House of Commons

Treasury Committee

# The 2004 Budget

## Sixth Report of Session 2003–04

*Volume I*

HC 479–I

House of Commons

Treasury Committee

# The 2004 Budget

## Sixth Report of Session 2003–04

### *Volume I*

*Report together with formal minutes*

*Ordered by The House of Commons to be printed 31 March 2004*

**HC 479–I**
Published on 6 April 2004
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

## The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration and policy of the HM Treasury and its associated public bodies.

**Current membership**

Mr John McFall MP (*Labour, Dumbarton*) (Chairman)
Mr Nigel Beard MP (*Labour, Bexleyheath and Crayford*)
Mr Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)
Angela Eagle MP (*Labour, Wallasey*)
Mr Michael Fallon MP (*Conservative, Sevenoaks*)
Rt Hon David Heathcoat-Amory MP (*Conservative, Wells*)
Norman Lamb MP (*Liberal Democrat, Norfolk North*)
John Mann (*Labour, Bassetlaw*)
Mr George Mudie MP (*Labour, Leeds East*)
Mr James Plaskitt MP (*Labour, Warwick and Leamington*)
Mr Robert Walter MP (*Conservative, North Dorset*)

**Powers**

The Committee is one of the departmental select committees, the powers of which are set out in the House of Commons Standing Orders, principally in SO No. 152. These are available on the Internet via www.parliament.uk The Committee has power to appoint a Sub-committee, which has similar powers to the main Committee, except that it reports to the main Committee, which then reports to the House. All members of the Committee are members of the Sub-committee, and its Chairman is Mr Michael Fallon.

**Publications**

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) from Session 1997–98 onwards are available on the Internet at: www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_reports.cfm.

**Contacts**

All correspondence for the Treasury Committee should be addressed to the Clerk of the Treasury Committee, 7 Millbank, House of Commons, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769. The Committee's email address is: treascom@parliament.uk.

# Contents


## Report

*Page*

**Summary** 3

**1 Introduction** 5

**2 The Economy** 6
- The recent past 6
- The outlook 7
  - Consumer spending and debt 7
  - The global economy 8
  - Inflationary pressures 10

**3 Public Sector Finances** 12
- The fiscal balance 12
  - Meeting the golden rule in the current cycle 13
  - The fiscal position in the medium term 14
- Revenue 15
  - Income tax 18
  - Corporation tax 18
  - National Audit Office 19
- Expenditure 20

**4 Other Budget issues** 22
- Protecting tax revenues 22
  - Tax avoidance 22
  - The tax treatment of pre-owned assets 24
  - Corporation tax for small companies 25
  - Corporation tax: transfer pricing 27
- Public sector efficiency savings 28
- Review of housing supply 30
- Savings 30
  - ISAs 30
  - Savings thresholds for benefits 31
  - Financial inclusion 32
- Other matters 32

**Conclusions and recommendations** 34

**Formal minutes** 39

**Witnesses** 41

**Written evidence** 42

# Summary


### *The economy*

The Committee welcomes the renewed vigour of the UK economy in recent months. Outturn growth for 2003 was higher than many outside commentators had forecast and buoyant growth is forecast for 2004. The net deterioration in household balance sheets over recent years is relatively limited. While the probability of a fall in house prices or a rise in interest rates on a scale which would cause widespread problems is limited, there is no room for complacency. It is important for policymakers internationally to seek to avoid the dollar's depreciation becoming destabilising in the face of the large US trade deficit.

### *The fiscal balance and borrowing*

The Government remains on track to meet the golden rule for borrowing over the economic cycle. The margin for error has however diminished further over recent months, in spite of the strong growth in the economy. In the medium term, if the economy were to grow above its trend level then it will be important for policymakers to ensure that larger fiscal surpluses accrue than those currently projected. The sustainable investment rule will also be met, although the margin has narrowed since the last Budget.

### *Revenues*

Despite the growth in the economy, and the record levels of employment, tax receipts in 2003-04 have been below the Treasury's forecasts. The Committee hopes the overestimation over the last three years of both absolute tax receipts and taxes as a proportion of GDP will not continue. The Committee makes a number of proposals for greater transparency in the Treasury's tax forecasts.

### *Public expenditure*

The growth rate of public expenditure in the next spending review period (2005—2008) will be slower than the recent increases. Whether increases in expenditure on front-line public services are to match those of recent years will depend on the success of the Government's efficiency savings programme. This programme involves a challenging target which leaves little room for manoeuvre. The House will wish to see clear indications in the Spending Review as to how the savings are to be made and how their achievement is to be measured.

### *Protecting tax revenues*

The Government's proposed disclosure regime for tax avoidance schemes will need to be one which tackles avoidance effectively without creating undue compliance burdens for taxpayers and their advisers or undue administrative burdens for the tax authorities. The details will merit close examination during the passage of the Finance Bill. The Committee welcomes the changes made so far to the initial proposals for a charge on income to close tax loopholes on pre-owned assets.

On the proposals for closing the loophole caused by the introduction of the zero rate of corporation tax, we are puzzled that, unlike other commentators, the tax authorities and the Treasury did not anticipate the likely effect of introducing the zero rate; we are concerned about the possible compliance burdens of the proposals compared with abolishing the zero rate band. Also on corporation tax, the Committee shares the concerns of a number of witnesses over the effect on competitiveness of the extension of transfer pricing rules but were reassured by the Chancellor's comments and looks forward to this being treated sympathetically in the passage of the Finance Bill.

### Housing supply

The Committee welcomes the contribution to the debate on housing supply from Kate Barker's review. It sees the design and implementation of any tax along the lines of a Planning Gain Supplement as challenging; the Committee suggests that, if it is set at a level to raise excess revenue rather than to encourage developments and to fund additional investment in housing, then it will not be successful.

### Savings

The Committee reaffirms its view that to reduce the cash limits for ISA contributions appears to run counter to the policy of encouraging people to save and calls on the Treasury to examine closely the effect that reducing the £3,000 limit for cash ISAs might have on the opportunities for lower income and younger savers and also to keep under review the issue of the treatment of capital in assessing retirement benefits. We also point to the need for progress in developing greater access to advice for the less affluent in relation particularly to debt but also to mortgage borrowing and pensions.

### Other matters

The Committee draws attention to, without coming to conclusions on, evidence taken on tax stamps for spirits, venture capital schemes, the lifetime limit for tax assistance for pension savings, council tax, the devolution of Business Link to the RDAs, the Local Authority Business Growth Incentives Scheme, and the Lyons Review of public sector relocation.

# 1 Introduction

1. The 2004 Budget was delivered on Wednesday 17 March.[1] As in past years, the Committee agreed that it should conduct an immediate Budget inquiry with a view to reporting to the House in time for the debate on the Second Reading of the Finance Bill.

2. We accordingly held three oral evidence session in the week following the Budget, with outside experts[2] on Tuesday 23 March (morning), Treasury officials (led by Mr Jon Cunliffe, Managing Director, Macroeconomic Policy and International Finance) on Tuesday 23 March (afternoon), and the Rt Hon Gordon Brown MP, Chancellor of the Exchequer, on Wednesday 24 March. This evidence, together with the written evidence submitted by our expert witnesses and others,[3] is published in Volume II to the Report. We are most grateful to all those who have assisted in the inquiry.

3. As is our practice in reports on the Budget and on Pre-Budget Reports, we begin by discussing the general state of the economy, including growth forecasts and international developments, and then go on to consider the public finances and overall revenue and expenditure issues, before discussing a selection of individual Budget measures or issues.

1 HC Deb, 17 March 2004, col 321. The accompanying Economic and Fiscal Strategy Report and Financial Statement and Budget Report were published in Budget 2004 HC, 2003–04, 301 (hereafter referred to as "HM Treasury Budget 2004")

2 Mr Ciarán Barr (Chief UK Economist, Deutsche Bank), Mr Robert Chote (Director, Institute for Fiscal Studies), Professor Peter Spencer (York University), Mr Edward Troup (Simmons & Simmons), Mr Martin Weale (Director of the National Institute of Economic and Social Research) and Mr John Whiting (PricewaterhouseCoopers)

3 In addition to the papers submitted by the witnesses indicated above, papers were received from Professor David Heald (University of Sheffield, the Committee's specialist adviser on expenditure matters), Ms Anne Redston and Mr Russell Gardner (Ernst & Young), and (after the oral evidence had been taken) from the CBI.

# 2 The Economy

## The recent past

4. The IMF has observed that, after faltering in the wake of the Iraq war, UK economic activity has "staged a strong recovery" in recent quarters.[4] Indeed the recent pace of the UK recovery seems to have taken even the Treasury by surprise, in spite of the fact that at the time of the Pre-Budget Report (PBR) the Treasury's assessment of the growth outlook was seen as optimistic by many outside forecasters. Treasury officials told us "that the economy grew a little bit more strongly at the end of last year than we were forecasting. At PBR time, if you remember, we shaded our forecast for 2003 down from 2.3 to 2.1 per cent."[5] The Budget forecasts now estimate 2003 growth to have been 2¼%.[6]

5. Since the Pre-Budget Report the Treasury has maintained its 3% to 3½% growth forecasts for 2004 and 2005[7], but the renewed vigour evident in the UK economy has come as a particular surprise to many independent forecasters (including some of our own experts), many of whom have been forced to revise their UK growth expectations significantly upward towards the Treasury's forecasts. At the time of the Pre-Budget Report, independent forecasters were, on average, forecasting growth of 2.6% for 2004.[8] This has now risen to 3.0%,[9] consistent with the lower end of the Treasury's forecast range. Several outside experts told us that the Treasury forecasting record in recent months deserved praise. Mr Barr told us that "in terms of the growth forecasts, you have to doff your cap to the Treasury, they certainly were more accurate than the independent forecasters."[10] Professor Spencer told us "that the Treasury is to be congratulated on its forecast for the outgoing year and also for this year, there is no question about that."[11]

6. One of the main factors behind the recent growth in the economy has been the strength of consumer demand. Treasury officials told us that "going into 2004 the main factor that is a bit new from our PBR forecast is stronger consumption growth coming through".[12] One independent expert, Professor Spencer, noted that much of the recent strength in consumption could ultimately be traced back to "the injection of demand by the public sector" and argued that "looking back over the last two years….this has actually been very helpful".[13] A similar view has been expressed by the OECD, which noted that "the performance of the UK economy has been impressive in recent years, underpinned by wide-ranging structural reforms and sound macroeconomic policy frameworks" allowing

4 *Staff Report for the 2003 Article IV Consultation*, International Monetary Fund, March 2004, p 4

5 Q 116

6 HM Treasury Budget 2004, p 221, table B3

7 *Ibid.*

8 *Forecasts for the UK Economy: A Comparison of Independent Forecasts*, H M Treasury, November 2003

9 *Forecasts for the UK Economy: A Comparison of Independent Forecasts*, H M Treasury, March 2004

10 Q 2

11 Q 3

12 Q 116

13 Q 5

"fiscal policy to be strongly supportive of growth."[14] **The Committee welcomes the renewed vigour of the UK economy in recent months. It notes that this strong growth performance has justified the Treasury's growth forecasts made at the time of last year's Budget and Pre-Budget Report, and recognises the effect of fiscal policy in supporting this growth.**

## The outlook

7. Looking forward, there are a number of areas meriting particular attention.

### *Consumer spending and debt*

8. Media comment has often emphasised the role of rapidly rising consumer debt in fuelling the recent growth in consumer spending. Concern has been expressed that this could ultimately represent a source of dangerous instability in the economy, but the evidence we received in the course of our inquiry was generally reassuring on this issue. Mr Weale told us that while there was a risk that "at some point, particularly if interest rates rise markedly, people will decide that they have borrowed too much and they will have to have a rest from borrowing which will slow consumer growth very markedly",[15] at this stage he was not sure that the British economy was either over-borrowed or under-borrowed. Other experts pointed out that household sector financial assets were rising rapidly alongside the rise in debt, so that the net deterioration in household balance sheets was less severe than the headlines tended to suggest. They noted that the prime driver of consumption growth was in reality real disposable income growth.[16] Treasury officials also highlighted that although household debt had gone up, so had household assets via a rise in both housing assets but also holdings of liquid assets.[17] Mr Cunliffe also told us that "debt servicing cost is roughly running at 7 per cent of income whereas in the early 1990s it was running at 15 per cent, so it is about half the level, and households' mortgage repayments are about 16 per cent of income whereas they were about 28 per cent, so the debt servicing measures suggests that this debt burden, even if interest rates go up a little, is much more sustainable."[18] Mr Weale also commented on the fact that the Budget statement made no comment at all on the "national balance sheet"; he suggested that the Treasury ought to publish a consultative document about how the national balance sheet evolves and how they think it would be prudent for it to evolve.[19] **The Committee notes the evidence it has heard that the rise in household debt has been matched by a rise in holdings of both housing and financial assets by the household sector, so that the net deterioration in household balance sheets over recent years is relatively limited. The Committee would nevertheless welcome the publication of more information on the distribution of assets and liabilities across the household sector to assist policymakers and others to quantify the number of households potentially facing difficulties as interest rates rise.**

---

14 *Economic Survey of the United Kingdom, 2004*, OECD, January 2004, pp 1–2

15 Q 20

16 Q 22

17 Q 142

18 Q 143

19 Q 37

9. Worries have also been expressed that the housing market could be a significant source of instability. The IMF has argued that, looking out beyond the next few months, in its view the main risk to the UK economy "related to a hard landing scenario of house prices and consumption", not least because recent international evidence "suggests housing price booms are followed by busts about 40 percent of the time."[20] One witness said that "it is a significant risk".[21] Treasury officials took a more sanguine view, pointing out both the cushion provided by households' holdings of liquid assets and lower debt servicing costs.[22] While acknowledging that "when interest rates go up there will be some households that have problems",[23] Mr Cunliffe of the Treasury told us "there must be a risk on the downside of house prices correcting sharply. I would say it is quite small."[24] Expert witnesses generally agreed with this assessment. Mr Weale, for example, argued that "if interest rates rise to five per cent then we are more likely to have a period of house price stagnation rather than a collapse."[25] Equally, however, our expert witnesses felt it could be beneficial if the UK were to move over to a fixed rate mortgage system, as outlined in the Miles Report on housing finance.[26] Professor Spencer, for example, told us that "I do not think there is any question that our housing market would be more stable if we moved over towards a system of long-term [fixed-rate] finance… I think the economy would certainly be less prone to external shocks."[27] **When the Committee considered the 2003 Pre-Budget Report we concluded that "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".[28] The evidence we have heard this spring, although not unanimous, suggests that this conclusion remains generally valid; but there is no room for complacency. The Committee welcomes a thorough examination being given to any proposals, such as those put forward by Professor Miles, which could serve to limit the potential for the UK housing market to have a destabilising influence on the rest of the economy.**

### *The global economy*

10. The evidence we received suggested that the factors spurring on UK growth in recent quarters are not confined to the domestic economy. Mr Cunliffe of the Treasury told us that: "What is driving the economy forward? I would say the pick-up in the world economy has strengthened and become more broadly based, certainly since we discussed it at PBR time; world trade is now set to pick up, and the conditions in the United Kingdom economy, I think, are there for some rebalancing of economic growth away from consumption and more towards investment."[29] The Treasury has thus revised upward

20 *Staff Report for the 2003 Article IV Consultation*, International Monetary Fund, March 2004, p 8, para 10

21 Q 32

22 Qq 141, 143

23 Q 143

24 Q 145

25 Q 33

26 *The UK Mortgage Market: Taking a Longer-Term View* Final Report and Recommendations, HM Treasury March 2004

27 Q 38

28 Third Report of Session 2003–04, *The 2003 Pre-Budget Report*, HC 136, p 11 para 13

29 Q 116

slightly its forecast of G7 GDP growth in 2004 and 2005 from 3% and 2¾% respectively at the time of the Pre-Budget Report[30] to 3¼% and 3% in the Budget forecasts.[31] In the US, the depreciation of the dollar is giving a substantial boost to growth. The Asian economies are also rebounding, with Japan now staging a sustained recovery, helped in part by the dynamism of the Chinese economy. In the euro area, however, the revival of activity is more modest and the danger is, as the OECD's chief economist noted in Davos earlier this year, that "the sizeable appreciation of the euro since late 2003 will hold back the fledgling recovery."[32]

11. While the overall external environment continues to improve, it nevertheless poses some significant risks for the UK outlook, not least in the context of a record deficit in trade in goods recorded in January. The IMF has suggested that "the near term growth outlook is subject to upside risk on the domestic front and, although fading, downside risks on the external front", citing in particular the risk that UK exports "could suffer from weaker than expected recovery in the euro area, the destination of half UK exports, or a further depreciation in the dollar". [33] Many of our witnesses agreed with this assessment. Mr Barr, for example, highlighted that "on the trade deficit, we are very vulnerable right now because of the weakness of the dollar".[34] He suggested that there was a risk that a deteriorating trend in the UK's trade balance with the EU, in large part due to the weakness of the euro economy, would coincide with a withering of the trade surplus with the US due to sterling's strength relative to a weak dollar. The Chancellor told us he was more optimistic, suggesting that British industry was in a good position to benefit from the expected increase in world trade.[35] Treasury officials also suggested that "on the record current account deficit, a sensible way to look at all of these figures is as a ratio of the GDP. So you look at the current account deficit against the size of the economy and, as such, it is forecast to go to 2.75 per cent—which is not a record"[36] and posed little threat of a financing crisis. Independent experts generally agreed that a financing crisis seemed only a remote possibility,[37] the danger being instead that "because of the strength of the pound we are losing competitiveness very rapidly"[38]—thereby threatening hopes of the economy rebalancing from domestic demand towards external demand.[39]

12. The dangers posed by global currency volatility, in particular the fall in the dollar, were highlighted as a cause for concern by the Committee in its discussion of the Pre-Budget Report.[40] These dangers are also recognised by the Treasury, with the Budget arguing that there is an "urgent need for policy makers to push ahead with structural reforms that will ensure a more broadly based and sustainable global recovery over the medium term,

30 HM Treasury Pre-Budget Report 2003, Cm 6042, p 168 Table A1

31 HM Treasury Budget 2004, p 215 Table B1

32 Jean-Philippe Cotis, Chief Economist, OECD, Press Conference, World Economic Forum, Davos, 22 January 2004

33 *Staff Report for the 2003 Article IV Consultation*, International Monetary Fund, March 2004, p 8

34 Q 15

35 Q 309

36 Q 121

37 Q 16

38 Q 15

39 Q 17 and Q 18

40 Third Report of Session 2003–04, *The 2003 Pre-Budget Report*, HC 136, para 6

minimising the risk of a disorderly unwinding of global trade positions."[41] **The Committee endorses the Treasury's call for international structural reforms that will ensure a more broadly based and sustainable global recovery. It is particularly important for policymakers internationally to seek to avoid the dollar's depreciation becoming destabilising in the face of the large US trade deficit.**

### *Inflationary pressures*

13. A further consequence of the fall in the dollar and the gathering rebound in the global economy has been a strong rise in both oil and non-oil commodity prices. The Treasury notes that oil prices are likely to remain significantly above the long-run average for the remainder of this year and that, particularly given low stocks, they "remain vulnerable to shocks".[42] Few witnesses to our inquiry saw any direct risk of a major upsurge in UK inflationary pressure from this direction, not least because of the economy's increasingly limited exposure to raw material costs as services take a rising share of GDP.[43] Mr Weale nevertheless suggested that he saw "commodity prices and lax monetary and fiscal policy in the United States as the early indicators of an international inflationary situation which is augmented by the fact that demand in the Far East is growing strongly."[44] Other experts disagreed with this view, but Treasury officials acknowledged that the commodity price background is one issue "contributing to inflation coming back up again over the two year period."[45]

14. The other major upward pressure on the UK inflation rate over the coming quarters is likely to come from the closing of the UK output gap. The level of spare capacity in the UK remains a subject of keen debate. Treasury officials told us that, looking at the labour market, unemployment on the ILO measure was about 1.5 million and the claimant count was well below a million. Meanwhile the participation rate in employment in the economy was 74.5 per cent. These figures are all historically suggestive of relatively tight conditions, but, as Treasury officials stated, "at the same time we have average earnings growing below their long term trend."[46] This suggested major changes in the functioning of the labour market which, when combined with survey evidence on spare capacity, pointed to a relatively large amount of slack in the economy.[47] Moreover, "financing costs are low; corporate profitability is high. In all the conditions the optimism seems to be there for an increase in business investment going forward."[48] Others told us that very low levels of unemployment suggest relatively little spare capacity.[49] All sides agree, however, that the output gap will close over the coming year and that this will produce a rising trend in CPI

41 HM Treasury Budget 2004, p 220 para B15

42 HM Treasury Budget 2004, p 218 para B13

43 Q 12

44 Q 13

45 Q 118

46 Q 127

47 Q 127

48 Q 126

49 Q 6

inflation. Treasury officials told us that they are "expecting inflation to increase and to come back towards 2 per cent on the CPI measure."[50]

15. The Monetary Policy Committee (MPC) has already started to respond to this prospect, with two 25 basis point rises in the base rate since last autumn, but the task ahead of it is complicated by the high levels of debt surfacing in some areas of the personal sector. Professor Spencer told us that "interest rates should have a very strong bite through the high level of debt and through high mortgage interest payments essentially. You can see that a rise from three and a half to five per cent in the base rate, in other words a rise of 1.5 per cent in interest rates, has the effect of reducing gross household disposable incomes by nearly two per cent, so there is a very strong bite there."[51] This, plus the volatile international background we noted earlier, only adds to the difficulty confronting the MPC in calibrating the correct response from monetary policy. The IMF has argued that a strategy of "gradual, early interest rate increases"[52] is appropriate and recent rate moves from the MPC fit in well with such a pre-emptive strategy. **The Committee believes that recent rate moves from the MPC have been fully consistent with the gathering momentum in the UK economy and remains confident that the MPC will continue to respond to economic developments in a timely and appropriate way. The Committee has also been reassured by the MPC's handling of the recent switch to a CPI inflation target.**

50 Q 130

51 Q 23

52 *Staff Report for the 2003 Article IV Consultation*, International Monetary Fund, March 2004, p 10

# 3 Public Sector Finances

## The fiscal balance

### *The framing of the golden rule*

16. The golden rule has acquired a central role in UK fiscal policy but, at the time of last autumn's Pre-Budget Report, the Committee found evidence of uncertainty amongst commentators about the exact calculation of the golden rule. The Committee therefore recommended that "the presentation of the Government's progress towards meeting the golden rule should be standardised."[53] The source of confusion last autumn was an apparent change in emphasis in the Pre-Budget Report away from assessing the golden rule in terms of the simple cash summation of the surplus (or deficit) on the Government's current budget across the economic cycle—the method used in the Chancellor's 2003 Budget speech[54]—towards a presentation that highlighted the summation of the current surplus each year as a percentage of GDP.

17. The Committee heard evidence from the Treasury at the time of the PBR, which it accepted, that there had been no underlying change of substance in the golden rule and that it had been focused on the average annual figures for the current Budget surplus as a percentage of GDP since it inception. The Treasury further told us that "Improving knowledge of the fiscal framework is important to building a credible fiscal policy, and while being methodologically sound, the concept of an average annual ratio expressed as a ratio to GDP can be difficult to grasp. Presenting figures in terms of billions of pounds is designed to help people understand the scale of the margin against unexpected events. That does not detract from the position that compliance with the golden rule is measured using ratios to GDP and this has been consistently the case since the rule was first introduced."[55] Using this basis for measurement, the Chancellor told the House in this year's Budget statement that "Our first fiscal rule is that over the cycle we balance the current budget. Having accumulated surpluses at the start of the economic cycle, we meet our first rule, the golden rule. Indeed we have an average annual surplus over the whole cycle—an overall margin or surplus of £11 billion",[56] while the Budget documentation explained that "The projections show the average current budget since the start of the current economic cycle in 1999–2000 up to 2005–06 in surplus by an annual 0.1 per cent of GDP and the Government is therefore on track to meet the golden rule on the basis of cautious assumptions. There is a margin against the golden rule of £11 billion in this cycle, including the AME margin."[57]

18. The Treasury's presentation of the golden rule nevertheless continues to be the focus of debate among external analysts. Several outside commentators have highlighted the scope for confusion created by the current variety of measures used to present the golden rule.

53 Third Report of Session 2003–04, *The 2003 Pre-Budget Report*, HC 136, p 17, para 27

54 HC Debates , 9 April 2003, col 284

55 Third Special Report of Session 2003–04, *Government Response to the Committee's Third Report on The 2003 Pre-Budget Report (HC 136)*, HC 478, p7

56 HC Debates, 17 March 2004, col 325

57 HM Treasury Budget 2004, p 244, para C5

Deutsche Bank summarised the situation as "the golden rule is met — but only on one of three possible yardsticks."[58] Moreover the presentation in this year's Budget documentation has added a further area of confusion by the explicit inclusion of the £3 billion AME margin[59] in the surplus used in calculating the golden rule. Barclays Capital Research argued that this "did not make any sense to us at all."[60] The Institute of Fiscal Studies also implicitly excluded the £3 billion AME margin in its calculation of the golden rule surplus, which its post-Budget press release described as "equivalent to just over £8 billion."[61] The Chancellor told the Committee that it was correct to include the AME margin in the golden rule calculation since it was "£3 billion that is available to us which we have not got any plans to use at the moment.."[62] This is a position that Mr Weale did not feel was unreasonable.[63] But neither outside experts[64] nor Treasury officials[65] were clear as to the treatment of the AME margin in previous Budgets. This suggests a lack of clarity in the precise formulation of the fiscal rules and Mr Chote suggested that the Treasury had engaged in "various attempts to sort of tweak the presentation"[66] of the numbers. The Chancellor told us that "I think you will find we have always done it in previous years, but we can obviously write to the Committee[to confirm this]."[67] **The Committee awaits with interest clarification on the issue of the treatment of the AME margin in the past in calculating compliance with the golden rule, but notes that any differences in phrasing in Treasury documents in this crucial area may be a source of confusion which may undermine the rule's credibility. As the Committee stated at the time of its report on the PBR, presentation of the Government's progress towards meeting the golden rule should be standardised in order to avoid any possible confusion in the future.**

### *Meeting the golden rule in the current cycle*

19. In spite of the uncertainties created by presentation issues, there was a broad consensus among our expert witnesses that the "the key point here is just the degree to which the previous buffer on the Golden Rule has just been sliced away and sliced away and sliced away, despite the fact….that [the Chancellor] was absolutely bang on in his growth forecast."[68] The IFS, for example, has concluded that the surplus on the golden rule is now "equivalent to just over £8 billion—a smaller amount than the £14 billion he predicted just three months ago. With two years of the cycle still to go, this leaves little margin for error."[69] Similar sentiments have been expressed by Goldman Sachs, who have written; "If revenues were to continue to disappoint in the coming year, the government will have little

58 Deutsche Bank, *UK Budget Special*, 17 March 2004

59 The AME margin is the margin for unplanned increases in the Annually Managed Expenditure (AME) element of Total Managed Expenditure; in Budget 2004 the margin has been set at £1m for 2004–05 and £2m for 2005–06.

60 Barclays Capital Research, *Budget Analysis*, 18 March 2004, p 7

61 *IFS Response to the Budget 2004*, 17 March 2004

62 Q 336

63 Q 48

64 Q 44

65 Q 168

66 Q 49

67 Q 339

68 Q 54 (Mr Barr)

69 *IFS Response to the Budget 2004* 17 March 2004; see also Memorandum 7 (Professor Spencer)

option but to hike taxes next spring. There is little margin of error on the golden rule. On our estimates, it will be met by a margin of 0.02% of GDP on average over the current cycle. But our forecasts for 2004/05 are very similar to the Treasury's. Hence, whether or not taxes need to rise in the medium term might be more of an issue for the 2006 Budget than for 2005."[70] Mr Brown told us that "we do meet our fiscal rules",[71] over the current cycle (which is taken as ending in 2005–06). **The Government remains on track to meet the fiscal rules over this cycle on its central forecasts. The margin for error has, however, diminished further over recent months, in spite of the strong growth in the economy. This is a development which requires careful monitoring by the Treasury.**

### *The fiscal position in the medium term*

20. Looking further out, the Chancellor forecasts current budget surpluses of £0bn in 2006–07, £4bn in 2007–08 and £9bn in 2008–09.[72] Several independent experts told us that fiscal policy needed to be tightened in the medium term. Professor Spencer suggested that this might be necessary "First of all, to help fiscal policy aid monetary policy in managing the cycle… and, secondly, to help restore a fundamental balance in the public sector's arithmetic."[73] Mr Chote[74] also suggested that it was far from clear from recent trends that the fiscal arithmetic will begin the next cycle in structural balance, let alone structural surplus. Other experts were less concerned. Mr Barr told us that he did "not think the time was right for significant fiscal tightening, simply because of the degree of uncertainty that exits in both the global economy and also around the UK economy" although there was a "need for some small, medium-term fiscal tightening."[75] Similarly Goldman Sachs have observed that " Lower borrowing means that, for the first time in five years, the fiscal stance will tighten in 2004/05—by 0.1% of GDP on our estimates (0.3% of GDP on the Treasury's). This is appropriate when the global economy is recovering, but it will not be enough to prevent further increases in interest rates by the Bank of England."[76] Mr Weale argued that some degree of fiscal tightening was already in place.[77]

21. Treasury officials confirmed this view. Mr Cunliffe told us that: "What we forecast going forward from 2005/2006 onwards is that the economy comes up to its trend level and stays there. That in a way is a fairly stylised view of the world. … so that [the economy] is not operating above capacity; it is just staying at capacity for three years, we start to build up a fiscal surplus culminating, I think, in £7 billion by the end of the period. Were the economy to go above trend then, with the automatic stabilisers, ….a larger surplus would appear."[78] The Chancellor also told us that "there are circumstances that any Chancellor has to take into account [when looking at taxes], but the point I have got to say to you is that every commitment we have made, right up to the years in which we have forecast

70 Goldman Sachs, *European Weekly Analyst*, 19 March 2004

71 Q 350

72 HM Treasury Budget 2004, p 32 Table 2.5

73 Qq 60, 62

74 Q 64

75 Q 64

76 Goldman Sachs, *European Weekly Analyst*, 19 March 2004

77 Q 62

78 Q 179

ahead, is fully financed, every commitment is perfectly affordable."[79] **The current fiscal projections are consistent with Treasury's forecasts that growth in the economy comes up to trend from 2005–06 but does not go above trend. If the economy were to move above its trend level and begin to operate above capacity, it will be important for policymakers to ensure that larger fiscal surpluses than those currently projected do indeed accrue, both to ensure sufficient flexibility for fiscal policy through the next cycle and to help fiscal policy aid monetary policy in managing the cycle.**

22. The Treasury's 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". The projections in the Budget show net debt rising to 36.4% of GDP at the end of the forecast period (2008–09); the figure for the end of 2007–08 is 36.3%, which compares to a figure of 33.8% of GDP for that year in Budget 2003. Mr Weale told us that the increase in net debt over the forecast period reflected "a revenue shortfall relative to current expenditure in the short to medium term and at the same time continued expansion of public sector investment". The Chancellor emphasised in the Budget statement that "We meet [the sustainable investment] rule over the cycle and in each and every year". **Public sector debt is predicted to rise over the forecast period, in the near-term due to the shortfall in current revenue but also due to the programme of public sector net investment. The latest projections of public sector net debt indicate that the sustainable investment rule will be met, although the margin has narrowed since the last Budget.** We note that the level of debt is still low compared to most other EU and G7 countries.

## Revenue

### *Overall tax receipts*

23. Tax receipts in 2003–04 are now expected to be £398.2 billion, £4.7 billion lower than projected in the 2003 Budget and £0.4 billion lower than forecast in the 2003 Pre-Budget Report. As discussed earlier, economic growth in the past financial year has been above the Treasury's forecast and is now expected to be 2¾% in fiscal year 2003–04, compared to 2¼% at the time of the 2003 Budget and Pre-Budget Report. Net taxes and social security contributions are now forecast to be 35.7% of GDP in 2003–04, compared to a forecast of 36.3% in the 2003 Budget and 35.9% in the 2003 Pre-Budget Report. The job market has remained robust with the employment level reaching a record high of 28.27 million in the fourth quarter of 2004. **Despite the growth in the economy being above forecast, and record levels of employment, tax receipts in 2003–04 have been below the Treasury's forecasts in the Budget last year, although only slightly below those in the Pre-Budget Report.**

24. From 2005–06 onwards receipts are expected to be marginally higher than previously forecast, reflecting a new VAT forecasting methodology, higher equity prices (than at the time of the PBR) and consumer expenditure and the effects of the Inland Revenue compliance package. The Treasury continues to project a sharp rise in net taxes and social

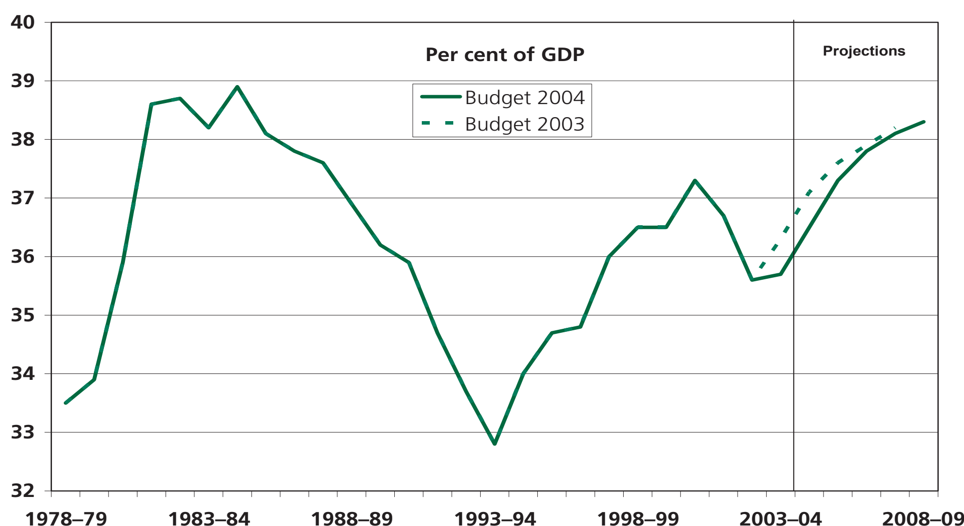
79 Q 349

security contributions as a percentage of GDP from 35.7% in 2003–04 to 38.3% in 2008–09 (see Chart 1 below). The Treasury explains in the Budget documentation that this increase is caused by "normal fiscal drag…; a recovery in financial sector bonus payments; the lagged impact of the recovery in equity prices observed in 2003; and discretionary measures announced in this and previous Budgets".[80] As Table 1 shows, the main taxes driving this projected rebound in receipts are income tax and corporation tax. Goldman Sachs were concerned that "the projected rise in the share of taxes in GDP over the next three years is starting to look very strong relative to what might be expected given the Treasury's rules of thumb relating the tax share with GDP growth."[81] Professor Spencer believed that "these very large increases in the tax-take at a time when the economy is apparently on trend would be quite unprecedented [on unchanged policies]".[82]

**Table 1: Net taxes and social security contributions as a proportion 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 | 11.2 | 11.4 | 11.6 |
| Social Security Taxes | 6.1 | 6.5 | 6.6 | 6.6 | 6.6 | 6.7 | 6.8 |
| Non-North Sea corporation tax | 2.5 | 2.3 | 2.7 | 3.2 | 3.3 | 3.4 | 3.4 |
| 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 | 0.3 |
| Value Added Tax | 6.0 | 6.3 | 6.2 | 6.2 | 6.2 | 6.2 | 6.2 |
| Excise Duties | 3.6 | 3.5 | 3.4 | 3.4 | 3.3 | 3.3 | 3.2 |
| Other | 6.6 | 6.6 | 6.7 | 6.9 | 7.0 | 7.1 | 7.1 |
| **Net Taxes & Social Security Contributions** | 35.6 | 35.7 | 36.5 | 37.3 | 37.8 | 38.1 | 38.3 |

**Chart 1: Tax-GDP ratio**




*Source: Budget 2004, page 261–262*

25. Other forecasting bodies remained sceptical that the increase in revenues would reach the magnitude projected by the Treasury. The IFS believed that "it remains doubtful whether the bounce-back in revenues—above and beyond any bounce-back in the economy—will be large enough to turn the public finances around in quite this dramatic

80 HM Treasury Budget 2004, p 261 para C57

81 Goldman Sachs, *European Weekly Analyst*, 19 March 2004

82 Q 59

fashion."[83] The IMF , in their recent report on the UK economy, took a more pessimistic view of the potential of tax revenues to bounce back, projecting only a rise to 37% of GDP by 2007–08.[84] Mr Cunliffe told us that the Treasury's tax forecasts are "grounded in the micro detail" and they have "a lot of information from the Inland Revenue and Customs [& Excise]" about how taxes are paid and what is happening to corporates, which is confidential but feeds into the way in which tax is forecast.[85] He told us that "outside international commentators, I think, necessarily, have to take a much more broad brush view".[86] The Treasury had previously told us that "In terms of forecasting, although the Treasury forecasts for taxes such as PAYE and corporation tax are constructed using a bottom up approach that aggregates the tax forecast for individual firms and employees etc, those individual projections are themselves largely based on forecasts of more aggregated economic determinants".[87] **While recognising the need to preserve confidentiality in tax matters, we believe it would be helpful for the Treasury to consider ways of sharing as much aggregated data as possible on the way taxes are paid with outside forecasters. We note the Treasury has over-estimated tax revenues in the last three years, but we also note that the differences between external forecasters and the Treasury are in line with past margins of uncertainty affecting all such forecasts.**

26. There seem to be more reasons for optimism regarding the outlook for receipts than at the time of the Pre-Budget Report. Company profits have been rising strongly, with gross trading profits from non-financial corporations rising by 10.7% in the year to the fourth quarter of 2004.[88] Oil prices have remained high, which will affect corporation tax receipts and North Sea revenues. Mr Barr told us that income tax receipts had partly been weak because full-time employment growth had slackened sharply, but that this had now begun to recover and was something to keep a close eye on because it would certainly feature very quickly in income tax returns. The Chancellor noted that City bonuses had been relatively high in January and February this year, a fact reflected in higher than expected income tax receipts in those two months. However, the Treasury's forecasts continue to call for robust growth in tax receipts of 7.9% in 2004–05 and 7.3% in 2005/06. These rates are in excess of the growth of money GDP for the next two years and at similar levels of growth to those experienced in the late 1990s. Mr Cunliffe told us that he thought we had seen the end of the run of over-forecasts of tax revenue and that "these aggregates are starting to come back. Within individual components like VAT we have seen them come back more strongly than we were forecasting. It is not a one-way street."[89] **Given that the economy is now growing relatively strongly we hope the over-estimation over the last three years of both absolute tax receipts and net taxes and social security contributions as a proportion of GDP will not continue. Last year we concluded that the risks to the Treasury's revenue projection were on the downside. While this risk has receded given recent positive data, the forecasts remain challenging and the Treasury needs to**

83 *IFS response to Budget 2004*, 17 March 2004

84 *Staff Report for the 2003 Article IV Consultation*, International Monetary Fund, March 2004, p 38 Table 5

85 Qq 203, 206

86 Q 206

87 Seventh Special Report, Session 2002–03, *Government Response to the Committee's Seventh Report on the 2003 Budget (HC 652)* HC 1028, para 15

88 ONS National accounts, 4th quarter 2004

89 Q 198

**monitor developments closely.** This highlights the importance of measures being taken to protect tax revenues, and we discuss some of the Budget's proposals in this area below.

## *Income tax*

27. Income tax receipts are expected to be £119.1 billion in 2003–04, broadly in line with the projections in the 2003 Pre-Budget Report, but £3.0 billion lower than forecast in the 2003 Budget. Income tax receipts have now been weaker than expected in the past three Budgets, by a cumulative total of £8.5 billion. Mr Cunliffe explained that these over-estimates had mainly been caused by a reduction in bonuses in the financial sector and by average earnings growth which had been low and remained low even as the economy recovered.[90] The Treasury is expecting growth of income tax receipts of 7.3% in the 2004–05 financial year.

28. The Treasury recently told us that there was

> "no direct data available on the proportion of salaries paid in annual bonuses, although inferences can be made from the pattern of monthly income tax receipts data. Inland Revenue data on receipts from large employers suggest that most of the variability in the end year surges in income tax receipts associated with bonus payments stems from the financial sector. The fiscal projections assume that the strong relationship between employee remuneration (including bonuses) and profits in the financial sector will continue in the projection period."

In response to our previous requests the Treasury told us that they "will consider publishing the components of the forecast in greater detail."[91] **We welcome the Treasury's statement that it will consider publishing its income tax forecast in more detail. We recommend that it does so in the forthcoming Pre-Budget Report, differentiating between PAYE, self-assessment, bonus payments and income at standard and higher rates.**

## *Corporation tax*

29. The Treasury has revised up its forecast of corporation tax receipts in future years due to "the impact of higher equity prices;…the new Inland Revenue compliance package; and …the introduction of a 19 per cent minimum rate of corporation tax on distributed profits."[92] Given that corporation tax receipts for the current year have come in broadly in line with the expectations in the Pre-Budget Report, the Treasury is now projecting a sharp rise in revenues over the next two years—similar in magnitude to that which occurred in the early 1990s (see Chart 2). Professor Spencer noted that in 2004–05 "corporation tax receipts are forecast to increase by over 21%, about twice as fast as company profits."[93] Mr Chote described the forecast for corporation tax receipts in the medium term as "relatively

90 Q 194

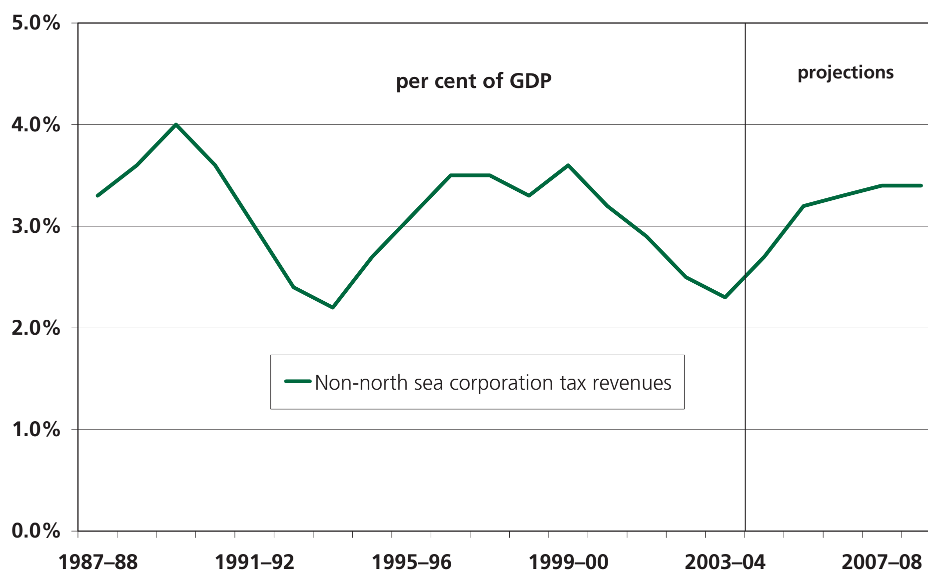
91 Third Special Report, Session 2003–04, *Government Response to the Treasury Committee's Third Report on The 2003 Pre-Budget Report (HC 136)*, HC 478, para 23

92 HM Treasury Budget 2004, p 257

93 Memorandum 7

upbeat"; the projections had been revised up from those in the PBR and "partly reasonably so" on the basis of the new minimum rate of corporation tax.[94]

**Chart 2: Non-North Sea corporation tax receipts as a proportion of GDP**




*Source: Institute for Fiscal Studies*

30. The Chancellor told us that they divided corporation tax into three areas, "the non-financial companies; the life assurance companies; and the financial sector companies" and that the reason the Treasury was in a position to forecast rising corporate tax revenues was that the "results that are coming out from a number of different banks and financial sector companies, [indicate] that the profitability of these companies is up substantially…this means they are delivering and will deliver extra revenues to the Treasury" and that the rise in the equity market would affect the profits of life assurance companies. He told us that "corporation tax was something in the order of 3.4 per cent of GDP, it then fell to 2.3 per cent of GDP [during the world downturn] and all [the Treasury] are suggesting is that corporation tax revenues will return to what was roughly its previous level, over the course of the next few years and that is not an unreasonable assumption." The Chancellor explained that "It was important to remember that the Inland Revenue bases its projections on what it knows are the returns of individual companies and, therefore, aggregated upwards, that will create quite a different position."[95] **The Treasury is projecting a very strong bounce in corporation tax receipts over the next two years. We note that profitability of both financial and non-financial companies has been strong in recent quarters. To aid our understanding of their forecast we recommend that in the next and future Budgets the Treasury publish a breakdown of their corporation tax forecast between financial companies, non-financial companies and the life assurance sector.**

## *National Audit Office*

31. Sections 156 and 157 of the Finance Act 1998 provide the scope for the Comptroller and Auditor General to examine and report on conventions and assumptions submitted to

94 Q 70

95 Q 343

the NAO by HM Treasury for examination. The Budget explains that "a number of key assumptions that underpin the public finance projections are independently audited by the Comptroller and Auditor General under a three-year rolling review process."[96] For Budget 2004 the Chancellor asked the C&AG to examine an assumption for the increased tax yield from a new compliance package for direct tax and National Insurance contributions announced in the Budget. In addition to this, the audit of assumptions examined aspects of the new method of projecting VAT receipts and reviewed assumptions governing the composition of GDP and funding arrangements. Professor Heald noted that "Unlike in its financial and value for money work, the National Audit Office cannot choose which assumptions to audit. It can only audit (a) those assumptions that are specifically referred to it by the Treasury, and (b) previously audited assumptions that come up for review on a three-year cycle." **We ask the Treasury to clarify how they decide which macroeconomic assumptions, apart from those automatically revisited, should be referred to the National Audit Office. This is an issue which we shall be monitoring.**

## Expenditure

32. The Budget set firm overall spending limits for the 2004 Spending Review period, that is, 2005–2008. The Chancellor confirmed the allocation for 2005–06 set in the last spending review and announced that:

- Current spending is to increase by an average of 2.5 per cent in real terms in 2006–07 and 2007–08.
- Public sector net investment is to rise from 2 per cent of GDP to 2¼ per cent by 2007–08, to continue to address the historic under-investment in the UK's infrastructure

33. The figures for Total Managed Expenditure are shown in the table below

**Table 2: Expenditure**

£ billion

| | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 |
|---|---|---|---|---|---|---|---|
| Current Expenditure | 394 | 428 | 450 | 479 | 504 | 530 | 554 |
| Depreciation | 14 | 15 | 16 | 16 | 17 | 18 | 19 |
| Net Investment | 10.6 | 16.2 | 22 | 25 | 27 | 31 | 32 |
| Total Managed Expenditure | 419 | 459 | 488 | 520 | 549 | 579 | 605 |

*Source: Budget 2004, Table C4, page 252; and Professor Heald, Memorandum 1*

34. In addition to setting the overall limits, the Chancellor made (or confirmed earlier) announcements concerning decisions on health and education expenditure that:

- Health spending is to rise by 10 per cent in nominal terms (7.2 per cent in real terms) each year to 2007–08, from £90.4bn in 2005-06 to £109.4bn in 2007-08[97]
- Education spending in the UK is to rise from £68 billion (5.5% of GDP) in 2005–06 to £77 billion (5.6% of GDP) in 2007–08.

96 HM Treasury Budget 2004, p 250 para C27

97 HM Treasury

35. The IFS estimate that taking account of the commitments made on health, education and overall net investment, current spending in other areas will "grow at an average annual real rate of 1.4%, corresponding to a fall as a percentage of national income". They observe that this is "relatively low compared both to spending growth during the 2002 Spending Review and to expected real growth in national income during 2006–07 and 2007–08." [98] The Chancellor made a number of commitments concerning other departments, although no estimates of costs were provided:

- Departmental Expenditure Limits for Department for Work and Pensions, Inland Revenue, HM Customs and Excise and HM Treasury, will be held constant in nominal terms at 2005–06 levels, representing a real terms cut;
- There will be a real terms increase in defence spending; there will not be a freeze in expenditure on the Home Office; there will be real terms growth in transport funding; there will not be a freeze in spending on housing, local government and services to the elderly and children.[99]

36. **We note that the growth rate of public spending in the next spending review period will be slower than recent increases. Whether increases in expenditure on front-line public services are to match those of recent years will depend on the success of the Government's efficiency programme.** We discuss this further below (see paragraphs 57–61).

98 *IFS response to Budget 2004*, 17 March 2004, www.ifs.org.uk

99 Memorandum 8

# 4 Other Budget issues

## Protecting tax revenues

37. The Budget introduced a number of measures designed to protect tax revenues including: a requirement that tax avoidance schemes be disclosed to the Inland Revenue; an income tax charge on pre-owned assets to counter various schemes designed to avoid inheritance tax; and changes to corporation tax to address concerns about increasing numbers of self-employed individuals adopting the corporate legal form to avoid tax.[100] These decisions are considered in the following paragraphs.

### *Tax avoidance*

38. In his Budget statement the Chancellor stated that "It has been put to me that we should now introduce a general anti-avoidance rule. I do not at this stage intend to introduce this but I will today close loopholes in partnerships, finance leasing and VAT, and I will make it a requirement—as in the United States of America—that accountancy firms and those promoting these schemes register them with the tax authorities: the Inland Revenue."[101] The background to this announcement was set out in the Budget document which noted that "schemes designed to avoid tax represent a significant threat to the integrity of the tax system. These sophisticated and aggressive avoidance schemes thrive on concealment and secrecy. Therefore, Budget 2004 introduces new measures to improve transparency in the tax system. The rules, aimed at those marketing and using certain tax avoidance schemes and arrangements, will allow early detection of such schemes and enable more effective targeting of avoiders. As a result of these measures:

- promoters who market schemes and arrangements that meet certain criteria for direct taxes will be required to disclose details of these schemes to the Inland Revenue; and

- businesses with an annual turnover of £600,000 or more using VAT avoidance schemes that appear on a statutory list, and businesses with an annual turnover of £10 million or more using VAT arrangements that meet certain criteria, will be required to notify HM Customs and Excise."[102]

39. In evidence to the Committee Mr John Whiting of PricewaterhouseCoopers noted that "there can be no issue with the concept of full disclosure of tax planning to the tax authorities … but we do see problems with the definition of what exactly has to be disclosed or registered—the definition of a scheme or shelter—and the general administrative burden this may create for taxpayers, advisers and the authorities alike."[103] Asked about the benefits of this disclosure regime as opposed to a general anti-avoidance rule, Mr Edward Troup of Simmons & Simmons told us that

100 HM Treasury Budget 2004, pp 118–120, paras 5.84, 5.87, 5.88, 5.93

101 HC Debates, 17 March 2004, col 329

102 HM Treasury Budget 2004, p118 para 5.84

103 Memorandum 6, section 7

> "one of the problems that the Revenue and the Government face is the asymmetry of information between what businesses are doing and what they find out about them. At the moment the Revenue does not generally find out about tax-avoidance schemes until months or even years after they have taken place and very often, because they are constructed as complex, financial transactions, it may not even detect them … so getting hold of the information earlier is one of the planks of dealing with avoidance. It is a very different approach from …a general anti-avoidance rule [which] effectively seeks to change the law … The problem with a [general anti-avoidance rule] is that it is incredibly uncertain and international experience has shown that the courts are likely to react to [one] in very different ways so you can never be confident actually that it would work. Also, because of its uncertainty, it necessitates the introduction of a clearance procedure whereby businesses undertaking legitimate tax planning can go to the Revenue [to seek confirmation that the general anti-avoidance rule will not apply] in order to plan their affairs with certainty …"[104]

40. The Treasury told us that it has often been several years before the Revenue have uncovered information about tax avoidance schemes that are in place. The Budget proposals will require through legislation the provision of more information up front at the point at which tax avoidance schemes are marketed so that the Revenue and Customs can become more aware of them and Treasury ministers can "take action if they find those schemes to be particularly abusive."[105]

41. The legal specifications setting out the definition of what exactly has to be disclosed or registered under the scheme will be set in the Finance Bill. Treasury officials told us that the scheme

> "is targeted very much at the abusive end of the spectrum, so [at] schemes and arrangements which are of sufficient complexity that they are beyond the reach of any concept of the normal taxpayer. That is where we are targeting our efforts, and we are specifying two categories in particular of activities: those involving financial products and those involving remuneration strategies. … On the question of penalties, … there is a range of penalties, a fine system for non-disclosure and a system of daily penalties for persistent non-disclosure. You will see when the Finance Bill is published that those appear relatively modest and I think they are modest given the scale of the commitment. That is partly because this is a new area and we recognise that it is a big change for the professions, but also we would hope to rely on professional integrity and the obligations that naturally fall on professions to abide by the law. We regard this as a proportionate step. …"[106]

42. **The Government has a duty to protect the tax revenues and has announced the introduction of a disclosure regime whereby promoters who market tax avoidance schemes and arrangements that meet certain criteria will have to disclose details of them to the tax authorities. We agree with the statement made by one of our expert witnesses working in the tax field that there can be no issue with the concept of full**

104 Q 72

105 Q 214

106 Q 222

**disclosure of tax planning to the tax authorities, and we fully support this proposal in principle. We believe what is required in practice is a scheme that tackles tax avoidance effectively without creating undue compliance burdens for taxpayers and their advisers, or undue administrative burdens for the tax authorities. The details of the scheme will merit close examination once they are available during the passage of the Finance Bill through the House.**

### *The tax treatment of pre-owned assets*

43. The Government is concerned that various schemes designed to avoid inheritance tax have been marketed in recent years using artificial structures to get round the existing rules about gifts made with reservation. As a result, people have been removing assets from their taxable estate but continuing to enjoy all the benefits of ownership. To block this sort of avoidance the Government announced in the 2003 Pre-Budget Report that people who benefit from these sorts of schemes would be subject to an income tax charge from April 2005, to reflect their additional taxable capacity from receiving these benefits at low or no cost.[107]

44. The Budget document noted that the Government had been clear since the outset of the consultation that the income tax charge on pre-owned assets would not affect legitimate transactions between family members, and it confirmed "that the charge:

- will not affect parents or grandparents who have helped their children or grandchildren onto the property ladder;
- will not affect transactions between married couples;
- will not apply where the benefit is incidental;
- will not apply if the assets still count as part of the taxpayer's estate for inheritance tax purposes;
- will not apply if a person who has used a contrived avoidance scheme to remove their property from the inheritance tax system opts to bring the property back into their estate for inheritance tax purposes; and
- is not retrospective as it will not take effect until April 2005."[108]

45. Ms Anne Redston from Ernst & Young noted that the proposals put forward in the Pre-Budget Report were wide-ranging and would have caught many innocent transactions. She therefore welcomed the announcement in the Budget that the charge to income tax will not apply in a number of situations and that individuals will be able to elect for the asset in question to form part of their estate for inheritance tax purposes and thus avoid the income tax charge. However, Ms Redston noted that "… taxpayers who undertook transactions 18 years ago will now suffer a tax charge which was not in contemplation when the transaction occurred. The only alternative is for them to undo those transactions, either in reality or for tax purposes, if they do not want to suffer the new income tax cost. It

107 Inland Revenue Budget Note 40, para 4

108 HM Treasury Budget 2004, p 119 para 5.88

is difficult to see why this is not retrospective taxation."[109] Mr Troup told us that the need to act to prevent abuse of inheritance tax raised wider questions about the structure and future of the tax. He considered that the measures on pre-owned assets "represent an ingenious approach to avoidance schemes already in place, but will inevitably increase compliance burdens and worries for those already concerned about the application of the tax …"[110] With regard to whether the measures are retrospective or not, Mr Troup told us that "I do not think the pre-owned assets measure is strictly retrospective but it does have the effect of penalising people who have already done schemes [which they] do not want to unwind."[111]

46. **We note the introduction of a charge on income to close tax loopholes on pre-owned assets designed to avoid inheritance tax. We welcome the changes that have been made so far to the initial proposals designed to ensure that the new charge will not affect legitimate transactions between family members. We expect the details behind this proposal to be scrutinised during the passage of the Finance Bill through the House.**

## *Corporation tax for small companies*

47. To provide further support to new and growing companies the 2002 Budget announced a reduction in the corporation tax starting rate from 10 per cent to zero, which would result in 150,000 small companies no longer paying any corporation tax.[112] Commentators at the time, including outside experts in evidence to this Committee, questioned the impact this change would have on the tax base as it would create an incentive for the self-employed to incorporate and avoid tax and national insurance contributions. For example, Mr Carl Emmerson of the Institute for Fiscal Studies told the Committee that the introduction of the zero per cent corporation tax rate "dramatically increases the incentive that self-employed individuals have to start up their own business with themselves as the sole employee. There is no economic rationale for the tax system to provide such an incentive. The clear risks to the income tax base do not appear to be reflected in the Government costings."[113]

48. We noted in our report on the 2003 Pre-Budget Report that the Government was concerned that the differences in tax treatment between earned income and dividend income should not distort business strategies and that it would "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."[114] In his Budget statement the Chancellor stated that

> "I would like to do even more to encourage new and growing businesses to invest and expand. I can only do so if we close a loophole under which some have, without

109 Memorandum 2, section 2

110 Memorandum 4

111 Q 95

112 HM Treasury Budget 2002, p 50 para 3.31

113 Second Report of 2001–02, *Budget 2002*, HC 780–II, Ev 8, para 5

114 Third Report of 2003–04, *The 2003 Pre-Budget Report*, HC136, para 61

> changing their economic activity, used our zero tax rate for small businesses not to invest and grow but simply to avoid tax and national insurance by reclassifying their income as dividends.
>
> There are those who have proposed that to tackle this avoidance we should abolish the zero and reduced rates altogether. Instead, I propose to retain the zero rate and also the reduced rates for retained profit, and indeed do more for investment. But I will close the loophole by taxing distributed profits at 19 per cent, bringing the tax on distributed profits for those small companies into line with other companies."[115]

49. Mr Troup noted that "the need to address the distortions to behaviour caused by the zero per cent starting rate of corporation tax for small companies was inevitable and anticipated in previous submissions I have made to the Committee. It is regrettable that the Government was not willing to adopt the simplest approach of abolishing the zero per cent band. The proposal to tax distributed profits of small companies at 19 per cent, if it is to be effective, will necessarily create significant compliance and legislative burdens, in order to deal with such issues as profits retained and subsequently distributed, and changes of ownership. …"[116] Mr Troup also told the Committee that " …the only slight light at the end of the tunnel is that at the same time the Government have announced that there will be a review of the interaction between the self-employed and the owned and managed business and I hope they will take the opportunity of that to do a graceful U-turn … and get rid of the zero per cent rate and introduce, if they feel it is appropriate to have incentives for small businesses, incentives which are both better targeted and workable."[117]

50. Treasury officials told the Committee that they expected people to be surprised about the simplicity of the arrangements for the new provision and that they expected compliance costs to be "considerably below the compliance costs that the old advance corporation tax system imposed before 1997/1998."[118] Asked why, unlike others, they had not anticipated this problem, the Head of the Tax Policy Team at the Treasury admitted:

> "I think we were surprised by the extent and the thing that we did not anticipate was the growth in these often internet-based tax planning schemes directed at self-employed individuals. It may be that we should have done that. We acknowledged that there was likely at the time to be some gravitation from self-employment into company form. The judgement was reached that, given the importance of directing tax reductions at small and growing companies, that was a risk worth taking. We still think that the zero rate that was introduced in 2002 continues to have a role and we have not withdrawn that rate, but what we do want to ensure is that it is targeted effectively on companies that want to reinvest their profit, taking advantage of the opportunities that the corporate legal form provides for them."[119]

51. Treasury officials noted that it has been very difficult to identify the total cost to the taxpayer of the unexpected consequences of introducing the zero rate of corporation tax,

---

115 HC Debates, 17 March 2004, col 328

116 Memorandum 4

117 Q 77

118 Q 225

119 Q 233

but there had been "a step up" in incorporations with around 300,000 incorporations in the period since April 2003."[120] According to the Budget document, the estimated reduction in tax payments by small businesses incorporated for tax reasons since the last Budget are £250 million for 2003–04 and £420 million for 2004–05.[121]

52. **The Budget includes a proposal to tax distributed profits of small companies at 19 per cent to close a loophole caused by the introduction of the zero rate of corporation tax, which led people to incorporate to avoid tax and national insurance by reclassifying their income as dividends. Such a reaction was widely predicted. We are puzzled as to why, unlike other commentators, neither the tax authorities nor the Treasury anticipated that this would be the likely effect of introducing the zero rate of corporation tax, an oversight that over the two years 2003–04 and 2004–05 will cost the taxpayer an estimated £670 million in lost revenues.**

53. **We note concerns that the decision to tax distributed profits of small companies at 19 per cent will create significant compliance burdens compared with simply abolishing the zero per cent band. We seek the details behind this decision, setting out the respective compliance costs of each option and how many companies are now expected to benefit from the zero per cent rate.**

### *Corporation tax: transfer pricing*

54. The Budget announced that the scope of transfer pricing and thin capitalisation rules will be amended to include wholly domestic transactions but exclude most domestic or cross border transactions undertaken by small or medium sized enterprises.[122] The CBI told the Committee that the decision to proceed with UK/UK transfer pricing "will significantly increase the regulatory burden for business, thereby damaging competitiveness, while producing no extra revenue for the government."[123] Mr Whiting told us that "I do not think the Government had any choice and I sympathise with them that they feel they have to push forward on this because of the European impact."[124] His rough estimate was that as a result of this change "a good sized plc would have to create one extra position in its tax department [on an ongoing basis] …"[125]

55. We asked the Chancellor about the regulatory impact of these measures. He told us that "I am happy to look at the evidence that was produced yesterday from the individual companies and talk to them about that. …Let us be absolutely clear that small and medium-sized enterprises are virtually exempt from this and almost all unincorporated businesses are exempt with the exception of a very small number of very large partnerships. Most … companies that are affected, are a relatively small number of a very large group of

120 Q 236

121 HM Treasury Budget 2004, p 187 footnote 1 to Table A1

122 Budget 2004 Press Notice 4, page 3

123 Memorandum 9

124 Q 99

125 Q 101

companies, so the number of groups affected will represent a very small proportion of all corporate businesses. …"[126]

56. **We share the concerns of a number of witnesses including the CBI over the possible effect on business competitiveness of the extension of the transfer pricing rules to wholly UK transactions, in response to a European Court of Justice ruling, but were reassured by the Chancellor's comments and look forward to this being treated sympathetically in the passage of the Finance Bill.**

## Public sector efficiency savings

57. As part of the build-up to the 2004 Spending Review, the Chancellor announced:

> "Departments are to achieve—in the spending review period—annual efficiency savings of 2½ per cent. a year, boosting front-line service delivery by £20 billion a year by 2008."[127]

These savings do not affect the amounts to be made available to departments, under their Departmental Expenditure Limits,[128] but they could affect significantly the level of public services delivered for the amount provided.

58. The savings are to be achieved "By cutting in real terms the administrative budgets of departments, by reforming procurement both nationally and locally, by unlocking productivity gains from technology and work force improvements".[129] The programme will draw both on the work of the Office of Government Commerce (which has helped departments to save £1.6bn in its first three years since 2000 and has been tasked with delivering a further £3bn over the Spending Review 2004 period)[130] and on the work of the Efficiency Review announced in Budget 2003 led by the head of the OGC, Sir Peter Gershon. The Government envisages savings "for example, through back office rationalisation, improvements in procurement processes and streamlining of transaction services".[131] As part of the programme of savings, "total central government administration costs will be capped at 2005–06 nominal levels in 2006–07 and 2007–08" thereby reducing administration costs "to a planned 3.7% of total spending, the lowest level since the running costs regime (the predecessor of the current administration costs regime) was introduced in 1986–87".[132]

59. It is too early to state with more precision how the savings will be achieved across departments. As the Chancellor indicated, departments "will be reporting in the Spending

126 Q 307

127 HC Debates,17 March 2004, col 332; the £20bn figure can be reached by applying 2.5% cumulatively to the baseline for DELs in 2004–05 of £279.3bn.

128 Mr Stephens, for the Treasury, explained that the "broader 2.5% efficiency target is not coming off anyone's budget, but it is 2.5% efficiency gains which are fully available to each department to reallocate within their departmental budget to front-line services… [We] are setting the challenge to all departments to secure 2.5% efficiency gains" Qq 253–254

129 HC Debates, 17 March 2004 col 332

130 HM Treasury Budget 2004, p 132 para 6.10 and p 135 para 6.17

131 HM Treasury Budget 2004, p 135 para 6.16

132 HM Treasury Budget 2004, p 133 para 6.15; according to Chart 6.1 of Budget 2004 p 135, administration costs were around 5½% of total spending in 1992 and around 4½% of total spending in 2002.

Review about what their plans are".[133] It is already clear, however, that a proportion of the savings will be represented by reductions in posts, with the Chancellor announcing a net loss of 40,500 posts in two of the largest departments: 30,000 in the Department of Work and Pensions[134] (enabled in part by the introduction of new technology), and 10,500 in the new single revenue collection department to be formed from the newly announced merger of Customs & Excise and the Inland Revenue.[135] However, the Government has indicated that "there will be a strong emphasis on using normal staff turnover, and for example making the most of the opportunity for staff to be redeployed to posts out of London and the South East in the wake of the Lyons Review."[136]

60. Given the long history of public sector efficiency targeting, there is clearly an issue of how certain it is that the envisaged savings will be achieved. For the Treasury, Mr Stephens told us "We are confident that the level of overall efficiency savings of 2.5 per cent a year is achievable while maintaining the level of improvement in public services overall that the government is committed to."[137] Sir Peter Gershon stated at the time of the Budget that:

> "I consider that the overall efficiency target of 2.5 per cent a year… is challenging but achievable. It is important that the drive for efficiency should not put at risk the delivery of public services and a target in excess of 2.5 per cent is likely to present such a risk."[138]

Mr Chote noted that the required rate of savings was "in line with and slightly higher than the estimate of productivity growth in the economy as a whole" but that:

> "Obviously we have the great difficulty of actually being able to measure productivity in the public sector and I think one issue in terms of working out whether we are on track to make those sorts of achievements is—Is the information going to be there that we can say in a year or two's time that we are on the path that the Chancellor was laying out?"[139]

The importance of measurement issues should not be underestimated: we note the evidence given by Treasury officials to our Sub-committee in September last year that a target for 2.5% efficiency savings set in an earlier Spending Review for the Treasury itself had been dropped in part because "it has not been possible to measure efficiency for the whole of the Treasury in quite those terms".[140]

61. Wider responsibility for the implementation of the efficiency programme will be one of the tasks of the new head of the OGC, John Oughton, who will "work closely with HM Treasury to monitor the progress of departments against their agreed efficiency

133 Q 421

134 A proportion of these reductions had already been announced before the Budget.

135 HC Deb17 March 2004 col 331

136 HM Treasury Budget 2004, p 136 para 6.18; the Independent Review of Public Sector Location by Sir Michael Lyons was published by the Treasury in March 2004.

137 Q 245

138 Budget 2004 Press Notice 9

139 Q 89

140 Oral evidence on HM Treasury Departmental Report 2003, 10 September 2003, HC(2002–03) 1079, Q 89

programme".[141] **It is clear that the efficiency savings target is challenging and one which leaves little room for manoeuvre: if a Department underachieves its target then the funds it has allocated to programmes will be squeezed, and if it overachieves its target then the quality of delivery of those programmes will be put at risk. The House, including this and other departmental select committees, will wish to see clear indications in the Spending Review as to how the savings are to be made and how their achievement is to be measured.**

## Review of housing supply

62. The Review of Housing Supply by Kate Barker was published alongside the Budget.[142] We have not examined the review in detail, but may consider aspects of it at a later date during our inquiry into Regional Productivity. We did take evidence on the recommendation for a Planning Gain Supplement—a supplementary contribution to the exchequer based on the increase in land values resulting from the granting of planning permission.[143] Our advisers commented that previous attempts to use tax to capture the gains resulting from planning permission had floundered due to behavioural effects (developers hold back land in the anticipation that the tax will prove unworkable and be abolished) and due to difficulties in assessment. Mr Troup believed that "while the justification for such measures is sound, the prospects for successful implementation are not."[144] He noted that the Inland Revenue had devoted around 5 to 6 per cent of revenues administering previous forms of the tax. Mr Whiting believed that if the tax was used as a lever to encourage certain forms of development [such as that on brownfield land] rather than only used to raise revenue then it might have a chance of success.[145] Treasury officials told us that Kate Barker had advised that if the proposal for a Planning Gain Supplement were to be successful the rate ought to be set quite low to avoid the problems experienced previously. For the Treasury, Mr Kingman told us they would need to look at the workability of the Planning Gain Supplement and consider it alongside other options.

63. **We welcome the valuable contribution to the debate from Kate Barker's Review of Housing Supply. The evidence we have received suggested that successful design and implementation of the Planning Gain Supplement will be challenging. Previous experience suggests that if the tax is set at a level to raise excess revenue, rather than to encourage development and to fund additional investment in housing, then it will not be successful.**

## Savings

### *ISAs*

64. ISAs have been an extremely successful initiative in the field of savings. As the Treasury states, "Individual Savings Accounts (ISAs) are the Government's primary vehicle for tax-

141 HM Treasury Budget 2004, p 135 para 6.17

142 Kate Barker, *Delivering Stability: Securing our Future Housing Needs* HM Treasury March 2004

143 Barker Review Recommendation 26, page 87

144 Memorandum 4

145 Qq103–106

free saving outside pensions. Over 15 million people now have an ISA and over £130 billion has been subscribed to ISAs since their launch in 1999."[146] The limits for ISA contributions, currently £7,000 a year for share ISAs and £3,000 for cash ISAs, are set to fall to £5,000 and £1000 respectively from April 2006;[147] this date represents a significant extension from the original time limit set for the higher maximum contribution levels, which was April 2000. The Committee noted in its discussion of the 2003 Pre-Budget Report that "to reduce cash ISAs from £3,000 to £1,000 per year, and share ISAs from £7,000 to £5,000, appears to run counter to a policy of encouraging people to save."[148]

65. We further note that when the original ISA scheme was extended the Government said that: "To build on the success of ISAs, the Government will retain the £7,000 contribution limit… until April 2006. Keeping a higher £3,000 limit for cash will particularly help those low-income and younger savers who have saved in mini cash ISAs."[149] Mr Chote also told us that ISAs would always be inherently more attractive than conventional pension savings for those on lower income with interrupted work histories and limited liquid financial savings.[150] **The Committee acknowledges the fresh initiatives the Government has taken to encourage savings via the Child Trust Fund and the Savings Gateway. The Committee reaffirms its view that to reduce cash ISAs from £3,000 to £1,000 per year, and share ISAs from £7,000 to £5,000 per year, appears to run counter to a policy of encouraging people to save. The Treasury should examine closely the effect that reducing the higher £3,000 limit for cash ISAs might have on the opportunities for lower income and younger savers.** The evidence we have heard in the course of our inquiries into the *Transparency of credit card charges* and *Restoring confidence in long-term savings* has highlighted the importance of helping and encouraging the young and the less affluent to save adequately, both to cope with short-term shocks, such as illness or loss of employment, and to make long-term provision for retirement.

### Savings thresholds for benefits

66. The Budget announced that from April 2006, "the threshold above which savings reduce eligibility for Income Support, Jobseeker's Allowance, Housing Benefit and Council Tax Benefit will be raised from £3,000 to £6,000."[151] While the Government has also announced that it "will keep under review the treatment of capital in income-related working-age benefits",[152] the treatment of capital savings accrued by the elderly and the impact this may have on means tested benefits was highlighted as a problem by several expert witnesses.[153] **The treatment of capital in assessing retirement benefits is an issue which needs to be kept under review; it is also one we may wish to examine as part of our separate inquiry into *Restoring confidence in long-term savings*.**

146 HM Treasury Budget 2004, p 114 para 5.59

147 HM Treasury Pre-Budget Report 2000, Cm 4917, p 107 para 5.70

148 Third Report of Session 2003–04, *The 2003 Pre-Budget Report*, HC 136, p 33, para 63

149 Third Special Report of Session 2003–04, *Government Response to the Committee's Third Report on The 2003 Pre-Budget Report (HC 136)*, HC 478, p16

150 Q 114

151 HM Treasury Budget 2004, p 114 para 5.62

152 *Ibid.*

153 See for example Mr Weale Qq 111–112

67. We also draw attention to the evidence given by the Chancellor about the effects of closures of occupational pension schemes. This too can be examined as part of our inquiry into *Restoring confidence in long-term savings*.

### *Financial inclusion*

68. The Budget acknowledges that significant progress remains to be made in three key areas related to financial inclusion: access to banking services, access to affordable credit, and access to free debt advice.[154] In the course of the Committee's inquiry into the transparency of credit card charges we noted that "there is a specific and particularly serious issue in relation to consumers' understanding of debt."[155] While the Committee heard that valuable work is being done by Citizens Advice Bureaux, National Debtline, the Consumer Credit Counselling Service and the Money Advice Trust, we felt there was a need for greater support from the industry for these organisations and concluded that "When households become over-indebted, it is essential that clear advice is available for them to manage their commitments."[156] In the course of our inquiry into *Endowment Mortgages*[157] we also heard evidence of an 'advice vacuum' on issues such as mortgage finance and pensions savings for those without ready access to IFAs. **Given the further evidence the Committee has heard from Treasury officials in the course of this inquiry regarding the vulnerability of some highly indebted households to higher interest rates, the Committee would welcome early progress on initiatives in the area of financial inclusion, but particularly the provision of ready access to free and independent debt advice. Consideration should also be given to extending any proposals in this area to ensure access for the less affluent to more wide-ranging financial advice on issues such as mortgage borrowing and pension rights.**

## Other matters

69. In addition to the points just discussed, we received written or oral evidence on a number of further points raised in the Budget. These include:

- tax stamps for spirits[158]
- changes to the venture capital tax schemes[159]
- devolution of Business Link services to RDAs[160]
- the Local Authority Business Growth Incentives scheme[161]
- the Review of Public Sector Relocation by Sir Michael Lyons[162]

---

154 HM Treasury Budget 2004, p 114 para 5.63

155 First Report of Session 2003–04, *Transparency of Credit Card Charges*, HC 125–1, p 53, para 134

156 *Ibid.*, p 53, para 135

157 Within the inquiry into *Restoring confidence in long-term savings*; see Fifth Report, Session 2003–04, HC 394

158 Qq 403–411

159 Q 87; Memorandum 3 (Russell Gardner, Ernst & Young)

160 Qq 282–284

161 Qq 88, 285–290

- the cap on the lifetime limit for tax assistance for pension savings, within the proposed pension reforms[163]
- the proposal in the Barker Review for Property Investment Funds[164]
- council tax.[165]

These were not examined in sufficient depth during the inquiry to support specific conclusions. However, a number of them are relevant to our current inquiry into *Regional Productivity* or other inquiries and we may give further consideration to them in the course of that work.

70. We have noted the publication, as part of the Budget, of the Review of the Revenue Departments[166] by Mr Gus O'Donnell, Permanent Secretary to the Treasury, which proposes the bringing together of Inland Revenue and Customs and Excise into a single department, a recommendation which this Committee has made in the past and which the Chancellor has accepted; the Committee's Sub-committee will be taking evidence on this in the near future.

162 *Well Placed to Deliver? Shaping the Pattern of Government Service*, Sir Michael Lyons, HM Treasury March 2004; see Qq 85–86, 291–300

163 Memorandum 4 (Edward Troup, Simmons & Simmons) and Memorandum 6 (John Whiting, PricewaterhouseCoopers)

164 Q 106

165 Qq 371–385

166 *Financing Britain's Future*, Cm 6163 HM Treasury March 2004; see also Memorandum 4 (Edward Troup, Simmons & Simmons) and Memorandum 6 (John Whiting, PricewaterhouseCoopers)

# Conclusions and recommendations

## The Economy

1. The Committee welcomes the renewed vigour of the UK economy in recent months. It notes that this strong growth performance has justified the Treasury's growth forecasts made at the time of last year's Budget and Pre-Budget Report, and recognises the effect of fiscal policy in supporting this growth. (Paragraph 6)

2. The Committee notes the evidence it has heard that the rise in household debt has been matched by a rise in holdings of both housing and financial assets by the household sector, so that the net deterioration in household balance sheets over recent years is relatively limited. The Committee would nevertheless welcome the publication of more information on the distribution of assets and liabilities across the household sector to assist policymakers and others to quantify the number of households potentially facing difficulties as interest rates rise. (Paragraph 8)

3. When the Committee considered the 2003 Pre-Budget Report we concluded that "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". The evidence we have heard this spring, although not unanimous, suggests that this conclusion remains generally valid; but there is no room for complacency. The Committee welcomes a thorough examination being given to any proposals, such as those put forward by Professor Miles, which could serve to limit the potential for the UK housing market to have a destabilising influence on the rest of the economy. (Paragraph 9)

4. The Committee endorses the Treasury's call for international structural reforms that will ensure a more broadly based and sustainable global recovery. It is particularly important for policymakers internationally to seek to avoid the dollar's depreciation becoming destabilising in the face of the large US trade deficit. (Paragraph 12)

5. The Committee believes that recent rate moves from the MPC have been fully consistent with the gathering momentum in the UK economy and remains confident that the MPC will continue to respond to economic developments in a timely and appropriate way. The Committee has also been reassured by the MPC's handling of the recent switch to a CPI inflation target. (Paragraph 15)

## Framing of the golden rule

6. The Committee awaits with interest clarification on the issue of the treatment of the AME margin in the past in calculating compliance with the golden rule, but notes that any differences in phrasing in Treasury documents in this crucial area may be a source of confusion which may undermine the rule's credibility. As the Committee stated at the time of its report on the PBR, presentation of the Government's progress towards meeting the golden rule should be standardised in order to avoid any possible confusion in the future. (Paragraph 18)

## The fiscal position: the current cycle and the medium term

**7.** The Government remains on track to meet the fiscal rules over this cycle on its central forecasts. The margin for error has, however, diminished further over recent months, in spite of the strong growth in the economy. This is a development which requires careful monitoring by the Treasury. (Paragraph 19)

**8.** The current fiscal projections are consistent with Treasury's forecasts that growth in the economy comes up to trend from 2005–06 but does not go above trend. If the economy were to move above its trend level and begin to operate above capacity, it will be important for policymakers to ensure that larger fiscal surpluses than those currently projected do indeed accrue, both to ensure sufficient flexibility for fiscal policy through the next cycle and to help fiscal policy aid monetary policy in managing the cycle. (Paragraph 21)

**9.** Public sector debt is predicted to rise over the forecast period, in the near-term due to the shortfall in current revenue but also due to the programme of public sector net investment. The latest projections of public sector net debt indicate that the sustainable investment rule will be met, although the margin has narrowed since the last Budget. (Paragraph 22)

## Revenues: general

**10.** Despite the growth in the economy being above forecast, and record levels of employment, tax receipts in 2003–04 have been below the Treasury's forecasts in the Budget last year, although only slightly below those in the Pre-Budget Report. (Paragraph 23)

**11.** While recognising the need to preserve confidentiality in tax matters, we believe it would be helpful for the Treasury to consider ways of sharing as much aggregated data as possible on the way taxes are paid with outside forecasters. We note the Treasury has over-estimated tax revenues in the last three years, but we also note that the differences between external forecasters and the Treasury are in line with past margins of uncertainty affecting all such forecasts. (Paragraph 25)

**12.** Given that the economy is now growing relatively strongly we hope the over-estimation over the last three years of both absolute tax receipts and net taxes and social security contributions as a proportion of GDP will not continue. Last year we concluded that the risks to the Treasury's revenue projection were on the downside. While this risk has receded given recent positive data, the forecasts remain challenging and the Treasury needs to monitor developments closely. (Paragraph 26)

## Income tax and corporation tax

**13.** We welcome the Treasury's statement that it will consider publishing its income tax forecast in more detail. We recommend that it does so in the forthcoming Pre-Budget Report, differentiating between PAYE, self-assessment, bonus payments and income at standard and higher rates. (Paragraph 28)

**14.** The Treasury is projecting a very strong bounce in corporation tax receipts over the next two years. We note that profitability of both financial and non-financial companies has been strong in recent quarters. To aid our understanding of their forecast we recommend that in the next and future Budgets the Treasury publish a breakdown of their corporation tax forecast between financial companies, non-financial companies and the life assurance sector. (Paragraph 30)

## Macroeconomic assumptions and the NAO

**15.** We ask the Treasury to clarify how they decide which macroeconomic assumptions, apart from those automatically revisited, should be referred to the National Audit Office. This is an issue which we shall be monitoring. (Paragraph 31)

## Public expenditure

**16.** We note that the growth rate of public spending in the next spending review period will be slower than recent increases. Whether increases in expenditure on front-line public services are to match those of recent years will depend on the success of the Government's efficiency programme. (Paragraph 36)

## Protecting tax revenues and tax avoidance

**17.** The Government has a duty to protect the tax revenues and has announced the introduction of a disclosure regime whereby promoters who market tax avoidance schemes and arrangements that meet certain criteria will have to disclose details of them to the tax authorities. We agree with the statement made by one of our expert witnesses working in the tax field that there can be no issue with the concept of full disclosure of tax planning to the tax authorities, and we fully support this proposal in principle. We believe what is required in practice is a scheme that tackles tax avoidance effectively without creating undue compliance burdens for taxpayers and their advisers, or undue administrative burdens for the tax authorities. The details of the scheme will merit close examination once they are available during the passage of the Finance Bill through the House. (Paragraph 42)

**18.** We note the introduction of a charge on income to close tax loopholes on pre-owned assets designed to avoid inheritance tax. We welcome the changes that have been made so far to the initial proposals designed to ensure that the new charge will not affect legitimate transactions between family members. We expect the details behind this proposal to be scrutinised during the passage of the Finance Bill through the House. (Paragraph 46)

**19.** The Budget includes a proposal to tax distributed profits of small companies at 19 per cent to close a loophole caused by the introduction of the zero rate of corporation tax, which led people to incorporate to avoid tax and national insurance by reclassifying their income as dividends. Such a reaction was widely predicted. We are puzzled as to why, unlike other commentators, neither the tax authorities nor the Treasury anticipated that this would be the likely effect of introducing the zero rate of corporation tax, an oversight that over the two years 2003–04 and 2004–05 will cost the taxpayer an estimated £670 million in lost revenues. (Paragraph 52)

20. We note concerns that the decision to tax distributed profits of small companies at 19 per cent will create significant compliance burdens compared with simply abolishing the zero per cent band. We seek the details behind this decision, setting out the respective compliance costs of each option and how many companies are now expected to benefit from the zero per cent rate. (Paragraph 53)

21. We share the concerns of a number of witnesses including the CBI over the possible effect on business competitiveness of the extension of transfer pricing rules to wholly UK transactions, in response to a European Court of Justice ruling, but were reassured by the Chancellor's comments and look forward to this being treated sympathetically in the passage of the Finance Bill. (Paragraph 56)

## Public sector efficiency savings

22. It is clear that the efficiency savings target is challenging and one which leaves little room for manoeuvre: if a Department underachieves its target then the funds it has allocated to programmes will be squeezed, and if it overachieves its target then the quality of delivery of those programmes will be put at risk. The House, including this and other departmental select committees, will wish to see clear indications in the Spending Review as to how the savings are to be made and how their achievement is to be measured. (Paragraph 61)

## Housing supply

23. We welcome the valuable contribution to the debate from Kate Barker's Review of Housing Supply. The evidence we have received suggested that successful design and implementation of the Planning Gain Supplement will be challenging. Previous experience suggests that if the tax is set at a level to raise excess revenue, rather than to encourage development and to fund additional investment in housing, then it will not be successful. (Paragraph 63)

## Savings

24. The Committee acknowledges the fresh initiatives the Government has taken to encourage savings via the Child Trust Fund and the Savings Gateway. The Committee reaffirms its view that to reduce cash ISAs from £3,000 to £1,000 per year, and share ISAs from £7,000 to £5,000 per year, appears to run counter to a policy of encouraging people to save. The Treasury should examine closely the effect that reducing the higher £3,000 limit for cash ISAs might have on the opportunities for lower income and younger savers. (Paragraph 65)

25. The treatment of capital in assessing retirement benefits is an issue which needs to be kept under review; it is also one we may wish to examine as part of our separate inquiry into Restoring confidence in long-term savings. (Paragraph 66)

26. Given the further evidence the Committee has heard from Treasury officials in the course of this inquiry regarding the vulnerability of some highly indebted households to higher interest rates, the Committee would welcome early progress on initiatives in the area of financial inclusion, but particularly the provision of ready access to free

and independent debt advice. Consideration should also be given to extending any proposals in this area to ensure access for the less affluent to more wide-ranging financial advice on issues such as mortgage borrowing and pension rights. (Paragraph 68)

# Formal minutes

## Wednesday 31 March 2004

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard
Mr Jim Cousins
Angela Eagle
Mr Michael Fallon
Mr David Heathcoat-Amory
Norman Lamb
John Mann
Mr George Mudie
Mr Robert Walter

Draft Report (The 2004 Budget), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 4 read and agreed to.

Paragraphs 5 and 6 read, amended and agreed to.

Paragraph 7 read and agreed to.

Paragraphs 8 and 9 read, amended and agreed to.

Paragraphs 10 to 13 read and agreed to.

Paragraph 14 read, amended and agreed to.

Paragraphs 15 to 17 read and agreed to.

Paragraph 18 read, amended and agreed to.

Paragraphs 19 to 23 read and agreed to.

Paragraphs 24 to 26 read, amended and agreed to.

Paragraph 27 read and agreed to.

Paragraph 28 read, amended and agreed to.

Paragraph 29 read and agreed to.

Paragraphs 30 and 31 read, amended and agreed to.

Paragraphs 32 and 33 read and agreed to.

Paragraph 34 read, amended and agreed to.

Paragraphs 35 to 45 read and agreed to.

Paragraph 46 read, amended and agreed to.

Paragraphs 47 to 51 read and agreed to.

Paragraphs 52 and 53 read, amended and agreed to.

Paragraphs—(*The Chairman*)—brought up, read the first and second time, and inserted (now paragraphs 54 to 56).

Paragraphs 54 to 59 read and agreed to (now paragraphs 57 to 62).

Paragraphs 60 to 63 read, amended and agreed to (now paragraphs 63 to 66).

A paragraph—(*Mr George Mudie*)—brought up, read the first and second time, and inserted (now paragraph 67).

Paragraphs 64 and 65 read, amended and agreed to (now paragraphs 68 and 69).

Paragraph 66 read and agreed to (now paragraph 70).

Summary read, amended and agreed to.

*Resolved*, That the Report be the Sixth Report of the Committee to the House.

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

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

*Ordered,* That the Appendices to the Minutes of Evidence be reported to the House.—(*The Chairman*).

[Adjourned till Tuesday 20 April at 9.15 am

# Witnesses

**See Volume II [HC 479–II]**

## Tuesday 23 March 2004

[Morning sitting]

**Mr Ciarán Barr**, Deutsche Bank, **Mr Robert Chote**, Institute for Fiscal Studies, **Professor Peter Spencer**, University of York and **Mr Martin Weale**, National Institute of Economic and Social Research

**Mr Robert Chote**, Institute for Fiscal Studies, **Mr Edward Troup,** Simmons and Simmons, **Mr John Whiting**, PricewaterhouseCoopers and **Mr Martin Weale**, National Institute of Economic and Social Research

[Afternoon sitting]

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

## Wednesday 24 March 2004

**Rt Hon Gordon Brown MP,** Chancellor of the Exchequer**, Mr Ed Balls,** Chief Economic Adviser, **Mr Jon Cunliffe**, Managing Director, Macroeconomic Policy and International Finance, **Mr Nicholas Holgate**, Director, Welfare Reform, **Mr John Kingman**, Director, Enterprise and Growth Unit, **Mr Jonathan Stephens**, Director, Public Spending, and **Mr Andrew Lewis**, Head of Tax Policy Team, HM Treasury

# Written evidence

**See Volume II [HC 479–II]**

*Evidence received before oral evidence sessions*

1. Professor David Heald, Sheffield University Management School
2. Ms Anne Redston, Ernst & Young
3. Mr Russell Gardner, Ernst & Young
4. Mr Edward Troup, Simmons & Simmons
5. Mr Martin Weale, National Institute of Economic and Social Research
6. Mr John Whiting, PricewaterhouseCoopers
7. Professor Peter Spencer, University of York

*Evidence received after oral evidence sessions*

8. HM Treasury
9. The Confederation of British Industry (CBI)

## List of Reports from the Treasury Committee since 2001

### Session 2003–04

| | | Report | *Govt Response** |
|---|---|---|---|
| First Report | The Transparency of Credit Card Charges | HC 125 | *HC 431* |
| Second Report | Child Trust Funds | HC 86 | *HC 387* |
| Third Report | The 2003 Pre-Budget Report | HC 136 | *HC 478* |
| Fourth Report | Annual Report for 2003 | HC 386 | — |
| Fifth Report | Restoring confidence in long-term savings: Endowment mortgages | HC 394 | *awaited* |
| Sixth Report | The 2004 Budget | HC 479 | |

### 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 | 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 (2002–03) 149* |
| 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 | — |

* Government Responses are usually received in the same session as the Report was published. Accordingly, the HC number refers to that session unless otherwise indicated.