasters.

Deciding how much caution you want to build into your forecasts for the public finances at different points in the economic cycle is a complicated and opaque question of judgement. It depends in part on how confident you want to be at any given point that existing policies will be consistent with meeting the golden rule when the cycle ends. The Treasury is not explicit about this. It could say, for example, that bearing in mind the size of forecast errors in the past it wished to be 80% certain of meeting the target on unchanged policies at any given time.

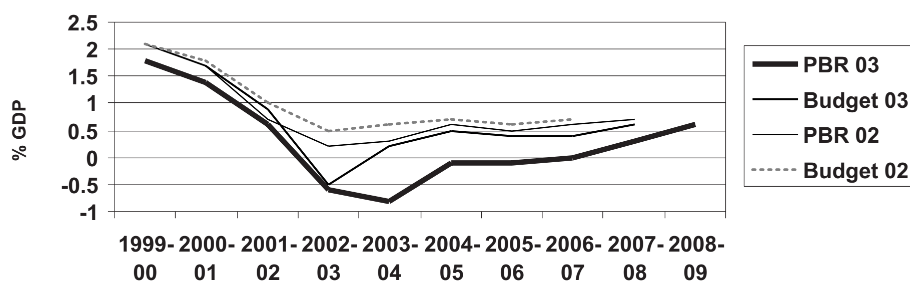
As the end of the cycle approaches, judgements of this sort could have important policy implications. Imagine that in Budget 2004 the Treasury expected to meet the golden rule exactly but that in PBR 2004 it unveiled forecast revisions of a similar magnitude to those announced last week—reducing the current budget balance by 0.9% of GDP in 2004–05 and 0.6% of GDP in 2005–06. This would imply that the government expected to miss the golden rule by an average of around 0.2% of GDP over the cycle. Do we really believe the government would tighten policy by an extra 1.5% of GDP—around 5p on the basic rate of income tax—for one year simply so it could once again expect to meet the golden rule on its central forecast?

Questions of this sort underline the problem in focusing on the achievement of the golden rule between two essentially arbitrary dates. It would be better to pose the following question: are current tax rates and spending plans consistent with expecting to meet the golden rule in the future over some appropriate medium term time horizon? There is an analogy here with monetary policy. We do not ask the Bank of England to try to get CPI inflation to average 2% over a defined economic cycle, but rather to set interest rates now at a level that will be consistent with hitting the inflation target approximately two years ahead—effectively a rolling target.

It is possible to get a snapshot of whether policy is consistent with the golden rule on this basis by looking at a cyclically adjusted measure of the current budget balance—in other words asking what the deficit or surplus would be if the output gap were zero.

A year ago, the Treasury expected the cyclically adjusted budget to be in surplus through to the end of the end of the then forecasting period in 2007–08. In this year's Budget, it was assumed that this structural balance would dip into deficit by 0.5% of GDP in 2002–03 (in part reflecting the one-off costs of the Iraq war) before rebounding to a surplus of 0.2% of GDP this year.

But higher forecast government borrowing—together with little change in estimates of the output gap—mean the structural balance is now thought to have been in deficit by 0.6% of GDP last year. It is expected to widen to 0.8% of GDP this year and to remain in modest deficit for the following two years. Balance should be restored in 2006–07, with surpluses thereafter of 0.3% of GDP in 2007–08 and 0.6% of GDP in 2008–09. In other words, although the underlying fiscal position looks worse over the next few years, the underlying budget balance is expected to move back into surplus on unchanged policies and therefore to be consistent with meeting the golden rule on a forward-looking basis.



To assess whether the Chancellor can credibly claim that policy is consistent with the golden rule on this basis we need to ask whether he is correct about the relative extent to which past and expected changes in the budget balance reflect cyclical and structural components, and—if he is—whether it is realistic to expect the structural budget position to move from a deficit of 0.8% of GDP to a surplus of 0.6% of GDP over five years on unchanged policies.

The IFS has been concerned in the past that the chancellor may be over-optimistic about the extent to which tax revenues will recover as the economy moves back towards trend. In particular, we wondered whether it was sensible to assume that corporation tax revenues would rise to 3.4% of GDP in 2007–08, a level achieved in the past (on a comparable basis) only when the economy was running well above potential or when the stock market boom was boosting the profits of the financial sector. We argued that assuming

a return to the long-run average of 2.9% of GDP might be more prudent. In the PBR, the Treasury has reduced its medium term forecast for corporation tax revenues to 3.2% of GDP in 2007–08 and 2008–09. We will revisit this question in next month's Green Budget.

The PBR also underlines the uncertainty currently surrounding trends in the yield of VAT as a proportion of consumer spending. The Treasury assumes that the ratio of VAT to consumer spending falls by 0.05 percentage points a year. In the first three years of the current cycle the decline was in fact 0.11 percentage points a year, resulting in overly optimistic VAT forecasts. But recent data suggest that the ratio this year may be increasing by 0.3 percentage points to 9.6%. Customs and Excise is not sure why and is therefore reviewing the assumption. It will have a new estimate to be audited by the National Audit Office before the Budget.

One notable feature of the Treasury's fiscal projections is the apparently spontaneous tightening in policy by 0.3% of GDP a year in 2007–08 and 2008–09—the basis upon which one can argue that the fiscal position will be strengthening into the next economic cycle.

One explanation is "fiscal drag", which forces us to look more closely at what we mean by "unchanged" tax policies. Projections for the public finances are based on the assumption that tax allowances and thresholds are indexed in line with inflation. But earnings typically rise by more than inflation, which means that over time a higher proportion of people's earnings fall into the higher tax brackets.

In consequence, we see the share of GDP taken in income tax rising from 11.3% in 2006–07 to 11.6% in 2008–09, at a time when the output gap is constant. The longer fiscal drag continues, the greater the impact each year as the higher rate threshold moves down into the more densely populated parts of the income distribution.

Thanks to fiscal drag and the freezing of the personal allowance this year, the effective higher rate threshold (ie the basic rate limit plus the personal allowance) has fallen from 161% of average earnings in 1996–97 to 143% in 2003–04, which has seen the number of higher rate taxpayers rise from 2.1 million to 3.3 million. The Treasury deliberately does not publish its assumptions about earnings growth looking forward, for fear of being seen to define a "going rate". But if we were to assume that earnings rose by 2% a year on top of inflation (slightly less than the trend rate of increase in productivity), then the effective higher rate threshold would drop to 129% of average earnings over the next five years. This would increase the number of people paying higher rate income tax to around 4.2 million by 2008–09.

The tightening into the next economic cycle is larger than predicted in the Budget in part because higher forecast inflation in the medium term reduces the indicative cash spending plans for departments in the Budget as a share of GDP. Current spending is now expected to fall from 38.6% to 38.5% of GDP in 2008–09.

PUBLIC SPENDING: AVERAGE ANNUAL REAL% INCREASE UNTIL 2007–08

	Budget 2003	*PBR 2003*
Total managed expenditure	3.3	3.1
PSNI	10.4	11.6
Current DEL	3.5	3.1
Current AME	2.2	2.2
Current UK NHS DEL	3.9	3.8
Current UK non-NHS DEL	3.3	2.8

In our Green Budget next month we will examine the PBR forecasts in more detail and assess them against the benchmark of the chancellor's fiscal rules. At this stage a number of questions (not all of which we will try to answer) suggest themselves:

— Are the Treasury's public finance projections based on a sensible assessment of the size of the output gap and of the trend growth rate of the economy?

— Is it realistic to expect the structural budget position to improve by 1.4% of GDP over the next five years on "unchanged" tax and spending policies?

— Is the Treasury's current tentative projection of 2.8% a year real growth in non-NHS current spending by departments consistent with the government's objectives for public services?

— Is it politically realistic to assume a further significant rise in the number of people paying higher rate income tax over the next five years?

16 December 2003

Letter to the Committee from Friends of the Earth

At this pre-Budget, the Chancellor can choose to promote a sustainable economy. Therefore Friends of the Earth, in the run up to the pre-Budget, is proposing a raft of initiatives that would move the UK in a sustainable direction, across energy, transport, waste, farming and housing issues.

We propose a balanced package of taxation policies, aimed at furthering environmental progress whilst discouraging harmful activities. Our view is that these taxes need to be linked in a positive loop. In this way the government can raise revenue through taxation on regressive activities and channel these funds to promote positive change.

Accelerating the progress of the green tax agenda would help deliver key economic and social policy goals, as well as environmental ones. A clear and strong strategy for green tax reform at the next Budget will lay the foundation for a socially progressive and economically dynamic programme for creating jobs, and deliver the low-carbon low-waste economy, and a greened agricultural sector, promised in Labour's manifesto. British companies would benefit from a fiscally-driven move away from using dirty and inefficient technologies towards modern, renewable, resource-efficient and clean alternatives.

Also these measures would help meet the Government's social exclusion goals. Poor communities are worst affected by a range of environmental threats, including traffic pollution, toxic chemical emissions from heavy industry and climate change. These neighbourhoods are also frequently deprived of decent services, public transport, energy conservation and waste minimisation opportunities. Improving environmental conditions and services will tackle social exclusion.

For over a decade, Friends of the Earth has played a prominent role in promoting the green tax reform agenda Enclosed is our pre-Budget 2003 Briefing: Time for a sustainable economy.[1] This sets out a package of practical green tax and respending measures to be proposed at pre-Budget 2003 and implemented in Budget 2004.

I hope you find this briefing both interesting and useful. As always Friends of the Earth is keen to stimulate and engage in constructive dialogue, and any comments you have on our proposals are most welcome.

19 November2003

Memorandum from Professor Iain McLean, University of Oxford

In his PBR speech on 10.12.03, the Chancellor said:

> "Alongside the Allsopp report published today on regional statistics, the Secretary of State for Work Pensions and I are also publishing for each region of the country full employment plans.
>
> For 2,000 enterprise areas covering high unemployment communities in 417 constituencies:
>
> in addition to fast track planning and abolishing stamp duty, I can announce—subject to state aid approval—first year 100% investment allowances to renovate vacant commercial premises.
>
> And I can confirm that as a result of the Lyons Review we will relocate out of London and the south east 20,000 civil service jobs, to the benefit of the regions and nations of the UK.
>
> Local authorities who successfully promote small business creation should be rewarded for doing so.
>
> And the Deputy Prime Minister and I propose that any additional business rate income be shared with local authorities. Although I will consult further before the Budget, we expect local authorities to be eligible for an additional £150 million in 2005, £300 million in 2006, rising to £450 million a year."

In the printed Pre-Budget Report, the following paragraphs are of interest:

3.8 The RDAs [Regional Development Agencies] have also been asked, in advance of Budget 2004 and the 2004 Spending Review, to identify the top ten institutional and administrative barriers that are hindering effective coordination of policy decisions and service delivery in the regions.

3.61 Sustainable economic growth cannot be achieved in all regions and localities of the country through top-down policy making by central government . . . At the LGA conference in July, the Chancellor and the Deputy Prime Minister launched a consultation on the Local Authority Business Growth Incentives scheme, which will give local authorities a direct financial incentive to maximise economic growth in their areas. Analysis based on historical growth rates shows that the scheme could be worth up to £1 billion to local authorities over a three-year period, by allowing them to retain a proportion of increases in local business rate revenues. The extra resources will be entirely additional to local authorities, with no ringfencing by central government. Furthermore, no business will pay more under the scheme.

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[1] Not printed. For full text see www.foe.co.uk/resource/briefing/prebudget2003.pdf

3.62 The Government set out three key principles for the scheme in the consultation document. These were that the incentive must be applicable to all authorities, that the distribution of benefits must be fair, and that the scheme should be as intelligible as possible. Following the consultation, two thirds of those who expressed clear preferences favoured basing the scheme on either the national historic growth model or the sub-regional model. The Government has decided to take the scheme forward based on the national historic growth model as this is fairer on local authorities in different regions with similar growth rates.

3.78 The Government recognises the value that regional bodies can add in promoting R&D and innovation, and in facilitating knowledge transfer. All RDAs are now investing in science and innovation, with an estimated £240 million invested in 2002–03.

Box 6.4: The Lyons Review of public sector relocation The independent review of public sector relocation announced in the 2003 Budget is being led by Sir Michael Lyons. The Review published an interim report in September 2003 confirming that at least 20,000 government jobs could be relocated from London and the South East. The review's final report will be published in March 2004. Sir Michael will shortly be publishing new evidence, which further demonstrates the benefits for efficiency and quality of public services in relocating government activities. Work based unnecessarily in London and the South East imposes extra costs on departments, through higher accommodation and staff costs and lower recruitment and retention rates, and affects the delivery of public services . . . relocation is likely to have a positive economic impact on the areas receiving government activity, with potential benefits for the UK economy as a whole. Sir Michael will also be exploring other potential benefits of relocation, including a contribution to regeneration and urban renewal, delivery of the Government's PSA target for regional economic growth, improving the visibility and accessibility of government functions and preparing for future devolution. In the light of Sir Michael's work the Government has committed to take forward relocation as a key strand of the public service reform agenda, underpinned by a clear responsibility on civil service heads to realise the benefits of relocation for their departments, the need for suitable incentives and a tighter coordination of the Government estate. Work on these elements will be taken forward by the Government over the coming months.

The document Full Employment in Every Region (at http://www.hm-treasury.gov.uk/media//EAD48/employment—372.pdf) shows that the employment rate is lowest in the North-East, Northern Ireland, and London. It puts the low London employment rate down to, among other things, discrimination and cultural effects in the Bangladeshi and Pakistani communities, and low employment among newly arrived immigrants.

The Local Authority Business Rate Growth Incentive scheme is explained on the ODPM website at http://www.odpm.gov.uk/pns/DisplayPN.cgi?pn—id = 2003—0268. The Government there explains that it will apply the "National Historic Growth" model. The most popular option among respondents to the consultation had been the Sub Regional model. The regional implications of this choice are complex but your advisers could assist Members should they wish to take up this issue.

Possible questions to Ministers and/or officials on matters relating to regional productivity in the Pre-Budget Report

P1. Given that Inner London has the lowest employment rate in the UK, are you confident that the transfer of public sector jobs envisaged in the Lyons Review will not simply move (un)employment from one region to another?

P2 Why did the Government choose the National Historic Growth model rather than the Sub-Regional model for the Local Authority Business Growth Incentive scheme?

Most of the regional productivity issues raised in the PBR papers are in the two interim reports of independent reviews also released on 10 December 2003: the Allsopp Review of Statistics for Economic Policymaking, and the Barker Review of Housing Supply. A separate note on each of these follows.

Christopher Allsopp, Review of Statistics for Economic Policymaking, First Report

The Chancellor commissioned this review in February 2003. Its First Report was published on 10.12.03. Part of its remit is to advise the Chancellor, the Bank of England, and the National Statistician on the regional information and statistical framework needed to support the Government's key objective of promoting economic growth in all regions and reducing the persistent gap in growth rates between the regions.

Its First Report contains several recommendations relevant to the Committee's inquiry into regional productivity and regional statistics. In particular,

2. Present estimates of regional Gross Value Added (GVA) are not of sufficient quality to support analysis of the Government's policy objective to increase growth in the regions. . . . The ONS should take preliminary steps, including proposing an appropriate timetable for the production of these data, in time for a statement on progress to be included in our Final Report.

9. Over the longer term, the ONS should identify and take the necessary steps to integrate Regional Accounts into the National Accounts framework as fully as possible and to increase the quality of Regional Accounts data towards that of the National Accounts. . .

12. There is a requirement for estimates of individual components of the expenditure measure of GDP. The ONS should put together proposals for the following

- extending the sample of the Expenditure and Food Survey, perhaps once a year as part of the developing Continuous Population Survey, in order to provide a more robust annual regional breakdown of Household Final Consumption Expenditure;
- the development of fuller regional measure of Gross Fixed Capital Formation that look beyond apportionment techniques;
- the production of an annual National Accounts measure of Government Final Consumption Expenditure that takes into account the recommendations in Professor McLean's Report and subsequently revisits the fuller government accounts exercise; and
- potential deflation techniques for each measure.

20. Resolution of concerns with population statistics is of crucial importance from the perspective of regional and local policymakers. We welcome the programme of work set out in the Quality Review of "International Migration Statistics", and recommend further that the ONS develops its programme of research in order to establish how intra-UK migration can also be estimated more accurately.

24. The NUTS hierarchy is now widely accepted across a broad range of statistical and administrative bodies. It should ideally be the standard, at the very least at the NUTS 1 level, unless there are overriding operational reasons to do otherwise.

The First Report is a large and, in places, highly technical document. However, here are some. . .

Possible questions to Ministers and/or officials

A1 How (and by when) do you plan to have data on regional GVA of sufficient quality to measure progress on the regional productivity PSA target?

A2 How (and by when) do you propose to implement Professor McLean's recommendations on improving the data published in Public Expenditure Statistical analyses on identifiable expenditure in each region of the UK?

A3 When will better data on internal and international migration become available?

A4 Have you plans to ensure that all Government departments and agencies compile their statistical information using the NUTS1 boundaries? [Note: the twelve NUTS1 units are the nine English regions; Scotland; Wales; and Northern Ireland].

KATE BARKER REVIEW OF HOUSING SUPPLY: SECURING OUR FUTURE HOUSING NEEDS

The Chancellor commissioned this review in April 2003. Its interim report was published on 10.12.03. Its remit is to Conduct a review of issues underlying the lack of supply and responsiveness of housing in the UK [and] . . . If appropriate, identify options for Government action, including the use of fiscal instruments.

According to Barker, the supply of new houses in the UK is unresponsive to demand. Relatedly, UK real house prices have grown at an average 2.5% per annum since 1971, but most strongly in prosperous areas of the country. This has many consequences. Those related to regional productivity include:

- Home owners in the high priced region are reluctant to move to a low priced region for fear of being priced out if they want to return, or simply because they expect a lower rate of return or higher user cost for housing in the low priced location . . . Households in the low priced region have a larger credit hurdle to clear if they wish to move to the high priced region, even when the expected rate of return in housing is higher there. This leads to greater unemployment mismatch and higher unemployment at a national level and will have a permanent downward impact on the level of GDP. (para 1.37).
- The UK has invested a low proportion of GDP in housing compared to other EU countries and housing completions relative to the size of the existing housing stock shows relatively low provision. At current renewal rates houses built today would need to last around 1,200 years. (para. 2.4).
- There is a possible market failure in the provision of brownfield land for development. The fundamental problem may be due to the low value of brownfield land which results from the high costs of developing it, coupled with high existing use values which militate against redevelopment. (para. 4.17)

— Outsiders, those who would like a house and who would benefit from development, often have little or no voice in decision making. Insiders, the existing residents within a community, hold all the power and influence and often do not want housing for "outsiders", although housing development for "local people" is often more acceptable. (para. 8.22).

Chapter 7 considers the taxation of land and housing in the UK. It notes that the development gain the public sector confers through network developments and planning permissions is inadequately taxed; and that new house construction is zero-rated for VAT whereas repair, maintenance, and improvement is subject to the standard rate of VAT. It comments briefly on Council Tax and Stamp Duty. Although agreeing that Council Tax is regressive (falling more heavily on poor householders than on rich ones, and on regions with low property prices, mostly in the North, than on regions with high property prices, mostly in the South), it claims at 7.55 that Council Tax has "little impact" on distorting the housing market. Chapter 8 shows that "Section 106 agreements", whereby planning authorities can impose conditions such as affordable housing or contributions to infrastructure on permissions for housing development, are an inefficient means of securing these social objectives.

Possible questions to Ministers and/or officials

B1. Do the distortions in the housing market identified in the interim Barker report impede progress towards the HMT/ODPM/DTI PSA target of reducing regional disparities?

B2 Which of the following might make it easier to fulfil that target, and which harder:

— Increasing the total stock of new houses;

— Increasing the stock of new houses in the south-east;

— Changes in the taxation of land and housing (if so, what changes?)

B3 In view of the admitted weaknesses of Council Tax, why does the interim Barker review believe that it has "little impact on actual housing supply"?

B4 Would you support the scrapping of the "Section 106" mechanism for capturing the social benefits of development? If so, what would you put in its place?

11 December 2003

Memorandum submitted by Professor Peter Spencer York University

Is there going to be enough tax revenue to sustain the government's expenditure plans over the medium term, or will tax increases be necessary to meet the golden rule? This is the central issue that has faced economic forecasters and fiscal policymakers over the last 18 months.

I have been arguing that the government deficit is a structural rather than a cyclical phenomenon, and that a policy adjustment will be necessary at some stage. This view is partly based on the observation that the cyclically-adjusted current account balance is in substantial deficit. The Treasury's latest calculations put this at 0.8% of GDP. If this calculation is anything like correct, it means that the tax take will not recover in the way the Treasury suggest, even if their ambitious growth forecasts are met.

However, cyclical adjustments to the public finances are highly subjective and it is possible to arrive at a very different estimate of the output gap and its effect on government finances. Indeed, in presenting the November Inflation Report the Governor of the Bank of England commented that he thought the output gap was close to zero. However, the behaviour of taxes on income and wealth since 1997 suggests that the surge in the run up to the last election was the result of special factors like the stock market boom that are not likely to be repeated. Whilst not conclusive, this analysis also suggests that as the economy accelerates, tax revenues will disappoint.

The Treasury forecast is based on the view that the stupendous tax flows of the millennium represent the norm to which we will soon return. The precise reasons for the ebbing of this fiscal tide remain unclear, but the longer it continues, the more apparent it is that the millennium represents a high water mark that we are unlikely to see again. It is only a matter of time before this reality becomes apparent. This update sets out my reason for thinking that in the absence of policy adjustments, the golden rule will be broken, perhaps as soon as 2005.

THE ECONOMIC FORECAST

Since PBR 2002 the economy has performed as well (if not better) than the Treasury forecast, yet the public finances have gone from bad to worse. The stock market has also performed a lot better than anyone thought at the time of the Budget. This financial year the current deficit has widened out to £19.3 billions from last year's £11.8 billions, despite the recovery in the economy and the stock market and despite big

increases in National Insurance Contributions and Council Tax. A comparison with the Treasury's Budget forecast of £8 billions provides a stark warning of the scale of errors likely in forecasting the public finances, underlining the need for caution.

PBR 2003 shows the current deficit falling back to just £8 billion next year; to £5 billions in 2005–06 and then to zero in 2006–07. However, this forecast is based on the view that the economy will grow by 3 to 3½% in 2004 and again in 2005 and that there will be a spontaneous improvement in the tax take: the cyclically adjusted deficit falls back to just 0.1% of GDP next year. In other words, tax revenues will bounce back much more strongly than the economy. That seems very unlikely.

Although the Chancellor has made the lower half of his growth range this year, the forecasts for the next two years are much more ambitious. The average consensus forecast has growth next year of 2.6% accelerating marginally to 2.7% in 2005. The ITEM Club forecast is more optimistic, as shown in Table A. One of the reasons for our optimism relative to the consensus is that we believe that the move to the new CPI inflation measure amounts to a relaxation of monetary policy, making it more difficult for the MPC to raise interest rates as the economy recovers. Short term, as the Governor of the Bank of England has noted, CPI starts in the lower half of the target range rather than the top half. Long term, the superior technical construction of this index means that on our calculations it will remain 0.7 to 0.8% below the RPIX on average. Reflecting this, the RPIX is growing by 2¾% by the end of the Treasury forecast, while CPI stays at 2%. ITEM believe that interest rates will remain relatively low, and output growth stronger than consensus. However, our forecasts of 2.8% for next year and 3.1% for 2005 are still less optimistic the Treasury's:

Table A

GDP FORECASTS

	2002	*2003*	*2004*	*2005*	*2006*	*2007*
PBR 2003	1.7	2.1	3–3½	3–3½	2–2½	(−)
ITEM	1.7	2.0	2.8	3.1	2.8	2.7
Consensus	1.7	2.0	2.7	2.7	2.4	2.4

One of the reasons for our pessimism relative to the Treasury is that we remain concerned about the state of the company sector finances and the effect of pension fund deficits on business expenditure. The revisions to the National Accounts data this Autumn had the effect of dramatically reducing the financial surplus of non-financial companies. The surplus of £16 billions that we were looking at for 2002 was chopped back to just over £4 billions. Anecdotal evidence suggests that although the stock market is recovering, pension fund deficits remain a serious problem, particularly for small to medium sized companies. Business investment is unlikely to recover as quickly as the Treasury is suggesting.

The Treasury forecast also leaves me puzzling about the outlook for public sector investment. Budget 2003 forecast a hefty 47% real terms rise in this item in 2003, and the public sector returns for the first three quarters support this forecast. Public investment helps to explain the strength of the construction industry this year, and the upward revisions made in the Autumn. However, PBR 2003 puts this growth at just 15% in 2003, accelerating to 30% in 2004. The money allocated for net investment investment in the current financial year has also been reduced relative to Budget 2003, by nearly £1 billion.

The Fiscal Arithmetic and The Economic Cycle

However, my main concern about PBR 2003 lies with the fiscal arithmetic rather than the economic forecast. The Treasury estimate that the economy is currently 1½% below trend and that if an appropriate adjustment is made for this (PBR Box: B1) the deficit would be 0.8% rather than 1.9% of GDP this year. However, many commentators have argued that the upward revisions to GDP last Autumn pushed output up into line with trend, leaving much less spare capacity in the economy.

The judgement that is made about the output gap is critical for both fiscal and monetary policy. However, I side with the Treasury in believing that the economy is running significantly below trend. Indeed, following the ONS's revisions to the National Accounts, ITEM estimates suggest that the output gap is now larger than we previously thought—while past GDP growth has been revised up, so too has business investment and the capital stock, raising our estimate of potential output. The existence of this output gap means that there will continue to be downward pressure on firms' profit margins, and is another reason for thinking that new investment will be delayed.

Having said that, it seems unlikely that the bounce in tax revenues will be as dramatic as the Treasury are suggesting. The next table sets out the ITEM Club October forecast for government tax revenues alongside the PBR 2003 figures for public consumption and investment. Receipts grow by 7.2% next year and by 6.5% in 2005–06. These rates are well above those for money GDP, but are below the Budget assumptions of 7.4 and 7.1%, which we felt were too optimistic. As the table shows, these more cautious assumptions make a big difference to the current balance, which remains in deficit for the duration of the forecast.

Table B

CURRENT AND CAPITAL BUDGETS

£ billion	*2002–03*	*2003–04*	*2004–05*	*2005–06*	*2006–07*	*2007–08*
Current receipts	396.5	422.8	452	481	510	538
Current spending	394.0	427.3	449	478	503	528
Depreciation	14.4	14.8	16	16	17	18
Surplus on current budget	−11.9	−19.3	−13	−12	−10	−8
Net investment	10.7	18.0	23	25	27	31
Net borrowing	−22.6	−37.3	−36	−38	−37	−39
(% GDP)	5.9	4.3	6.1	6.3	5.7	5.4
Surplus on current budget	−1.1	−1.7	−1.1	−1.0	−0.7	−0.6
Cycle cumulative surplus	4.0	2.3	1.2	0.1	−0.6	−1.2
Net borrowing	−2.1	−3.3	−3.0	−3.0	−2.8	−2.8

On this forecast, the cumulative current surplus over the first four years of the cycle is eroded in 2005–06, turning negative in the following year. The optimistic Treasury forecast suggests that we will push up above trend in early 2006, meaning that the cycle could end in 2005–06, with a 50–50 chance of breaching the golden rule, or in the following year, with a much greater probability of violation. Either way, the margin of error is miniscule.

The narrow error margin is also clear from the PBR 2003 arithmetic. On the Treasury's central case, the average annual surplus over the cycle is 0.2% of GDP. But as paragraph 2.74 concedes, in the conventional "cautious case," which lowers the level of trend output by 1%, "the average surplus on the current budget is no longer positive." That is just a polite way of saying that the golden rule is broken.

11 December 2003

Memorandum submitted by Mr Edward Troup, Simmons & Simmons

1. *Small businesses*

The introduction of a 10% corporation tax rate in 2000 (reduced in 2002 to 0% on the first £10,000 of corporate profits and 10% on the next £40,000) has encouraged large numbers (probably several hundred thousand) of the self-employed to incorporate their businesses. This permits a significant saving of income tax and NICs as self-employed earnings (taxed at basic rate of 22% plus NICs of 11%) can be converted into dividends (subject to corporation tax at 10% or 0%) which are not subject to further tax in the hands of basic rate taxpayers. Paragraph 5.91 of the PBR indicates that the Government is proposing to take action against such businesses to stem the tax losses which are flowing from this.

It was inevitable (and indeed predicted) that such a behavioural change would follow from a reduction in corporation tax rates[2]. It is now common practice for accountants to advise the self-employed (taxi-drivers, hairdressers, plumbers etc) to operate through a company to take advantage of this differential in tax rates. Although the PBR does not provide any details of the proposed legislative action, it appears likely either to follow the "IR35" approach of deeming the owner manager to have paid him or herself a minimum salary, or to treat dividends as employment income. Either way this will be complex and involve compliance and regulatory cost.

If the reduced and zero rates of tax are not achieving their intended result, the Government should not adopt a complex retaliatory response, but should repeal these measures and, if appropriate, offer tax reductions to all small businesses (incorporated or self-employed) in some alternative way.

2. *Larger businesses*

The PBR set out details of reforms anticipated in August 2003 to remove inconsistencies between the UK corporate tax system and the European Treaty exposed by recent judgments of the European Court of Justice. Initially this involves the introduction of transfer pricing rules between related UK companies[3]. Other measures are likely to follow (reform of the tax treatment of dividends, losses and interest expense

[2] The Chancellor described the reduced rate as a "new incentive for men and women to start their own business" Budget Speech Tuesday 9 March 1999.

[3] Transfer pricing rules operate internationally to prevent UK companies shifting profits into low-tax territories by under-pricing sales to overseas affiliates (or over-pricing purchases). There is no need to operate such rules between two UK companies as no tax advantage can be obtained from mis-pricing. European rules treat the application of transfer pricing rules only to international transactions as discriminating against businesses in other EU Member States. Abolishing transfer pricing rules internationally would expose the Exchequer to material tax loss. The proposed response removes the discrimination by extending the existing rules to UK to UK transactions, thus treating international and domestic transactions in the same way.

and the rules for taxing controlled foreign companies), although there has, as yet, been no public acknowledgement by the Government of these other issues.

The Inland Revenue deserves credit for the considerable effort it has put into mitigating the effect of the transfer pricing measures and consulting on their details. However, the fact is that these changes produce no economic or fiscal benefit to the Exchequer or the economy but simply seek to defend the corporate tax system against rulings of the ECJ. In doing so they increase the regulatory burden on UK businesses, damage the competitiveness of the UK tax system and damage our international reputation for having a tax system favourable and open to international businesses.

It is also regrettable that other potentially worthwhile proposals for the reform of corporation tax, while still progressing, risk being side-lined while attention is focussed on defending the tax system against the ECJ.

The issues raised by the European Treaty and the decisions of the ECJ are enormously difficult. All solutions—reforming our own tax system, seeking an amendment of the European Treaty or adopting a more harmonised basis for taxing companies in Europe—are either politically or practically impossible or undesirable. Nevertheless this problem cannot be wished away. The Government's current approach of incremental defence—acknowledging and seeking to deal with single issues without addressing the wider problems—risks aggravating an already difficult situation.

All likely options and outcomes—including the possibility of moving an amendment to the European Treaty to seek to defend national corporate tax systems—need to be examined in a more public debate.

19 December 2003

Memorandum submitted by Mr M.R. Weale, National Institute of Economic and Social Research

1. The Pre-Budget Report acknowledges that the fiscal position is considerably worse than had been forecast in the Budget last Spring. The deficit now exceeds the 3% Maastricht limit. It should however, be remembered that, had Britain joined the Euro, an excess deficit would not have immediately led to the threat of financial penalties. These can be imposed only in the third successive year of an excess deficit but, following the debacle over the deficits in France and Germany, it is not clear that fines ever will be imposed.

THE GOLDEN RULE AND THE CYCLE

2. The Report nevertheless claims that the Government is "on track" to meet the Golden Rule, that, over the cycle the current budget should be in balance or in surplus.

3. It has to be remembered that the importance of the Golden Rule is political rather than economic. An economist would more probably have recommended instead either i) that taxes should be set at a level to keep expected future taxes constant independently of whether that leads to an immediate surplus or a deficit or ii) that the budget surplus/deficit should be set so as to offset fluctuations in private sector saving and to allow overall consumption to evolve steadily. Nevertheless, given the political importance of the rule comment about the public finances in the light of it is well justified.

4. The Committee has commented in the past that it is unsatisfactory that the cycle should be defined by HM Treasury rather than by, say the National Audit Office. It is nevertheless worthwhile sketching out the sorts of things which could happen and why political manipulation of the end of the cycle may occur.

5. Government revenues are highly seasonal, with substantial revenues accruing in the first quarter of the year. This means that it is more likely that the Golden Rule will be broken if the cycle ends in December than if it ends in March. No economic importance can, of course, be attached to this. It would have been more sensible to define the rule with reference to seasonally adjusted data, but the point is that it was not. Judgement is therefore likely to err away from a December end to the cycle.

6. A more general criticism is that the state of the cycle at any point in time cannot be identified with any reasonable precision until four or five years later (Orphanides and van Norden, 2002). Revisions to early estimates of the state of the cycle are often of magnitude similar to the estimates of the cyclical deviations themselves. This can be seen in Chart 2.3 of the End of Year Fiscal Report. The estimate of the output gap produced for budget 2001 of the economy in 2000–01 was 0.6% above trend. The current estimate is that the economy was 1.3% above trend. Since the end of the cycle is the point at which output returns to the trend level from below measurement of the state of the cycle is crucial to the assessment of performance against the golden rule. But the sort of revision described above may make it impossible, in practice, to know whether the Golden Rule has been met or not until well after the event.

Risks Implied in the Government Forecasts

7. Be that as it may, we can consider the Government claim that it is "on track" to meet the Golden Rule on the assumption that the cycle ends in March 2005. The Government projections show a cumulated surplus of £14 billion by the end of the period. We explore the margins of error round this using the information provided by the Government on its forecasting errors. Tables 2.6 and 2.7 of the End of Year Fiscal Report suggest average absolute errors of 1.1% of GDP in deficit forecasts one year ahead and 1.6% two years ahead. It is also clear (charts 2.4 and 2.5) that the forecast errors are serially correlated (an error in one direction in one year is likely to lead to an error in the same direction in the next year. The document unhelpfully does not say anything about the forecasting record of the Pre-budget Report itself.

8. We take the mean absolute error associated with the forecast for FY 2004–05 to be 1.3% of GDP (between the 1.1% error for 1 year ahead and the 1.6% error for two years ahead), and we assume there is an error of 0.6% of GDP associated with the Pre-budget Report forecast for the current year. We assume that the errors are normally distributed and that the expected error is zero.

9. If the error in the current year is unrelated to the error in the next year, then this implies a 20% chance of missing the target. If, on the other hand the two move step in step, then the chance rises to 25%. The truth is probably somewhere between the two, so it is probably fair to say that the Chancellor's own forecast implies that the chance of breaking the Golden Rule in the current cycle is between one in four and one in five. The key point is, however, that calculations like these should be performed by the Treasury as a matter of course and included in the Pre-budget Report and Budget Statement instead of being left to outsiders to do less than perfectly.

10. Looking at the medium term the End of Year Fiscal Report draws attention to the very big errors associated with forecasts three and four years ahead. Since the current budget projections show the current account simply returning more or less to balance, it is obviously quite incorrect to conclude that the medium term fiscal position is consistent with the Golden Rule. The most that can be said, if one accepts the underlying projections, is that the chance of meeting the rule without tax rises or spending cuts is 50%.

11. These calculations are performed on the assumption that the Treasury forecasts are on average correct, given what is known about the economy at the moment. There are, nevertheless, two surprising aspects to them.

12. The cumulated growth rate over the next three years is 1% point more[4] than would be delivered if the economy grew at the assumed trend growth rate of $2\frac{1}{2}$% p.a., so it is reasonable to assume that this is the output gap assumed by the Treasury. The unemployment rate has now fallen to 5%; there may be scope for further reductions but it is likely to be limited. Output growth might also be possible if inactive people, such as those who have taken early retirement, are brought back into the labour force. Without these it is difficult to see that there is much of a gap to be closed.

13. Secondly, the assumed buoyancy of tax revenue is surprising, even when one takes account of the assumed output gap. By 2008–09 revenues, as a share of GDP are expected to exceed the peak seen at the time of the fiscal boom in 1999–2000. The excess is largely attributed to the 2% point increase in National Insurance contributions. Thus the government is treating what seemed at the time a period of great revenue buoyancy as a period of normality to which the economy is expected to return. It is not surprising if other commentators have doubts about this. In particular we note that between 2006 (when the economy is expected to read trend output) and 2008–09 the government current balance improves by 0.6% of GDP even though there is no change to the output gap. Such a change relies almost entirely on revenue buoyancy unconnected with the cycle. Even if such trends exist at the moment, the projection of them forward is less than prudent.

International Comparisons

14. The Pre-budget Report makes a great deal of how Britain's fiscal position compares with those of other advanced countries. This analysis would be a complete picture if the government were concerned only with its own finances and not also with the overall state of the economy.

15. It is worth bearing in mind that running up a large national debt is one mechanism by which those currently economically active can improve their own living standards at a cost to their successors. Other mechanisms are rising house prices and pay as you go pensions; the effects of these are similar. Thus looking at public borrowing alone does not convey a true picture of whether the economy is showing "fairness and prudence".

16. There is one simple indicator which suggests, however, that the UK economy is performing poorly in this respect as compared to its neighbours. In the UK we save about 15% of GDP (taking saving attributed to the public and private sectors together). However we need to save about 20% of GDP to ensure that our national wealth grows in line with our income; France, Germany and Italy do much better in this respect. HM Treasury needs to put more work into understanding this shortfall of national saving, either developing policies to offset it, or explaining why it does not matter. At present the issue is simply ignored.

[4] Taking the lower end of the range provided. This is used in calculating the fiscal projections.

17. One can, however, see what may happen in discussing reforms to the Stability and Growth Pact. Countries with high public savings rates are likely to claim that this should be taken into account when setting limits for public borrowing. So on these grounds, the fiscal straightjacket imposed on the United Kingdom would be tighter than that faced by Italy.

Conclusions

18. Taking the short-term Treasury forecast at its face value the chance of meeting the Golden Rule in the current economic cycle is reasonably high (75–80%). There are nevertheless medium term concerns about the revenue projections; these have to be seen in the context of the large forecasting errors associated with medium term fiscal forecasts.

19. It is only but focusing solely on the public sector budget and ignoring the level of saving in the economy as a whole, that one can conclude the UK's fiscal position is better than that of the other advanced countries. A perfectly coherent argument is that countries with low private saving need higher public saving to make up for it. Seen from this perspective the UK, with its low level of private saving performs badly relative to major continental countries despite the fact that they have larger budget deficits.

Reference

Orphanides, A and S van Norden. (2002). "The Unreliability of Real Time Output Gap Estimates". Review of Economics and Statistics. Vol 84. pp 569–83.

12 December 2003

Memorandum submitted by Mr John Whiting, PricewaterhouseCoopers

I am responding to your note of 18 December requesting some observations on the tax measures contained in the Chancellor's Pre Budget Report 2003 (PBR). Given the short timescale available to the Committee, we agreed that my submitting a general note quickly would be of most assistance, rather than an in-depth analysis. Accordingly, I set out below comments on some of the major matters arising. As you will appreciate, this cannot be exhaustive. I also enclose, in case it would be of assistance to the Committee, a copy of the short summary of the Chancellor's report that PricewaterhouseCoopers prepared for clients on the afternoon of 10 December. We also, as a matter of interest, prepare a much fuller analysis for clients.

1. *Corporate Tax Reform: Transfer Pricing and Thin Capitalisation*

The Government's recognition that UK–UK Transfer Pricing could impose potentially huge administrative burdens on business is welcome. The announcement of a further period of consultation is also a step in the right direction, though it is to be hoped that this will result in further changes.

The few exemptions provided within the proposals so far do little to remove burdens from larger businesses that have extensive intra-UK transactions. Whilst we recognise that there is a problem here—the tax system found to be non-compliant with EU rules—progress needs to be made on simplification, in particular to the Thin Capitalisation area, possibly to bring in a UK consolidated basis. Whilst exemptions for smaller businesses are welcome, the practical effect of such exemptions is limited simply because most small businesses operate only through a single company.

2. *Research and Development (R&D)*

The announcements on R&D Tax Credits, which follow the consultation process, are welcome. The widening of the qualifying cost base to include fuel and water consumed and software used directly in the R&D process is sensible. The wider definition of what qualifies for R&D generally is also welcome.

3. *Childcare*

There was considerable attention paid to the increased support to be given through the tax system for employer-supported childcare. Whilst the proposal to allow £50 of childcare vouchers to be given to employees free of Income Tax and National Insurance Contributions (NICs) is welcome, it must be borne in mind that currently such vouchers can be provided free of NICs. Thus the income tax exemption is being given at a cost of a potential increase in NICs. We trust that this £50 limit is not to be applied to the provision of workplace nursery relief, where the removal of the existing requirement for the employer to have management responsibility for the childcare provision to ensure that it qualifies for the tax exemption is a sensible and constructive move.

4. *Pensions*

We are pleased to see the pensions reform is being taken forward in a measured way. We still have concerns over the impact of the £1.4 million "pot limit" but it seems that the proposals in the new consultative document offer a much improved transition to the new regime. We are studying the new consultative document and will in due course make detailed representations on it. One area that we will no doubt focus on is how widespread this pot limit will become in years to come and whether it will operate fairly comparing those in final salary pension schemes with those who have to accumulate their own private pension.

5. *Tax and Accounting*

We were pleased to see the announcement that companies choosing to adopt International Accounting Standards (IAS) to draw up their accounts will be able to use such accounts as the basis for their tax computations. However, consultation and dialogue with the Inland Revenue is essential during the coming year to identify and resolve the many issues that will arise as companies move towards IAS in terms of the tax issues that are created on particular items.

6. *Residence and Domicile*

We note that in para 5.108 in the main Pre Budget Report document there is reference to the review of the residence and domicile rules. The acknowledgement of the need to simplify and modernise the current rules for residence to fit with increases in international travel and commuting will be welcomed by business. At the same time we wholly endorse the need to proceed carefully in this whole area and be convinced of the merits of change before bringing in reforms in the area of domicile.

7. *Small Businesses*

We were concerned that the Chancellor made a brief announcement in his speech regarding husband and wife companies, which seems to refer to para 5.91 in the main Pre Budget Report document. Here there is reference to the Government taking action in Budget 2004 "to ensure that the right amount of tax is paid by owner managers of small incorporated businesses on the profits extracted from their company".

This development, coming on the back of concerns about the application of the Settlements legislation to small businesses, has caused a deal of concern to such businesses and their advisers. Surely it would have been possible to give a more detailed explanation of what is envisaged? In particular, it naturally arouses concerns as to whether this is simply an attempt to compensate for the huge numbers of small businesses that have incorporated in recent years in the wake of the introduction of the nil "starter rate" for corporation tax.

8. *Missing Items*

There are always things that business, or taxpayers generally, look to be included in a Budget or PBR, which in the event remains unaffected. Three things are worth highlighting this time:

(i) The Chancellor announced that there would be no change to the VAT treatment of the management costs of many different types of retail funds, for example Units Trusts and OEICs. Given the regulatory changes in the European Union from 1 January 2004, surely the opportunity should have been taken to make UK exemptions commensurate with those of other EU member states and maintain the UK's competitiveness in this market.

(ii) It is disappointing that there are no details of how UK tax law will apply to the new European company. Although we are promised that these will be included in Finance Bill 2004, it does delay the ability of businesses to make use of the single European company.

(iii) There was no update on employee share plans. There are a good number of anomalies created by the rules introduced in the Finance Act 2003, which could usefully be addressed.

9. *Organisation of the PBR Releases*

As a final observation, it would be helpful if all tax changes were explained in Inland Revenue or Customs and Excise Press Releases, not left to the main PBR volume. The references above to paras 5.91 and 5.108 are two examples of this.

I hope the above comments are useful to the Committee. I would be happy to submit further observations or attend to give oral evidence if that would be helpful

19 December 2003

List of Reports from the Treasury Committee since 2001

The Government Responses to the Treasury Committee's Reports are listed here in italics by the HC No. after the Report to which they relate.

Session 2003–04

First Report	The Transparency of Credit Card Charges	HC 125	
Second Report	Child Trust Funds	HC 86	
Third Report	The 2003 Pre-Budget Report	HC 136	

Session 2002–03

First Report	National Statistics: The Classification of Network Rail	HC 154	*HC 550*
Second Report	The 2002 Pre-Budget Report	HC 159	*HC 528*
Third Report	Split Capital Investment Trusts	HC 418	*HC 651*
Fourth Report	The Handling of the Joint Inland Revenue/Customs and Excise PFI Project	HC 184	*HC 706*
Fifth Report	Annual Report for 2002	HC 491	
Sixth Report	The UK and the Euro	HC 187	*HC 1004*
Seventh Report	The 2003 Budget	HC 652	*HC 1028*
Eighth Report	Appointment to the Monetary Policy Committee of the Bank of England of Mr Richard Lambert	HC 811	
Ninth Report	Appointment of Ms Rachel Lomax as a Deputy Governor of the Bank of England and member of the Monetary Policy Committee	HC 1011	
Tenth Report	Inland Revenue Matters	HC 834	*HC 1181*

Session 2001–02

First Report	The 2001 Census in England and Wales	HC 310	*HC 852*
Second Report	Budget 2002*t*	HC 780	*HC 1075*
Third Report	The Office of Government Commerce	HC 851	*HC 1217*
Fourth Report	Appointment to the Monetary Policy Committee of the Bank of England of Mr Paul Tucker and Ms Marian Bell	HC 880	
Fifth Report	Banking, the Consumer and Small Businesses	HC 818	*HC 1218*
Sixth Report	The Financial Regulation of Public Limited Companies	HC 758	*HC 1219*
Seventh Report	Parliamentary Accountability of Departments	HC 340	*HC 149 2002–03*
Eighth Report	Inland Revenue: Self Assessment Systems	HC 681	*HC 1220*
Ninth Report	Appointment of Sir Andrew Large as a Deputy Governor of the Bank of England and Member of the Monetary Policy Committee	HC 1189	

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