House of Commons
Treasury Committee

The 2004 Pre–Budget Report

First Report of Session 2004–05

Report, together with formal minutes, oral and written evidence

Ordered by The House of Commons to be printed 17 January 2005
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

Rt Hon 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 MP (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.
Summary

G7/8 and EU presidency

The UK’s joint leadership in 2005 of the G7/8 and the EU puts the Government in a strong position to play a positive role in advancing discussions on global economic institutional reform and fairer treatment of developing countries.

The economy

2004 has proved to be another year of solid economic activity in the UK, with evidence of some rebalancing of the economy. The Treasury growth forecast for 2005 is more optimistic than the external consensus, but the gap with other major forecasters probably lies within the bounds of forecasting error. Efforts to raise participation rates and the UK’s skill base are vital to meeting the competitive challenges posed by the global economy. In the near term, the evidence many experts detect of a tightening labour market needs to be monitored extremely carefully.

The public finances and the ‘golden rule’

On the Treasury’s current forecast, the golden rule for current borrowing will be met over the current cycle (on the Treasury basis for calculating the rule). The margin for meeting the rule has nevertheless fallen further since the Budget and now stands at £8 billion (0.1% GDP). Many independent forecasters believe that this is too narrow a margin to be confident that the golden rule will be met.

Given the significance for the fiscal rules of dating the beginning and the end of the economic cycle, the Treasury should clearly inform Parliament in a timely fashion of its preliminary analysis that the cycle has ended. It is now also appropriate to review the current fiscal rules.

Revenues and expenditure

Despite strong economic growth and employment, tax receipts—although they have grown strongly by historic standards—are emerging below forecast for the fourth consecutive year. Even so, the fastest growth in receipts since 1997 is projected over the next two years. It is important that forecasts for tax receipts are accurately constructed and avoid an over-optimistic trend. Questions have been raised in particular about the trend for corporation tax receipts and the Treasury should review the assumption that financial company profits will grow as a share of GDP.

The Treasury’s forecast for central government current expenditure in 2004-05 requires substantial spending restraint by government departments over the last four months of the financial year. The build up of End-year flexibility entitlement by departments has reached the point where it poses at least a theoretical risk to the achievement of the Government’s fiscal targets.
The Treasury should provide more detail on the process by which key assumptions are referred to the NAO. We expect to give further examination to suggestions that outside scrutiny of a wider range of the key variables in the forecasts might enhance transparency and credibility.

**Other expenditure issues**

The Treasury should take further action to improve the management and delivery of public sector investment and monitor its effectiveness closely. We call for more detail on breakdown of the sums re-allocated from central programmes to local authorities and other expenditure changes affecting local authority financing.

Although departmental plans for achieving the Gershon efficiency savings were the subject of advice from the NAO and the Audit Commission, the role of the central scrutiny panel sits uneasily with departments’ accountability for this process. It is not possible to determine what advice was provided by the NAO and Audit Commission nor the extent to which this was acted upon by departments: this advice and each department’s response should be published.

**Savings and welfare**

The Committee comments on a range of other issues relating to savings and welfare, including: the possibility of reviewing the plans to reduce the current ISA subscription limits, the extension of the Saving Gateway pilot schemes, the promotion of financial advice to consumers under the programme to tackle financial exclusion, changes to the savings thresholds for welfare benefits, and the plans for increased childcare provision.

**Tax avoidance**

The new tax avoidance disclosure regime is working both in terms of allowing the revenue departments to close off avoidance schemes earlier than was the case previously and in having disincentive effects on the tax avoidance industry. Some experts have indicated that the announcement that future legislation to outlaw future income/NIC avoidance schemes will be backdated to 2 December 2004 raises significant issues that could lead to challenge in the courts. The Inland Revenue should, without jeopardising their position, publish a paper setting out their thinking on the principles which will guide the way they implement this announcement.
**1 Introduction**

1. The Chancellor of the Exchequer made his annual statement\(^1\) introducing the Pre-Budget Report\(^2\) on 2 December 2004. The Committee has conducted an inquiry as in previous years, inviting written evidence and holding three sessions of oral evidence, with outside experts\(^3\) (9 December), Treasury officials (14 December) and the Chancellor (16 December). This evidence is published with this report,\(^4\) and we are most grateful to all those who have contributed.

2. In previous years, we have commented on the advantages which would arise for the House if more systematic and earlier notice were available of the date on which the PBR was to be published.\(^5\) In its response to our report last year, the Government reiterated its position that “it will announce the date of the Budget (and the Pre-Budget Report) at the earliest convenient opportunity. However, it may not prove possible to give two months notice.”\(^6\) On this occasion, the announcement of the PBR date was made on 11 November. This was only 3 weeks before the PBR itself, a reduction even on the 4 weeks notice given in 2003. **We reiterate our view that this is an unsatisfactorily short period of notice for what is meant to be an important event in the economic calendar.**

---

1. HC Debates, 2 December 2004, col 781ff.
2. Cm. 6408
3. Divided into two part-sessions, broadly concentrating on macro-economic issues (Mr Robert Chote of the Institute for Fiscal Studies, Professor Peter Spencer of York University, Mr Martin Weale of the National Institute of Economic and Social Research, and Mr David Walton of Goldman Sachs) and on micro-economic issues (Mr Chote and Mr Weale, accompanied by Mr John Whiting of PricewaterhouseCoopers)
4. See Ev 1
2 The economy

UK Presidencies of the G7/8 and EU

3. The Pre-Budget Report observes that the global economy has been buffeted by a range of forces, including “rising oil prices, large current account imbalances and shifting exchange rates between Europe, Asia and the US”. In addition the developing world, particularly sub-Saharan Africa, has continued to make slow progress in its struggle to defeat poverty.

4. Witnesses told us that these issues, taken together, suggest that there is a need to consider reforms to some of the major international institutions involved in encouraging international economic co-operation and development, many of which have their roots in the immediate post-war period. They also pointed out that the UK’s position as leader of both the G7/8 and the EU through 2005 puts it in a strong position to be at the centre of discussions about such reforms. The Governor of the Bank of England told us the combination of the UK’s leadership of the G7/8 in 2005 with China’s leadership of the G20 presented an “opportunity to start to talk again about a set of issues that have not been talked about for a long time, such as how does the international monetary system operate.” Mr Walton, of Goldman Sachs, went further. He described the G7 as “a pretty outdated body for the management of the world economy.”

5. The Pre-Budget Report outlines the key challenges that, according to the Treasury, need to be tackled during the UK’s Presidencies of the G7/8 and the EU. The Chancellor told us that “there is clearly a need for quite different international arrangements than those in 1945 and for there to be a reassessment of what the World Bank and the IMF does” and that he was hopeful that “reform of the international institutions is indeed something that will come out of our discussions over the next year.” In addition the Chancellor told us that he was pursuing discussions in a variety of specific areas such as debt relief and the International Finance Facility. “The Committee believes that the UK’s joint leadership of the G7/8 and the EU in 2005 puts the Government—particularly as the international community comes together to address the consequences of the tragic earthquake and tsunami in the Indian Ocean—in a strong position to play a positive role in advancing discussions with our international partners on the reform of key global economic institutions and ensuring fairer treatment of developing countries by the world’s major economies. We welcome the Chancellor’s commitment to pursue reform of the major international economic institutions and hope that solid evidence of progress here will emerge over the coming year.

---

7 Pre-Budget Report 2004, p 4 para 1.7
8 The UK holds the Presidency of the EU only through the latter half of 2005.
9 Q 146 HC 48–i–ii Session 2004–05
10 Q 22
11 Pre-Budget Report 2004, p 22 Box 2.4
12 Q 255
13 Q 254
The recent past

6. The IMF recently described the current environment as one in which “economic performance in the United Kingdom remains impressive.”14 Others have taken a similarly upbeat view of underlying growth trends, in spite of some erratic data through the autumn. The National Institute, for example, noted that “despite weak growth in the third quarter, the forces sustaining the upswing remain intact.”15 As the Pre-Budget Report points out, the UK economy continues to enjoy “its longest unbroken expansion since quarterly national accounts data began 50 years ago, with GDP now having grown for 49 consecutive quarters.”16

7. The solid growth performance of the economy has been complemented by inflation figures that have been described by at least one major independent forecaster as “surprisingly weak”.17 Indeed in September the CPI inflation rate fell to 1.1%, just above the lower bound of the range set around the MPC’s inflation target of 2%, although the figure subsequently rose to 1.5% in November. In spite of the modest level of reported inflation, as the Pre-Budget Report notes, “consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation as growth strengthens, the MPC has raised interest rates on five occasions since November 2003 to reach 4.75 per cent.”18

8. Within the recent mix of solid growth and low inflation the Pre-Budget Report also points to “significant evidence of a rebalancing in the composition of demand.”19 For the Treasury, Mr Cunliffe told us that, thanks to recent data revisions, “the economy is less imbalanced than we thought it was.”20 In addition, the Pre-Budget Report notes that “real private consumption has grown broadly in line with the expansion of the economy as a whole over the recent past, and is expected to rise by 3½ per cent ” in 2004, while “business investment is expected to rise by 5¼ per cent”.21 Mr Cunliffe added that “over time, if business investment grows faster than consumption [their] shares in the economy will rebalance.”22 In his evidence to us, Mr Walton broadly agreed with the Treasury’s assessment, arguing that “there are no great imbalances in the economy in contrast to economies like the United States [and] there seems to be a reasonable amount of momentum in domestic demand in contrast to the euro-zone area.”23 Mr Chote of the Institute for Fiscal Studies also pointed out that the UK had avoided some of the extreme fiscal imbalances that had built up elsewhere, noting that “in terms of the debt to GDP position, the UK is relatively in the middle of the league table as far as the older industrial countries are concerned.”24

---

14 United Kingdom—2004 Article IV Consultation, Concluding Statement of the IMF Mission, December 21, 2004
16 Pre-Budget Report, p 4, para 1.7
18 Pre-Budget Report, p 18, para 2.15
19 Ibid., p 23 para 2.27
20 Q 147
21 Pre-Budget Report, p 175, paras AS2 and AS5
22 Q 147
23 Q 2
24 Q 4
9. The Pre-Budget Report expects the UK economy to have grown by 3\% in 2004, in line with the current average of independent forecasts.\textsuperscript{25} This is above the 3.0\% growth the average of independent forecasts pointed to at the time of Budget 2004 but in line with the Treasury’s own growth expectations at Budget time.\textsuperscript{26} \textbf{The Committee welcomes the fact that 2004 has proved to be another year of solid economic activity in the UK, marking a long period of sustained quarter-on-quarter growth. The combination of 3\%-plus growth, rising employment, modest inflation and evidence of some re-balancing of the economy away from household consumption towards investment is particularly welcome.}

\textbf{The outlook}

\textit{Overall growth in 2005}

10. In spite of the turbulence seen in recent months in areas such as the oil market and currency markets the IMF recently concluded that “the outlook is favourable”\textsuperscript{27} for the UK economy. Even so, the Treasury’s forecast of 3 to 3½\% growth in 2005 compares with a consensus of independent forecasts of 2.5\% GDP growth over the coming year.\textsuperscript{28} Most experts we asked nevertheless felt that this was not a significant difference. Mr Weale, of the National Institute for Economic and Social Research, told us that in his view “a sensible assessment of the Treasury forecast is that it falls well within the margins of uncertainty that other, I hope, reputable forecasters have round their forecasts.”\textsuperscript{29} Mr Chote agreed, telling us that “the difference of half a per cent [in growth forecasts] is well within the bounds of forecasting error.”\textsuperscript{30} Only one expert told us that he felt the Treasury was being implausibly optimistic, with Professor Spencer of York University and the ITEM Club acknowledging that in 2004 the Treasury’s forecast came in “bang on the nose” but suggesting that “this time the odds are against the Treasury’s forecast coming in correctly.”\textsuperscript{31} The Treasury acknowledges that its growth forecast is higher than the external consensus, as was the case at the time of Budget 2004, but argues that its recent forecasting record “has been relatively good”.\textsuperscript{32} Indeed one expert, Professor Heald, told us that “the Treasury’s recent forecasting track record means that it would be unwise to bet against it.”\textsuperscript{33} \textit{While the Treasury’s economic growth forecast for 2005 is more optimistic than the external consensus, the majority of the experts we asked suggested that the gap between the Treasury’s growth forecasts and those of other major forecasters lay within the bounds of forecasting error. In any case, the Treasury’s recent forecasting record in the area of economic growth has been good.}

\begin{itemize}
\item \textsuperscript{25} Pre-Budget 2004, p 187, Table A8
\item \textsuperscript{26} Budget 2004, p 239, Table B8
\item \textsuperscript{27} United Kingdom—2004 Article IV Consultation, Concluding Statement of the IMF Mission, December 21, 2004
\item \textsuperscript{28} Pre-Budget Report, p 187, Table A8
\item \textsuperscript{29} Q 13
\item \textsuperscript{30} Q 14
\item \textsuperscript{31} Q 8
\item \textsuperscript{32} Pre-Budget Report, p 186 Box A5
\item \textsuperscript{33} Ev 72
\end{itemize}
The UK’s trade position

11. The Treasury expects the UK’s current account deficit, which is estimated to have been 2¼% of GDP in 2004 \(^{34}\) “to widen slightly in 2005, and thereafter to stabilise at around 2½% of GDP.”\(^{35}\) The Committee wished to establish the extent to which a UK current account deficit on this scale was likely to be sustainable, particularly given recent currency market volatility. Looking at the international scene, for example, the Governor of the Bank of England told us that the sheer scale of the US current account deficit was now raising “some potentially very awkward questions” about how an adjustment in the US economy and currency markets “which at some point will be necessary, can come about.”\(^{36}\) The evidence we received on the UK’s position was generally re-assuring. Mr Cunliffe of the Treasury told us that there were clearly questions about the sustainability of the US position “where their trade deficit is over 5% and all of the received wisdom has been that when you get over 5% it has to correct.”\(^{37}\) In contrast he felt the UK’s current account deficit was neither that far out of line with the past nor unsustainable. Independent experts generally agreed. Mr Walton told us that there is “certainly not really a sustainability question in the sense that things appear to have stabilised in volume terms.”\(^{38}\) Professor Spencer meanwhile told us “historically we have been able to run current account deficits at 2 or 3% of GDP for several years before there was a problem”, although he did signal that when the adjustment comes “in the UK context, these adjustments have been quite rapid and quite dramatic. When confidence turns in the foreign exchange markets the currency can fall quite rapidly.”\(^{39}\) The evidence the Committee received in the course of this inquiry indicates that there is little to suggest that the UK current account deficit is moving into unsustainable territory in the near term, although the volatile nature of currency markets does create risks.

Household sector consumption & saving

12. We noted earlier welcome evidence that the economy had begun to rebalance through 2004.\(^{40}\) In the context of the household sector this rebalancing has been characterised by housing market indicators which the Treasury describes as suggesting “unambiguously”\(^{41}\) that activity is now slowing down. Looking at the broader picture for consumer spending the Treasury expects the recent easing of consumption growth “to be consolidated going forward, as recent increases in interest rates, existing levels of debt, and more moderate house price inflation tend to inhibit borrowing and spending.”\(^{42}\)

13. Some experts felt that it may be premature to conclude that consumption growth is slowing. Mr Walton, for example, told us “what is not yet evident is whether or not

---

34 Pre-Budget Report 2004, p 188, Table A9
35 Ibid., p 185, para A95
36 HC (2004–05) 48–i–ii, Q 146
37 Q 122
38 Q 20
39 Q 17
40 See paragraph 8 above
41 Pre-Budget Report 2004, p 179 para A75
42 Ibid., p 181 para A80
consumer spending growth is going to maintain this slower growth path that we have seen in recent months.\textsuperscript{43} There were also doubts raised as to how far the household sector remains from an equilibrium position, particularly with respect to savings. The Pre-Budget Report notes that “the household saving ratio has risen slightly since 2002, and in the second quarter of 2004 stood a little above its average since the late 1990s.”\textsuperscript{44} The Treasury believes that the near term outlook is for only a limited further rise in the savings ratio, with the Pre-Budget Report stating “the saving ratio is expected to rise a little further next year and to stabilise”\textsuperscript{45} at around 6½%.\textsuperscript{46} Some independent experts suggested that a greater adjustment may be required. Mr Walton told us “if you look at the very long term average for the savings ratio, it is more like 8% and quite probably we will get to that level again, particularly if these other bits of the economy which have been quite depressed in the past few years grow quite strongly.”\textsuperscript{47} He also noted that households had not “necessarily realised that companies are making a much smaller provision for their future retirement than was the case just a few years ago and to fill that gap is almost certainly going to require people over time to devote more of their income into savings.”\textsuperscript{48} Mr Weale made a similar point. He noted that “the United Kingdom has one of the lowest savings rates in the OECD”\textsuperscript{49} and that “in the United States people have started to realise that the United States has a problem with aggregate saving and I think Britain is in the same position.”\textsuperscript{50}

14. In the near term Mr Walton was confident that monetary policy could be expected to adjust should the household sector retrench less than the Treasury envisages. He told us “the MPC has got a lot of flexibility to move in either direction on interest rates depending on just how things turn out in the next few months”.\textsuperscript{51} The longer term need to rebuild savings across the economy nevertheless remained, although he noted that if “it will happen next year or whether it is something that will happen over the next five or ten years is a much more uncertain point.”\textsuperscript{52} On the same topic Mr Weale indicated that he was disappointed that “although both the Pre-Budget Report and the Budget Statement are wide-ranging documents they make no reference at all to the question whether the overall level of saving in the country is adequate.”\textsuperscript{53}

15. Recent signs that the housing market may be cooling and that the household sector is beginning to rebuild its saving ratio are welcome. In the longer term, the evidence we have received on the Pre-Budget Report highlights the importance of work being done in restoring consumer confidence in long-term savings and reforming the UK’s pension system.

\textsuperscript{43} Q 25  
\textsuperscript{44} Pre-Budget Report 2004, p 179, para A72  
\textsuperscript{45} \textit{Ibid.}, p 181 para A80  
\textsuperscript{46} Pre-Budget Report 2004, p 179, Table A5  
\textsuperscript{47} Q 30  
\textsuperscript{48} Q 30  
\textsuperscript{49} Ev 87, para 9  
\textsuperscript{50} Q 21  
\textsuperscript{51} Q 25  
\textsuperscript{52} Q 30  
\textsuperscript{53} Ev 87, para 9
The labour market

16. The Pre-Budget Report notes that “the UK labour market has performed strongly in recent years... UK unemployment, on the International Labour Organisation (ILO) definition, has fallen to 4.6 per cent, the lowest of the G7 economies, while the working age employment rate has reached 74.7 per cent.” At the same time, while recent data suggests “the trend rate growth of productivity in the UK has increased in recent years, and that the productivity gap with major industrial competitors appears to be narrowing”, it remains true that, according to the PBR, “to produce the same output, UK workers work 14 per cent longer hours than German workers and 29 per cent longer than French workers.” The Pre-Budget Report thus announced a range of measures to both “strengthen the drivers of productivity growth and meet the long-term challenges of the global economy” and to “tackle the long-term challenges of increasing flexibility, reducing inactivity and helping those groups in society which face particular barriers to work.”

17. In spite of the Government’s fresh initiatives in this area, the National Institute has raised questions about how rapidly the workforce can continue to grow, given that “the participation rate in the UK is now amongst the highest in the OECD.” Moreover, all the independent experts we asked replied in similar terms to Mr Walton, who told us that the “labour market is just beginning to tighten and it is at a point where if it were to tighten much more you could potentially generate a bit more inflationary pressure.” Professor Spencer, for example, told us that “some of the indicators coming from Incomes Data Services and people like that who survey the pay scene is that wage settlements are now picking up.” The latest Inflation Report also concluded that “there seemed to be little slack in the jobs market” although it also noted that “despite this, wage growth remained steady.”

18. Mr Cunliffe of the Treasury told us he did not agree with suggestions that the labour market was now tight enough to cause problems. He argued that “there is still a stock of labour to come into the workforce.” Another official, Mr Holgate, told us that “lone parent employment has risen from 45% to 54%. We have an ambition to get it to 70% by 2010. We know that something approaching maybe 90% of those on sickness and disability benefits would like to work and... the Pathways to Work pilots are the first significant evidence we have that we can manage a combined series of interventions to help them to get back into work quicker than they otherwise would have done. Thirdly, I would mention older workers. The employment rate there has risen and it is very important that it carries

54 Pre-Budget Report 2004, p 71, para 4.2.
55 Ibid., p 37, para 3.1
56 Ibid., p 39, Box A3
57 Ibid., p 37
58 Ibid., p 71, para 4.1
60 Q 36
61 Q 35
63 Q 198
64 Q 200
on rising from the point of view of people able to provide for their own retirement.”

The Chancellor noted that another priority was to examine how “we might be able to help more people from ethnic minorities to get the jobs.” The Chancellor also observed that raising the skills of the workforce is as important as raising the participation rate, telling us that “there are now two million graduates a year coming out of Chinese and Indian universities. So the premium on skills becomes more of a pressure on the British economy. We will have to continue to upgrade and up-skill.”

19. Several witnesses also told us that high levels of migration had played an important role in improving the functioning of the UK labour market in recent years. Professor Spencer, for example, observed that “the new accession countries to the European Union are countries which have very high educational standards and a very highly skilled workforce. It would be very surprising if companies who were short of specialist staff, like the National Health Service, were not able to organise themselves to recruit from those areas. It is a fact that that is what they are now doing very successfully and in very large numbers.” Mr Cunliffe also highlighted the impact on growth of “immigration and particularly immigration from the accession countries of the EU, where people can come in now and work as a way of relieving supply side constraints in the economy”, while the Chancellor noted the role inward migration could play in improving the skills base of the economy, telling us “there are people with very good skills and if they are given a work permit and able to come into this country they can be of benefit to businesses in this country.”

20. Many of the Chancellor’s proposals to continue to raise labour market participation rates and raise skill levels have met with support from industry. The CBI, for example, told us “the government announced the national roll-out of the employer training pilots, to be known as the national employer training programme”: the CBI believes that a skills strategy along these lines is “crucial for the success of the wider UK economy” and “welcomes the aim to increase labour market participation still further, through the new deal for skills.” Others have nevertheless noted that it may be some years before the impact of labour market reforms is felt. The Chief Economist at the Bank of England, for example, told us that the recent improved performance of the labour market at least partly reflected “changes to the structure of the labour market as a result of the various reforms that have taken place over the last ten or 20 years.”

21. The Committee notes the evidence we have received suggesting that migration into the UK has played a useful role in relieving skill shortages in the labour market and boosting non-inflationary growth. We welcome efforts to improve the functioning of the UK labour market by raising participation rates and agree that raising the UK’s skill base is vital to meeting the competitive challenges posed by the global economy.

---

65 Q 200
66 Q 263
67 Q 270
68 Q 37
69 Q 198
70 Q 259
71 Ev 63, para 6
72 HC (2004–05) 48–i–ii, Q 96
long term nature of labour market reform nevertheless means that in the near term the evidence many experts detect of a tightening labour market needs to be monitored extremely carefully. The amount of slack left in the UK labour market is likely to be a key determinant of how long the UK economy can continue to grow above trend without generating inflationary pressure and is thus an essential element in judging the timing of the cycle and whether or not the Government has met its fiscal rules.
3 The public finances

The fiscal balance

Meeting the golden rule in the current cycle

22. The Pre-Budget Report states that “the Government’s macroeconomic framework is designed to maintain long-term economic stability.” 73 Within the Government’s macroeconomic framework there are two principal strands: “the monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term while allowing fiscal policy to support monetary policy over the economic cycle.” 74 The importance of the fiscal rules within the current macroeconomic framework is widely acknowledged. The Governor of the Bank of England, for example, told us that meeting the fiscal rules “is not an optional extra, it is an integral part of the overall macroeconomic framework”, adding that he thought “the Chancellor clearly agrees with that.” 75 Mr Cunliffe of the Treasury told us “for fiscal policy meeting the medium term fiscal rules, which on the golden rule is borrowing only to invest over the cycle, is quite important” and that “if you do not meet the golden rule it is important to explain why you have not met the golden rule.” 76

23. On the plans presented in the Pre-Budget Report the fiscal rules will be met. 77 The Treasury’s projections “show that the Government is meeting the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over this economic cycle of around 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £8bn in this cycle, including the AME margin.” 78 Similarly, the Government projects public sector net debt relative to GDP “to grow slowly, as the Government borrows modestly to fund increased investment in public services, reaching 35.4 per cent of GDP at the end of this economic cycle, £59bn below the 40 per cent level” 79 needed to meet the sustainable investment rule.

24. In spite of the confidence expressed in the Treasury’s forecasts that the fiscal rules will be met, the margin by which the golden rule is expected to be met in the current cycle has fallen to £8bn from £11bn at the time of the Budget. 80 Professor Heald told us that “the margins of error attached to forecasting means that it is a matter of judgement whether the

---

73 Pre-Budget Report 2004, p 13, para 2.1
74 Ibid., p 14, para 2.3
75 HC (2004–05) 48–i–ii, Q 129
76 Q 144
77 There has been considerable discussion in recent years over the exact method by which performance against the golden rule should be calculated. In previous reports we have contributed to this discussion but it is not an issue we pursue further here. Discussion in this report of the likely achievement or otherwise of the fiscal rules is, therefore, based on the method of calculation used by the Treasury in the Pre-Budget Report.
78 Pre-Budget Report 2004, p 192, para B7
79 Ibid., p 193, para B9
80 Budget 2004, p 244, para C5
golden rule will be met over the current or next cycle, when safety margins are so small.”

It was the judgment of most of the independent experts we asked that the Government was unlikely to meet the golden rule, across the current cycle. Mr Chote of the Institute for Fiscal Studies told us that “I would put the probability [of the fiscal rules being met in the current cycle] at somewhat lower than 50%.” Professor Spencer told us “I think it is very hard to see how the Chancellor can make the Golden rule in this cycle”, while Mr Walton argued that “my own estimate is that on the Treasury’s definition of the economic cycle, it [the golden rule ] will be missed by 0.02% of GDP on average over that six-year period.” Professor Miles is quoted as summarising the situation as being one in which “The Chancellor showed that on Treasury central assumptions the golden rule is met over this cycle, but by a reduced margin of about £8bn. This rests on relatively fast growth for next year, an assumption of 1% slack in the economy now, a bounce-back in tax revenues later this year and adherence to spending plans. None of those assumptions individually is implausible but the combination of all being realised would certainly count as a highly favourable outcome.”

25. Since we took evidence from experts in the course of this inquiry, further figures have been released by the Office for National Statistics indicating that “in November 2004 the public sector showed a deficit on current budget of £8.0bn, compared with a deficit of £5.7bn in November 2003… An alternative measure of the public sector fiscal position is public sector net borrowing. This additionally takes account of capital investment. In November 2004 there was net borrowing of £9.4bn, which compares with £6.9bn in November 2003.” Treasury officials are reported to have indicated that one-off factors, such as the fact that “the winter fuel payment was paid in November this year while much of the expenditure had slipped to December last year” had boosted the November 2004 borrowing figures. Even so, several analysts are reported as believing that the November public sector deficit figures make achieving the fiscal rules in 2004–05 harder. Christine Frayne of the Institute for Fiscal Studies, for example, is reported as stating that “the Chancellor will need a cumulative current budget surplus of £11.7bn over the last four months of this year compared to barely £100m in the same period last year. Spending departments will have to show, or be forced into, considerable restraint to bring this about.”

26. The IMF had concerns relating to the UK’s ability to meet the fiscal rules in the longer term, stating recently that “although it seems likely that both fiscal rules will be met in the current cycle, without early adjustment, a relatively weak initial current balance in the next cycle could weaken confidence in the rules.” Looking beyond the November borrowing figures, the IMF described the UK’s fiscal position as having “deteriorated substantially in
recent years” and suggested that “questions are emerging about how and when the necessary correction will take place.” The IMF went on to suggest that, on its forecasts for the public sector net deficit, “measures to close the gap vis-à-vis the PBR forecast will be needed”.

27. The Chancellor, in evidence to the Committee, rejected suggestions that the Government will fail to meet the fiscal rules in either this cycle or future cycles. He told us that “we have been meeting our fiscal rules and we will continue to meet our fiscal rules” and added that “there are no circumstances I see coming before this Committee today that mean I believe we will not meet our fiscal rules.” The fiscal rules are an important part of the framework for macroeconomic management and in the Treasury’s view will be met over the current cycle. However, the margin for meeting the golden rule in the current cycle on the Treasury’s forecasts has nevertheless fallen further since the Budget and now stands at £8bn, or 0.1% of GDP. On current Treasury forecasts, the golden rule will be met—by a narrow margin. Many independent forecasters believe that this is too narrow a margin to be confident that the golden rule will be met. The Chancellor has assured us that he could foresee no circumstances in which the Government would not meet its fiscal rules. We note, however, the narrow margin by which the golden rule would be met on current Treasury forecasts, particularly given recent data.

**Declaring the cycle closed**

28. Given the small margin by which the Government meets the golden rule on current forecasts, the issue of dating the end of the cycle across which the rule will be measured has acquired particular significance. The Treasury has for some time suggested that it expects the output gap to close, and thus the current cycle to end, in 2006. In the Pre-Budget Report, however, the Treasury states that “in the event that the current output gap were to prove less negative than now estimated, and this was solely accounted for by over-estimation of the current trend rate of growth, then the existing short-term growth forecast would imply the current cycle ending earlier than 2006.”

29. We asked Treasury officials how and when the decision to declare that the cycle had ended earlier than 2006 would be communicated to the public should such a decision be taken. Mr Cunliffe told us that the Treasury would produce a detailed report on the reasons it believed the cycle had ended “and we would probably release that analysis on a Budget or a PBR because that is when we release most of our economic analysis.” The Committee was concerned that this could leave a lag of up to six months after the cycle was deemed to have closed and before the announcement of that decision. Mr Cunliffe replied that after the data appeared to confirm the cycle had ended the Treasury would indeed “probably use the next Budget or PBR to do the detailed report”, but that “as to the view that the Treasury thought the cycle had now closed, you would have some sense of that

---

90 United Kingdom—2004 Article IV Consultation, Concluding Statement of the IMF Mission, December 21, 2004
91 Q 277
92 Pre-Budget Report 2004, p170, Box A3
93 Q 131
94 Q 130
outside the PBR and Budget process.”95 The Chancellor also argued that there would be very little time between the end of the cycle and the public knowing whether the fiscal rules had been met. He told us “economic data is coming out every month. In fact, there is probably quite a bit of economic data coming out this morning even as we speak. I think people will see, on the basis of the projections we are making, that we are clearly meeting our fiscal rules.”96

30. Independent experts nevertheless saw the issue of declaring the cycle closed as a continuing point of uncertainty in the fiscal rules. Mr Weale told us “the timing of the cycle is inherently uncertain, it can be established only with the hindsight of several years.”97 Mr Chote also told us “credibility is generally improved the greater the transparency of the system”98 and that in the context of determining the cycle open or closed “there is an argument for saying that you could have an independent scrutineer.”99 The Committee believes it is important that the operation of the fiscal rules should be as transparent as possible. Given the significance for the fiscal rules of dating the beginning and the end of the economic cycle we believe the Treasury should clearly inform Parliament in a timely fashion of its preliminary analysis that the cycle has ended. To delay making an announcement, potentially for several months, to the next Budget or Pre-Budget Report, would not be in the interests of informed public debate.

**Reviewing the fiscal rules**

31. Several commentators have suggested that it would be appropriate to review the fiscal rules as the end of the current cycle and the start of the next approaches. The IMF has argued that “within a fiscal policy framework that is at the forefront of international best practice, it will be worthwhile to review the operation of the fiscal rules as the cycle comes to a close.”100 Mr Walton expressed a similar view, telling us that while the current rules “really did serve their purpose” when first implemented in 1997, “it is time actually to look fundamentally again at the fiscal rules.”101 The Institute for Fiscal Studies (IFS) has also recently issued a paper on updating the Code for Fiscal Stability, which lays out the framework within which the fiscal rules operate. In this paper it argued that “to date the Code has generally worked well, and in any case many of the Treasury’s practices exceed the minimum requirements of the Code. However, improvements could be made in the light of recent experiences.”102 Mr Weale went further, telling us that a number of problems in forecasting and judging success or failure against the fiscal rules as currently formulated suggested that “it is not a sensible way of targeting fiscal policy.”103

---

95 Q 131
96 Q 275
97 Q 43
98 Q 46
99 Q 45
100 United Kingdom—2004 Article IV Consultation, Concluding Statement of the IMF Mission, December 21, 2004
101 Q 43
102 Updating the UK’s code for fiscal stability, Institute for Fiscal Studies, 11 November 2004
103 Ev 87, para 5
32. Several of those advocating reform of the fiscal rules have made detailed suggestions, many of which share common themes. The IFS, for example, suggested that “in particular it would be preferable for less emphasis to be placed on the precise forecasts for fiscal aggregates and greater emphasis to be placed on the magnitude of the risks to those forecasts.”104 Mr Weale also raised “the issue of the uncertainty surrounding budgetary forecasts”105 and how this was handled within the fiscal framework. He told us that what was required was “coherent and transparent statement of the chance of the golden rule being broken and an analysis of the policy changes which would be adopted if this probability rose over some threshold”106 and pointed out that “two years ago this Committee asked [the Treasury] to produce a fan-chart which would answer the question.”107 In the Committee’s Report on the 2002 Pre-Budget Report we recommended, among other things, that the Treasury should present its fiscal projections “in the style of fan-chart, similar in style to those published by the MPC and the US Congressional Office.”108

33. Another common theme of the comments we heard was that consideration should be given to introducing a greater degree of flexibility into the fiscal rules. The IFS, for example, has suggested that it may be desirable for the Government to consider means by which it could move away from “a ‘hard’ hit-or-miss interpretation of its fiscal rules (and the attendant rigidity that such an interpretation brings) to a softer, more probabilistic interpretation (which might allow greater tax and spending smoothing) without a loss of credibility.”109 Mr Weale also complained that the current framework is “flexible at the start of the economic cycle but becomes very rigid as you get to the end of the economic cycle.”110 Mr Walton suggested that “there are merits to a… gradualist approach to eliminating current budget imbalances”111 and pointed out that “once the election is out of the way, one of the first tasks for the Chancellor will be to set the fiscal framework for the new Parliament… There is nothing in the [Fiscal] Code that requires the fiscal framework to be the same as in the last two Parliaments.”112

34. The Committee believes that clear, well designed and well understood fiscal rules have an important role to play in lending credibility to economic policy. The current rules have generally worked well since their introduction but are likely to be capable of further improvement and refinement in the light of the practical experience accumulated over recent years. With the start of both a new cycle and a new Parliament likely within the next year or so we believe that it is now appropriate to review the current fiscal rules with a view to initiating any changes that are found to be desirable early in the next cycle. It should be made clear from the start that such a review will not consider any proposals that lessen the UK’s commitment to sound public finances or

---

104 Updating the UK’s code for fiscal stability, Institute for Fiscal Studies, 11 November 2004
105 Q 43
106 Ev 87
107 Ev 86
108 HC (2002–03) 159, para 37
109 Updating the UK’s code for fiscal stability, Institute for Fiscal Studies, 11 November 2004
110 Q 43
111 Ev 83
112 Ibid.
that unduly limit the ability of fiscal policy to support monetary policy in delivering economic stability alongside low inflation.

Revenues

**Overall tax receipts**

35. Tax receipts (net taxes and national insurance contributions) in 2004–05 are now projected to be £425.5bn, £3.9bn lower than forecast in Budget 2004. Total current receipts are expected to be £451.0bn, £3.7bn lower than forecast in Budget 2004. As discussed earlier, economic growth has been slightly above the Treasury’s forecasts and is now expected to be 3¼% in fiscal year 2004–05, compared to a projection of 3% in Budget 2004.

The labour market has remained robust, with the employment level reaching a record high of 28.44m in the three months to October. The Pre-Budget report shows that the main shortfall in tax receipts has occurred in non-North Sea corporation tax, which we discuss in further detail below. The reclassification of NHS trusts also resulted in a reduction in receipts of £1.5bn.\(^{113}\) This was partly off-set by the impact of higher oil prices on North Sea corporation tax and Petroleum Revenue Tax. Professor Spencer described this outcome as “very disappointing in view of the strength of the economy and the oil price”.\(^{114}\) Mr Cunliffe had told us in March that he thought we were seeing the end of the process of the Treasury over-forecasting tax revenues. He told us that he stood by that statement, adding that “If you look at the revenue shortfalls that we are seeing, they are getting smaller and smaller and they are concentrating on one tax, corporation tax”.\(^{115}\) **Despite strong economic growth and record employment, tax receipts are for the fourth consecutive year below the Treasury’s forecast. The growth in receipts has been strong by historic standards but has not matched the Treasury’s optimism at the time of the Budget.**

36. The Treasury continues to project a sharp rise in net taxes and social security contributions as a percentage of GDP, from 35.6% in 2003–04 to 38.4% in 2009–10 (see Chart 1 below). The Treasury explains that this is largely driven by the recovery in corporation tax receipts arising from financial company profits, the normal fiscal forecasting convention for the treatment of fiscal drag and anti-avoidance policies underpinning the increases.\(^{116}\)

---

\(^{113}\) The Pre-Budget Report indicates that “This classification change has no effect on the public sector as a whole, but does reduce the public sector gross operating surplus and VAT refunds. This has the effect of reducing both receipts and expenditure by around £1\(\frac{1}{2}\)bn each year”—Pre-Budget Report, para B43, page 206

\(^{114}\) Ev 79

\(^{115}\) Q 116

\(^{116}\) Q 158 and Pre-Budget Report, para B62, page 212
Chart 1: Tax-GDP ratio

Table 1: Tax receipts as a proportion of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax</td>
<td>10.6</td>
<td>10.8</td>
<td>11.1</td>
<td>11.3</td>
<td>11.5</td>
<td>11.7</td>
<td>11.8</td>
</tr>
<tr>
<td>Non-North Sea</td>
<td>2.3</td>
<td>2.5</td>
<td>3.0</td>
<td>3.3</td>
<td>3.4</td>
<td>3.4</td>
<td>3.4</td>
</tr>
<tr>
<td>corporation tax</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax credits</td>
<td>-0.4</td>
<td>-0.4</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.2</td>
</tr>
<tr>
<td>North Sea revenues</td>
<td>0.4</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>VAT</td>
<td>6.2</td>
<td>6.3</td>
<td>6.2</td>
<td>6.2</td>
<td>6.2</td>
<td>6.2</td>
<td>6.1</td>
</tr>
<tr>
<td>Excise duties</td>
<td>3.4</td>
<td>3.4</td>
<td>3.3</td>
<td>3.3</td>
<td>3.2</td>
<td>3.2</td>
<td>3.1</td>
</tr>
<tr>
<td>National Insurance</td>
<td>6.5</td>
<td>6.6</td>
<td>6.6</td>
<td>6.7</td>
<td>6.7</td>
<td>6.8</td>
<td>6.8</td>
</tr>
<tr>
<td>Contributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other taxes and</td>
<td>6.6</td>
<td>6.6</td>
<td>6.7</td>
<td>6.8</td>
<td>6.9</td>
<td>7.0</td>
<td>7.1</td>
</tr>
<tr>
<td>royalties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Taxes &amp; Social</td>
<td>35.6</td>
<td>36.2</td>
<td>37.1</td>
<td>37.7</td>
<td>38.1</td>
<td>38.3</td>
<td>38.4</td>
</tr>
<tr>
<td>Security Contributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Pre-Budget Report, pages 213–214

37. Other forecasting bodies remain sceptical that the increase in revenues will reach the magnitude projected by the Treasury. The IMF recently noted that “Despite the recent history of optimistic revenue projections, the PBR projects that revenues relative to GDP will rise over the medium term to close to the peak ratio at the turn of the century… Our central forecast, however, is for lower revenue growth, reflecting mainly slower real GDP growth in 2005 and a less pronounced rebound of corporation tax revenue over the medium term.”

117 IMF Article IV Consultation, concluding statement of the IMF mission, para 8, 21 December 2004
and 2005–06 were “vulnerable to the downside”. Mr Walton told us that although the Goldman Sachs forecast for current receipts in 2004–05 was only £1bn below the Treasury, their forecast for 2005–06 was “considerably more cautious about receipts. The Treasury is projecting a 0.9% rise in the share of tax receipts in GDP. Some rise is likely in response to the lagged effects of above trend growth and higher oil prices but the Treasury seems to be placing a lot of faith in the effectiveness of measures announced in the Budget to tackle tax avoidance. We expect an £8bn shortfall in receipts [in 2005–06] relative to the Treasury’s expectations”. As can be seen from the table below, the Treasury is predicting the strongest growth in net taxes and social security contributions and current receipts since 1997–98. Mr Ramsden told us that “This is the stage in the cycle where you would expect growth in receipts to be rather stronger than the growth in money GDP”. Also, in addition to strong economic growth and higher oil prices, the growth in income tax receipts has been strong during the latter half of 2004. We note that the Treasury continues to project a rise in the ratio of tax receipts to GDP over the forecast horizon, from 36.2% in 2004–05 to 38.4% in 2009–10. We also note that the Treasury is projecting the fastest growth in receipts over the next two years since 1997. This forecast implies an acceleration in receipts growth in the final four months of this year and even stronger growth in receipts in 2005–06. While there are grounds for optimism, there are significant risks to this forecast and the Treasury needs to monitor developments closely.

Table 2: Annual growth rates of net taxes and social security contributions and public sector current receipts

<table>
<thead>
<tr>
<th></th>
<th>97/98</th>
<th>98/99</th>
<th>99/00</th>
<th>00/01</th>
<th>01/02</th>
<th>02/03</th>
<th>03/04</th>
<th>04/05</th>
<th>05/06</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net taxes and social</td>
<td>10.1%</td>
<td>7.0%</td>
<td>5.8%</td>
<td>7.2%</td>
<td>2.7%</td>
<td>1.5%</td>
<td>5.8%</td>
<td>7.3%</td>
<td>8.4%</td>
</tr>
<tr>
<td>security contributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public sector current</td>
<td>9.7%</td>
<td>6.4%</td>
<td>6.8%</td>
<td>6.5%</td>
<td>2.0%</td>
<td>1.4%</td>
<td>6.4%</td>
<td>7.7%</td>
<td>8.0%</td>
</tr>
<tr>
<td>receipts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: HM Treasury

38. The Treasury continues to believe that the present shortfall in receipts is a cyclical phenomenon. Mr Cunliffe told us that when the Treasury “forecast the cyclical components of the economy we use long term averages” and that the question was “How long does it take for those taxes to come back to the long term average? The history is quite clear that there are long run averages in these things and the taxes do come back. Deciding… how sharp or how shallow that line is back to the average is where the judgement is, and there we were right to forecast a faster bounce-back in corporation tax but that it has not been as fast as we thought”. We would welcome a clearer explanation of how the Treasury forecasts the cyclical components of tax receipts and how this has influenced their current projections. This should include how the Treasury estimates the long-term averages of components such as corporation tax and financial company

118 Deutsche Bank: Data Flash 2 December 2004
119 Ev 83
120 Q 154
121 Q 116
profits, what factors it bases these estimates on and how quickly it expects them to return to their long-run averages.

The Treasury’s revenue forecasting record

39. In our report on the 2003 Budget we concluded that the spread of risks around the Treasury’s revenue assumptions were skewed downwards. We also commented that the Treasury’s forecasts relied on a large improvement in financial company profits. Over the past few years, during a number of exchanges, Treasury officials have robustly defended the accuracy of their revenue forecasts. We have also made numerous requests for more information surrounding the components of the forecast so that we might better understand what factors are driving projections of a strong growth in receipts.

40. Mr Cunliffe recently told us that regarding the Treasury’s forecasting record for receipts “It has not changed particularly since [the new fiscal] framework was introduced. Over the last seven or eight years it has had a bias towards caution and it compares quite favourably with other countries”. Looking back at the Treasury’s forecasting record indicates that current receipts were under-estimated in the three years to 1999–2000 and have been over-estimated in the four years to 2004–05. On average forecasts have been slightly over-optimistic, by around £1.9bn, or around 0.4% of total receipts. The average absolute difference for the year ahead forecast is £8.9bn or around 2.3% of current receipts.

Table 3: Treasury forecasting record for current receipts

<table>
<thead>
<tr>
<th>Year</th>
<th>Forecast</th>
<th>Outturn</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget 1998</td>
<td>330.1</td>
<td>334.5</td>
<td>4.4</td>
</tr>
<tr>
<td>Budget 1999</td>
<td>345.0</td>
<td>357.2</td>
<td>12.2</td>
</tr>
<tr>
<td>Budget 2000</td>
<td>375.0</td>
<td>382.9</td>
<td>7.9</td>
</tr>
<tr>
<td>Budget 2001</td>
<td>398.4</td>
<td>388.0</td>
<td>—10.4</td>
</tr>
<tr>
<td>Budget 2002</td>
<td>407.2</td>
<td>393.2</td>
<td>—14</td>
</tr>
<tr>
<td>Budget 2003</td>
<td>428.3</td>
<td>418.7</td>
<td>—9.6</td>
</tr>
<tr>
<td>Budget 2004</td>
<td>454.7</td>
<td>451 (est.)</td>
<td>—3.7</td>
</tr>
</tbody>
</table>


41. The Treasury maintains that it uses cautious assumptions in its preparation of forecasts of the public finance. One of the key assumptions is that trend GDP growth will be 2½% a year to 2006–07 (a quarter of a percentage point below the neutral view). Mr Cunliffe told us that “we are deliberately cautious in that we use a lower growth forecast than our central forecast to forecast the public finances and that is to build in a measure of caution”. The PBR also notes that the Government uses cautious audited assumptions to build a safety margin against unexpected events. The Chancellor told us that “If you take the key assumptions, privatisation processes, trend growth, claimant unemployment, interest rates,
equity prices, VAT and the rest you will find that our assumptions are actually cautious assumptions and it is on that basis that I think the country can have confidence which it did not have before in the fiscal framework”.125 We recognise the Treasury’s statement that it bases its forecasts on cautious assumptions. However, following a prudent start in the run up to the year 2000, we note that the Treasury has now over-estimated the growth in tax receipts in four consecutive years. Many other countries and outside forecasters have also over-estimated the growth of tax receipts during the world economic downturn. However, given that the economic recovery is now under way it is important that official forecasts for tax receipts are accurately constructed and avoid an over-optimistic trend.

Corporation tax

42. The main source of the downward revision to the forecast of receipts in 2003–04 and 2004–05 stems from corporation tax. Although corporation tax only accounts for around 7.5% of total tax revenue, its highly cyclical nature makes it one of the most difficult taxes to anticipate and it typically accounts for a large proportion of forecast errors. For the current year, non-North Sea corporation tax receipts are forecast to be £3.1bn lower than the Budget projections, although this is off-set by the fact that corporation tax from North Sea companies is projected to be £1.2bn higher due to the continuing strength in the oil price. Overall corporation tax receipts are projected to be £32.9bn, £1.9bn lower than in the Budget. The Treasury believes this is mainly due to “weaker growth in corporation tax receipts from financial companies. A number of factors may be responsible including a larger than expected backlog of unused losses and allowances which have temporarily depressed taxable profits.”126 Professor Spencer noted however that this explanation could not apply to the whole sector since analysis of the top ten clearing banks in the UK indicated that they were going to be paying to the Treasury around £1.6bn/£1.7bn extra [in 2004–05].127 This is the fourth consecutive year that the Treasury has over-estimated the growth of corporation tax. The End of year fiscal report indicates that the errors in previous years have also been due to lower than expected growth in financial company profits.128

43. A number of our experts and other outside commentators have expressed scepticism regarding the Treasury’s corporation tax forecast. Barclays Capital noted that the forecasts for non-North Sea corporation tax receipts still look “far too optimistic”; they noted that while “It is true that corporate profitability has improved recently, helping receipts growth in the current financial year”, it was “not at all clear why profit growth should be considered strong enough to support a doubling in the growth rate of non-North Sea corporation tax [in 2005–06] to 27% or growth of 17% in [2006–07].”129 The introduction of the minimum corporation tax rate of 19% on distributed profits is only forecast to increase corporation tax receipts by £340m in 2004–05 and £490m in 2005–06.130
The 2004 Pre-Budget Report

provided a chart of the share of total UK corporate profits in GDP since 1977. They concluded that “Given the stage of the economic cycle (i.e. very close to, if not already past, the peak), it would be highly unusual for this share to climb further from here... The best that might be expected... is for profits to grow broadly in line with GDP in the year or two ahead.”

44. Mr Chote told us that given the existing set of tax rates the Treasury is projecting a move to levels of corporation tax receipts “which have only ever been achieved in the past either when the economy has been clearly overheating or when the financial sector has been doing particularly well in the height of the stock market boom”; he noted that the Treasury in part bases its long-term optimism for corporation tax on an assumption that the profits of financial sector companies are going to rise as a share of national income and that is clearly a debatable question. The assumption used for the FTSE All-Share Index—which underlies some other elements of the revenue forecasts—is that it will grow in line with money GDP. We ask the Treasury to review the assumption that financial company profits grow as a share of GDP, given the contrast with the assumption used for the FTSE All-Share index which is that it grows only in line with GDP. We also ask the Treasury to publish data on the backlog of unused losses and allowances in the financial sector which the Treasury notes have “temporarily depressed taxable profits”.

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

Source: Institute for Fiscal Studies

45. In addition to the question of the Treasury’s growth assumption, there is also the issue of the scale of the rebound envisaged for corporation tax receipts. Previous cycles have seen a steep recovery in tax revenues. The Chancellor told us that “when people are coming out of a down-turn as in the late eighties, the mid-nineties and at other times the rise in receipts has been over 20%. In 1986–87 it was 38.8%, in 1987–88 it was 33.4% and in 1994–
95 it was 30%.” Treasury officials also noted that although the volatility of the economic cycle had been reduced, the last cycle and the downturn since 2001 was led by over-investment in the UK and the US and by equity market collapses, and the net result was that the pick-up in corporation tax receipts could be as steep as in previous cycles. Although Mr Cunliffe noted that “the tax might be coming back a little bit more slowly than it has done in previous cycles”, he told us that “If you have a cycle that is led by investment, by sharp reductions in financial asset prices, you would expect the way the hit is taken by financial companies, not so much the clearing banks but the investment banks that have a lot of proprietary trading, to be different from what has happened in past cycles”. Mr Ramsden told us that “because we expect the effect of these losses will wear off over time...we are forecasting significant growth next year”.

46. In addition to lower profit growth, there may be a number of other factors that could pose risks to the Treasury’s projections of corporation tax receipts. Mr Walton noted that “throughout the European Union corporation tax rates are coming down. If you want to attract companies and if you want business to grow, I do not think, as a government, you are going to be able to tax them more heavily”. Mr Whiting believed that given “the impact of ECJ cases, changing business patterns and generally lowering tax rates among our trading partners, we do have to worry about the projected yields of corporation tax in the PBR figures”; he thought the sums potentially at issue in litigation currently before the ECJ could be substantial.

47. In response to previous questioning of the validity of their corporation tax forecasts, Treasury officials have repeatedly made reference to the fact that their projections are based on confidential information from the Inland Revenue regarding company tax payments. In our report into Budget 2004 we recommended that the Treasury publish a breakdown of their corporation tax receipts between “financial companies, non-financial companies and the life assurance sector”. The Treasury did not take up our recommendation, but told us that it would “investigate how it can provide more detail about its corporation tax forecasts”. Mr Ramsden told us that “for financial companies excluding life assurance, for life assurance, for non-North Sea industrial and commercial companies and then for North Sea companies we have separate methodological models that drive those forecasts”.

48. There are widespread doubts amongst experts and outside commentators about the Treasury’s corporation tax forecasts. While it is true that corporation tax receipts have grown by over 30% in some previous years, this has typically taken place when the economy was recovering strongly, or where there was a significant stock market boom. To reinforce the credibility of the corporation tax forecasts, we recommend that the

133 Q 299
134 Q 161
135 Q 159
136 Q 54
137 Ev 90, Ev 91 and Qq 86–91. A paper from the Treasury on the current cases before the ECJ sent at the request of our Sub-committee is printed with the evidence to this report (Evidence p 91).
139 Q 160
Treasury publishes a breakdown of its corporation tax forecast, differentiating between the various sub-sectors involved. In the absence of further information, the evidence we have received suggests that the balance of risks to the Treasury’s corporation tax forecast is to the downside.

Expenditure

49. In the near term the Treasury’s spending plans continue to call for Total Managed Expenditure (TME) to rise more rapidly than the broader economy. After rising by 8.4% in 2003–04, current plans forecast a rise in TME of 7.0% in 2004–05 and 7.2% in 2005–06. The Spending Review 2004 outlined the Government’s plans for spending in 2006–07 and 2007–08. These plans provided for increases in TME of around 5.5% in each year in line with the growth of money GDP.

Current expenditure

50. Since the PBR, the Office for National Statistics has published data on the trend in the public finances in the current financial year to November, although monthly expenditure outturn data is only available for central government. For the first eight months of the year current expenditure was 7.4% higher than in the corresponding period of 2003–04, while the PBR projects that for the year as a whole current expenditure will be 5.3% higher. This implies that the growth rate of central government current expenditure will have to be just 1.1% in the remaining four months of the year. Current spending excluding social security benefits and debt interest (largely the current spending contained in Departmental Expenditure Limits) was 8.7% higher in the first eight months of 2004–05 than in the corresponding period of 2003–04, while the PBR forecasts that this component of spending will increase by 4.1% for the year as a whole. Given the November data, the PBR forecast for current central government spending excluding social security implies that spending in the final four months of 2004–05 will have to be 4.5% (or £4.1bn) lower than in the final four months of 2003–04 for the forecast to be met.

51. The PBR indicates that “growth in spending is likely to moderate as departments continue to adjust to the end-year flexibility arrangements and resource accounting, resulting in a flatter profile of spending throughout the year. In addition the introduction of the Pension Credit in September 2003 will have increased the year on year growth rates of spending in the first half of 2004–05”. Mr Stephens, reiterating these points, told us that the Treasury was “basically expecting our plans as set out to be met”. Despite the buoyancy of the recent figures Professor Spencer was not “expecting a large overshoot in spending this year as the pressure on budgets [in 2004–05] is much less than [in 2003–04] when it was increased by the Iraq war and the aftermath of the big pay restructuring agreements seen in 2001 and 2002” while “this year public sector pay settlements have been relatively restrained”. Mr Chote added that “you would expect the Treasury to have better knowledge than independent forecasters… of the profile of departmental

140 ONS Press Release Public Sector Finances November 2004
141 Pre-Budget Report, para 2.36, page 25
142 Q 177
143 Ev 79
spending.” The Treasury’s forecast for central government current expenditure in 2004–05 requires substantial spending restraint by government departments over the last four months of the financial year. This illustrates the importance of the recent reforms aimed at ensuring a smoother profile of spending over the course of the year. This is an area we will expect to examine further at the time of the 2005 Budget.

**End year flexibility and current spending**

52. End-year flexibility “allows departments to carry forward resources and capital not fully spent at the end of financial years into future years. This helps departments to plan their programmes more effectively and removes any incentive for wasteful end-year surges in spending.” Under previous arrangements cash which was not spent by the end of the financial year was lost to departments and had to be surrendered to the Treasury. The result was a regular surge of departmental spending each March, with the associated risk of wasted expenditure and poor value for money for the taxpayer.

53. The total stock of end-year flexibility (EYF) at the end of the financial year is reported annually in the Public Expenditure Provisional Outturn White Paper in the summer. The 2003–04 publication shows that the total stock of EYF carried over to 2004–05 was £11.4bn (of which nearly £9bn was in respect of current spending). Around £2.5bn was drawn down in the 2004 Winter supplementary estimates leaving a total remaining stock of around £8.8bn. Professor Heald believed that “One of the present uncertainties regarding compliance with the golden rule when the margins are small concerns the speed with which departments holding End-year flexibility entitlements will run these down, thus adding to current year expenditure”. Mr Stephens for the Treasury told us that “you would expect, having introduced end-year flexibility, that departments will want to operate with a certain level of stock in order to maximise their flexibility and freedom over the operation of their budget”; he thought that the “prospect of the £8.8bn being drawn down in totality is remote and indeed the pattern over the past five years has been of the stock building up.” Indeed we note that the stock of EYF has been building up over the period 2000–01 to 2003–04, from £6.7bn to £11.4bn, but that this has come at a time when departmental expenditure limits have been growing strongly, by an average of around 9% in nominal terms, over the three year period. As the growth in departmental expenditure slows to around 6.5% this year, and an average of 6.9% over the next three years, the likelihood of departments drawing down more of their EYF could be expected to increase.

54. We welcome the continued use of the End-year flexibility arrangements and the move away from potentially wasteful year-end surges in spending. We note, however, that the build up of EYF entitlement by departments has reached the point where it poses at least a theoretical risk, should there be major calls on their entitlements across departments, to the achievement of the Government’s fiscal targets as the end of the
cycle draws near and the available margin is small. The Treasury should make clear what arrangements are in place to ensure that this will not happen. It would also assist transparency and debate if the figures for outstanding entitlement for each department (following drawdowns in the Winter and Spring supplementary estimates) were updated and published at the time of the Pre-Budget Report and the Budget.

**Investment expenditure**

55. The Pre-Budget Report shows that net investment is “projected to increase from £14bn in 2003–04 to £31bn in 2007–08, as the Government seeks to rectify historical under-investment in public infrastructure”\(^\text{150}\). However, over recent years, departments, local authorities and public corporations have found it difficult to deliver investment to the level of the Government’s plans. The growth rate of government investment has been subject to slippage in both calendar years 2003 and 2004. The planned figure for central government for 2003 in Budget 2003 was 47%, while the outturn was 23%; the planned figure for 2004 in PBR 2003 was 30%, reducing to 17% in Budget 2004, against an estimated outturn of 5¾%.

56. A similar pattern emerges when looking at the figures on a fiscal year basis. The *End of year fiscal report* shows that public sector net investment in 2002–03 fell short of the Budget 2002 forecast by £3.2bn and in 2003–04 fell short of the Budget 2003 forecast by £5.2bn.\(^\text{151}\) In addition to these shortfalls the Treasury has revised down the forecast of public sector net investment (PSNI) by £2.5bn in 2004–05. Our experts could not identify any firm reasons for these undershoots. Mr Chote described them as a “genuine puzzle” and speculated whether the hurdles that needed to be gone through to consider investment schemes in the context of PFI might be the source of some of the delays.\(^\text{152}\) There is some evidence on the cause of these shortfalls in the Treasury documents. The *End of year fiscal report* indicates that in 2002–03 the shortfall reflected, in part, lower locally financed capital expenditure and lower expenditure by the National Lottery; for 2003–04 the shortfalls reflected lower than forecast capital expenditure by the Department of Health, and on transport, Scotland and defence.\(^\text{153}\) Mr Stephens told us that for 2004–05 “Most of [the shortfall] is actually lower investment outside of Central Government by public corporations and local authorities”.\(^\text{154}\) Since the Pre-Budget Report the outturn figures for November reveal that for the government to meet even this reduced target would require a surge in public sector investment in the last four months of the year. In the current year, in the eight months to November, there has been public sector net investment of £8.6bn; to meet the target of £21.7bn for 2004–05 there will have to be around £13bn of PSNI carried out in the last four months.

57. The Chancellor told us that the Government’s forecast of increasing public sector investment was “a very substantial rise whichever way you look at it and I do not think there has been a period in British history outside wartime when the scale of investment on

---

150 Pre-Budget Report 2004, para 837, page 205
151 HM Treasury: *End of year fiscal report* December 2004, page 30 (Tables 4.2 and 4.3)
152 Qq 57–59
153 HM Treasury: *End of year fiscal report* December 2004, page 28 (para 4.9) and page 31 (para 4.19)
154 Q 189
a consistent and sustained basis has been rising so much”. Commenting on the slippage to investment targets in previous years he said “Whereas there was slippage in previous years, we are getting to grips with this issue and it is really part of the psychology of departments that they have got to know that the investment is really guaranteed and they can go ahead with it, whereas in the past they always held back on plans thinking that there might be some stop-go or some cut take place which would prevent them doing things.”

58. This Committee attaches the highest possible importance to ensuring that the Government’s plans for historically large increases in public sector investment are delivered efficiently. However, despite recent improvements it is apparent that some departments, local authorities and public corporations are still failing to deliver capital spending at the planned level. We first identified this problem during our 2003 Pre-Budget Report inquiry and the Committee is disappointed that it has not yet been resolved. It seems inconsistent to say that reforms will enable departments to manage current spending more smoothly throughout the year but yet rely on a very large surge in public sector net investment in the final quarter to meet the forecast. We recommend that the Treasury take further action to improve the management and delivery of public sector investment and to monitor its effectiveness closely.

**Funding local services**

59. The PBR announced that the Government was taking action to reduce pressures on council tax by £1bn in 2005–06. This consisted of:

- an additional £125m in new funding for England
- an additional £24m for the devolved administrations
- the re-allocation of £512m of existing funding from central programmes to local authorities
- a third of a billion pounds in reduced ring fencing. The only three measures that have been identified are a reduction of £75m in the amount local authorities are obliged to passport to schools; the setting of upper limits for some recycling targets; and the levying of higher fees and charges for licensing and planning applications.

60. The Chancellor told us that “the overall level of spending remains as was expected, but this is spending which is now done by the local authority rather than the central government department”. When asked which programmes government departments were reducing to pay for the £512m re-allocated to local authorities the Chancellor told us that the figures “will be available when we publish the departmental estimates”. We ask the Treasury to provide us with a comprehensive note outlining the sources, with a breakdown, of the £512m re-allocated from central programmes to local authorities. We also ask for more detail of the areas where reduced ring-fencing and increased charges will reduce the pressures on council tax by £⅓bn.

---

155 Qq 331–332
156 Pre-Budget Report 2004, p 120, para 6.12
157 Q 340; limited further information was supplied in a supplementary note from the Treasury, Ev 93
61. In his Pre-Budget Statement the Chancellor announced that in 2005 “at a cost of an additional £260m, for those over 70 we will add to the winter fuel payment with an additional £50 payment”. The Pre-Budget Report notes that “Alongside Council Tax Benefit the Government believes that it is right to help older pensioner households with their council tax and other living expenses”.

We note that the equivalent payment for 2004, announced in the 2004 Budget rather than the 2003 Pre-Budget Report, was £100. **We welcome the announcement that in 2005 there will be an additional £50 payment to pensioners over 70 to help with council tax and other living expenses, but the level of this payment should be reviewed at the time of the Budget.**

**Reporting issues**

62. The Committee continues to be interested in the way in which spending is reported. In 2003–04 the Government adopted accounting standard FRS17 for the public services, which means that all pensions schemes in the public services are now required to reflect the accruing pension costs of scheme members in their resource accounts. In the national accounts, however, net public sector pensions are reported on a transaction basis and reflect the difference between contributions made by, and payments made to, scheme members. The Treasury therefore makes an accounting adjustment to reconcile the resource accounts with the national accounts. Mr Cunliffe told us that “The national accounts data is set for us by the European system of accounts which is in turn based on the UN system”. Mr Stephens told us that “there were a number of differences in treatment between the two different accounting approaches. Some of them work one way, some work the other way and I think to pick one out in particular and focus on that exclusively does not paint a complete picture”; he drew attention to the issue of single use fighting equipment, which was counted as current spending in the national accounts, whereas the accepted treatment under GAAP rules is to count it as capital investment. Present accounting arrangements thus create issues as to consistency of treatment and as to how the principle underlying the fiscal rules of ensuring fairness between generations is reflected.

63. The 2004 PBR saw the publication of the third annual *End of year fiscal report*. The focus of the report is on performance against the fiscal rules and fiscal policy objectives, with an analysis of the year ahead forecasts against outturn, for the forecasts published in Budget 2002 and Budget 2003. Professor Heald believed that “the Treasury should be commended on the *End of year fiscal report*” as “this brings together valuable fiscal data for the previous two years”. He also welcomed the style of the document, noting that it “exhibits the measured tone of PESA, not the breathless tone into which Pre-Budget and Budget Reports often lapse.” He believed that the *End of year fiscal report* is “the ideal

---

158 HC Debates 2 December 2004 cols 790–791
159 Pre-Budget Report, para 5.58, page 102
160 Office for National Statistics Consumer price indices, first release, 14 December
161 Q 204
162 Q 202
163 Ev 73. ‘PESA’ is the annual Public Expenditure Statistical Analyses publication.
place for systematic reporting of PFI capital expenditure and of the stock of future commitments” adding that “without this information it is difficult to place in context reported underspends of direct public sector capital expenditure.”

There are other areas also in which additional information could be included, such as the amounts of end year flexibility drawn down by departments during the year and statistical tables containing forecasts and outturns for receipts, expenditure and public borrowing for each of the last twenty years (which would better enable the Treasury’s recent forecasting record to be placed into a fuller historical context). We commend the Treasury on the publication of the End of year fiscal report. It could usefully be expanded to provide updates on certain other data which would help debate and scrutiny.

**The National Audit Office**

64. Sections 156 and 157 of the Finance Act 1998 provide scope for the Comptroller and Auditor General to examine and report on conventions and assumptions submitted to the NAO by HM Treasury for examination. The PBR indicates that “The key assumptions underlying the fiscal projections are audited by the NAO”. These are listed as privatisation proceeds, trend GDP growth, UK claimant unemployment, interest rates, equity prices, VAT, consistency of price indices, composition of GDP, debt funding costs, oil prices and tobacco. In our report on the 2004 Budget we asked the Treasury “to clarify how they decide which assumptions, apart from those automatically revisited, should be referred to the National Audit Office.” The Treasury response did not shed much light on the subject, stating “The audited assumptions are referred to the Comptroller and Auditor General as part of the three-year rolling review process. In addition, the assumptions are submitted for audit when they are changed or modified, as set out in the Code for Fiscal Stability. In addition, the Government asks the Comptroller and Auditor General to audit significant ‘spend to save’ compliance packages where these principally affect operational activity rather than requiring legislative change.”

65. The IFS has recently noted that the current requirements are less demanding than the IMF Revised Code of Good Practice on Fiscal Transparency on the independent scrutiny of fiscal information, which states “Independent experts should be invited to assess fiscal forecasts, the macroeconomic forecasts on which they are based and all underlying assumptions.” The IMF recently noted that “Several assumptions underlying the projections are now audited for reasonableness by the National Audit Office” and recommended that “It would be worth considering whether such outside scrutiny of other key variables would enhance transparency and credibility”. Mr Chote told us that “credibility is generally improved the greater the transparency of the system is, so the more we know about how the forecasts are being generated, the more we know about some of the assumptions, for example which are not publicly announced”; he added that the Treasury “does not tell us what it is assuming about average earnings growth, and nor have

---

164 Ev 71
165 Pre-Budget Report 2004, p 198, para B27
166 HC (2003–04) 654, para 15
167 HC (2003–04) 479-I, para 31
168 Institute for Fiscal Studies, *Updating the UK’s Code for fiscal stability*, page 19
169 UK 2004 Article IV consultation, Concluding statement of the IMF mission, para 13
previous governments of course in the same position, and that is crucial to knowing what your income tax projections are going to be.\textsuperscript{170} Professor Heald, however, cautioned that “the calls by policy critics for greater audit involvement seriously underestimate the limitations of audit in the area of macro-forecasting, where policy expertise and experienced judgement are paramount. The auditor needs to establish that the assumptions led to the forecasts, and were not chosen in order to generate particular forecasts”.\textsuperscript{171} For example, the forecast for average earnings is primarily an economic judgement and it could be argued that the Treasury is best placed to determine what this should be. However, the NAO could reasonably be asked to audit how this growth in average earnings is expected to translate into the growth of income tax receipts (for example, how much of the average earnings growth is expected to come from bonus payments which will mainly attract higher rate tax).

66. **We recommend that the Treasury provide more detail on the process by which key assumptions are referred to the National Audit Office, including how they decide which assumptions to refer, and how much notice they provide to the NAO of the assumptions that are due for audit. We note the comment of the IMF that it would be worth considering whether such outside scrutiny of other key variables would enhance transparency and credibility. This is an issue to which the Committee will be returning.**
4 Other issues

Efficiency savings

67. Following a review of public sector efficiency by Sir Peter Gershon,172 the 2004 Spending Review published targets for government departments to deliver efficiency gains, in aggregate, in excess of £20bn by 2007–08. Local government is expected to contribute at least £6.45bn of these efficiency gains. At least half of the savings are to be cashable, to allow resources to be recycled to fund priorities at the front line. Other efficiency gains are to lead to increases in public sector outputs including improvements in quality.173

68. The Pre-Budget Report noted that “since the 2004 Spending Review there has been good progress both by departments in delivering efficiencies and in cross-government action to support efficiency. Detailed long-term plans are being developed for the whole spending review period up to 2008 and departments have published Efficiency Technical Notes, explaining how efficiency gains will be measured.”174 The Pre-Budget Report also detailed the progress departments have already made in delivering efficiencies including:

- savings on branded and generic medicines for the NHS of £1bn per year from 2005–06;
- value for money gains of £2bn in central civil government procurement; and
- a total of around 4,000 posts moving out of London and the South east by the end of 2004–05.175

69. The 2004 Spending Review required each department to set out in Efficiency Technical Notes (ETNs) the precise measures and methodologies that they would use to assess efficiency gains and, to ensure confidence in and the credibility of the measures, the Government invited the National Audit Office (NAO) and the Audit Commission to scrutinise departmental ETNs before publication.176 In the absence of any indication on the face of the published ETNs that they had been subject to such a scrutiny,177 we asked the Treasury for details of the NAO and Audit Commission’s involvement in the process. The Treasury told us that the purpose of ETNs was to set out how departments would measure progress against their agreed efficiency targets and that the documents were designed to provide the public and Parliament with greater clarity on efficiency measurement, thereby increasing the Efficiency Programme’s transparency and accountability. The Treasury considered that “ideally, ETNs should describe efficiency measures in a simple way that is easily understood, covering issues such as baselines and the data that will be used. Balancing the need for clarity and simplicity with the need to provide an appropriate amount of detail on data and measurement is challenging. The role of the NAO and the

172 Releasing resources to the front line: Independent Review of Public Sector Efficiency, Sir Peter Gershon, CBE, July 2004
173 Pre-Budget Report 2004, para 6.15
174 Ibid., para 6.18
175 Ibid., page 117
176 HM Treasury 2004 Spending Review, Cm 6237, para 2.35
177 Departmental ETNs were published at the end of October 2004 and can be accessed from www.hm-treasury.gov.uk/documents/ (see Treasury written ministerial statement at HC Debates, 1 November 2004, col 1WS)
Audit Commission in advising departments on ETNs was designed with this purpose in mind. 178

70. The Treasury noted that the NAO and Audit Commission had been “asked to examine drafts of departments’ ETNs against agreed criteria—clarity of savings, measurement methods, data quality, service continuity, and readability... The NAO and Audit Commission co-ordinated their efforts and jointly produced advice on the draft ETNs to departments via a scrutiny panel comprising Office of Government Commerce and HM Treasury officials. The advice assessed the strengths and weaknesses of the drafts, highlighting areas where improvements were desirable. The risks to efficiency measurement, and ways to mitigate them, were subsequently discussed at meetings of the panel with the auditors. It was then for departments to take this advice into account before publishing their ETNs.” 179

71. The Department for Education and Skills’ ETN is 55 pages long and covers programmes as detailed as the installation of interactive whiteboards in schools. In contrast, the ETN for the Home Office is three pages long and provides little more detail than that contained in the Gershon review. We asked the Treasury who was responsible for ensuring that ETNs were to an acceptable standard and questioned why some proposals, which appeared to be changes in policy, were classified as efficiency savings, such as:

- the Ministry of Defence’s proposal to cut the number of attack submarines from 10 to eight;
- the Department of Transport’s proposal for fixed penalties applicable to Heavy Goods Vehicle and Passenger Services Vehicle operators under future legislation; and
- the Department for Education and Skills’ proposal for savings from the modernisation of the Teachers pension scheme, including raising the retirement age. 180

72. The Chancellor told us that it was departments who were accountable for efficiency gains and for showing how these would be made. Individual efficiency proposals were not a matter for the Treasury to take a view on. The Chancellor noted that measuring efficiency gains was an evolving process and said that the NAO and the Audit Commission would be asked to provide further advice. 181 He acknowledged the differing standards of departments’ ETNS and noted that:

“In some cases, differences are justified because the measurement of certain efficiency measures is complicated, in some areas it requires a lot more explanation and in other areas it is more simple. The ETNs were designed to set out the information and data which will underpin how progress can be measured. Now, I think we agree on this, that the ETNs published in October cannot be the last word and they are in a sense the first word in this, and we are working with the NAO to see how to return to some of the difficult measurement issues in the future, which some

178 Ev 91
179 Ibid.
180 Some further information on the planned efficiency savings arising from raising the retirement age of teachers was supplied in a supplementary Treasury note, Ev 93
181 Qq 375, 378, 383, 384
ETNs actually refer to explicitly, like the data sources of social care and children’s services which are being developed at the moment, so I think, as I said, it is an evolving process. We hear what you say as well as what has been said by the National Audit Office and this will develop with the co-operation of the National Audit Office, but it is primarily the departments that decide how best to move this forward because they have got to take responsibility for this.”

Departments will be required to report on efficiency in their Departmental Reports as efficiencies are achieved. The Chancellor noted that information on progress had been provided in the Pre-Budget Report and agreed to provide more updated information in the Budget.

73. As noted above, while the National Audit Office and the Audit Commission provided advice on draft ETNs via a scrutiny panel comprising Office of Government Commerce and Treasury officials, it was left to departments whether or not to take this advice into account in the published version of the notes. We are surprised that advice from the National Audit Office and the Audit Commission on each Efficiency Technical Note does not appear to have been provided directly to the department concerned. It is not clear what the role of the central scrutiny panel was in the process, but we consider that its existence sits uneasily with the evidence we received that it is departments that are accountable for this process and that individual efficiency proposals are not a matter for the Treasury to take a view on.

74. The National Audit Office and the Audit Commission were invited to scrutinise departments’ Efficiency Technical Notes “to ensure confidence in and the credibility of the measures.” It is not possible under the procedure adopted to determine what advice was provided by the National Audit Office and the Audit Commission nor the extent to which this was acted upon by departments. We welcome the Chancellor’s assurance that this is an evolving process and that the National Audit Office and the Audit Commission will be asked to provide further advice. We recommend that this advice and each department’s response be published.

75. We note that departments are required to report progress in their departmental reports. But given the size and importance of the overall efficiency programme, we believe consolidated progress reports are required. We therefore welcome the Chancellor’s undertaking to provide further details in the Budget and we recommend that this become a regular feature of forthcoming budget and pre-budget reports.

**Savings and welfare**

**ISAs**

76. The Pre-Budget Report contained a number of announcements designed to promote savings and tackle the problem of financial exclusion. Among them, the Government confirmed that it “remains committed to ISAs” and that it “plans, subject to consultation,
to further extend the existing higher ISA limits to 2009."\textsuperscript{185} Expert witnesses expressed some frustration at the announcement of a consultation on extending the ISA limits. Mr Whiting, for example, wondered "why not just get on and say, all right, ISA limits will go this way until 2009"\textsuperscript{186} rather than making the announcement subject to consultation, adding that the issues seemed "fairly simple."\textsuperscript{187} Mr Holgate of the Treasury confirmed that "when we noted that the temporary increases in the cash and share ISAs were coming to an end in April 2006 people did comment at the time... but the fact is that we have until April 2006 and it is just possible that when one announces something in one way people with an interest running against that presumption speak up".\textsuperscript{188} In its Report on the 2003 Pre-Budget Report the Committee suggested 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",\textsuperscript{189} a view we reaffirmed in our Report on the 2004 Budget.\textsuperscript{190} The Committee welcomes the Government’s clear statement that it remains committed to ISAs, a commitment which is in accord with our previous recommendations in this area. But given the lengthy public debate about the future of ISAs we do not see that any useful purpose will be served by more consultations on extending the limits on ISA savings. A clear statement of intent in the Pre-Budget Report to keep the current higher ISA limits would have been preferable.

\textbf{The Saving Gateway scheme}

77. For most households, tax incentives for saving of the sort provided via ISAs can play a role in encouraging savings. Such tax incentives are nevertheless likely to be of little benefit to those on low incomes who pay little or no tax. An alternative strategy is therefore for the government to provide a cash contribution rather than tax relief on individual savings. This approach is known as “matching” and has been in use since 2001 for personal and stakeholder pensions.\textsuperscript{191} In 2002 the Government set up a pilot scheme to extend the matching approach to savings, via the Saving Gateway, with government matching pound for pound savings of low-income households up to a limit. The Chancellor told us that participants in the Saving Gateway pilot were “either receiving out of work qualifying benefits or individual earnings below £11,000”, with the pilot scheme being based in Tower Hamlets, Cambridgeshire, Cumbria, Gordon and Hull.\textsuperscript{192} The pilot schemes have now matured and the Pre-Budget Report indicated that while “the full evaluation of the pilot will follow in early 2005”, the interim evaluation “finds that matching can provide an important new dimension to Government support for saving. Therefore, the Government will launch a larger, £15m Saving Gateway pilot in 2005.”\textsuperscript{193} In evidence to us the Chancellor added that the “interim evaluation says mostly it has been new saving and

\textsuperscript{185} Pre-Budget Report 2004, p 97, para 5.36
\textsuperscript{186} Q 100
\textsuperscript{187} Q 101
\textsuperscript{188} Q 204
\textsuperscript{189} HC (2003–04) 136, p 33, para 63
\textsuperscript{190} HC (2003–04) 479–I, p 31, para 65
\textsuperscript{191} Pre-Budget Report 2004, p 198, para 5.37
\textsuperscript{192} Q 385
\textsuperscript{193} Pre-Budget Report 2004, p 198, para 5.39
sustainable saving” which has been created by the schemes. We asked why, if the initial indications were positive, he was planning further pilot schemes for the Saving Gateway rather than extending the scheme nationally. He told us that while the full evaluation of the initial pilots was due in February 2005, it seemed appropriate “to widen the pilots before you make a final decision that you can afford to go nationwide or it is right to go nationwide” and that “what we are testing are alternative match rates, not just 50:50; we are looking at how it would affect a wider range of income groups and, therefore, there will be a larger set of pilots.” The Committee is encouraged to hear that the initial evidence suggests that the Saving Gateway has been successful in encouraging new, sustainable saving among the less affluent. Given the importance of encouraging saving among the less affluent we look forward to the Government moving as quickly as possible, subject to evaluation of the initiatives, to national availability of the Saving Gateway scheme.

Promoting financial inclusion

78. As well as the extension of the pilot scheme for the Saving Gateway, the Pre-Budget Report announced a variety of other measures aimed at promoting financial inclusion, including the establishment of a Financial Inclusion Fund of £120m over three years “to support initiatives to tackle financial exclusion. In particular, the Fund will support the Government’s aims to increase access to affordable forms of credit and to see a significant increase in capacity of free face-to-face money advice.” This follows the announcement of a Financial Inclusion Taskforce in the 2004 Spending Review. Given the evidence we have heard in the course of inquiries into the credit card industry and the long-term savings industry about the problems many households face in accessing financial advice and financial services, we were anxious to ensure that there were clear lines of responsibility and a sense of urgency in tackling the issues surrounding financial exclusion. Mr Holgate of the Treasury told us that Ministerial responsibility for the Financial Inclusion Taskforce “will be held jointly between the Treasury and the DTI” and that the new Chairman of the Taskforce would be proceeding “with alacrity.”

79. In our report on Restoring confidence in long-term savings we signalled concern at both the funding constraints and the regulatory hurdles that have made it difficult for organisations such as Citizens Advice to be effective in providing basic advice on financial issues to individuals. In terms of the regulatory hurdles constraining the provision of basic financial advice, the Treasury has subsequently indicated that it believes that “advice centres should be provided with an exemption from the FSMA financial promotion regime.” To ease the financial constraints on consumer access to basic advice we also recommended in our report on Restoring confidence in long-term savings “that the whole

---

194 Q 386
195 Q 387
196 Q 388
197 Promoting financial inclusion, HM Treasury, December 2004, p 8, para 1.32
198 Q 242
199 Q 245
of the financial services sector, including banks, credit card companies and the long-term savings industry, should give financial support to the provision of free basic financial advice. The Government intends that the Financial Inclusion Fund should help address the funding issues surrounding the provision of financial advice. Mr Holgate told us “the largest element [of the fund] will probably be the [funding of] face-to-face money advice.”

The Committee welcomes the funding assistance the Financial Inclusion Fund will give to the provision of basic financial advice to consumers and looks forward to rapid progress on tackling financial exclusion by the Financial Inclusion Taskforce. But the problems created by financial exclusion and poor access to basic advice when consumers get into debt or other financial difficulties are entrenched. We reiterate our earlier recommendation that the possibility of securing additional funding from the financial services industry to support the activities of non-profit organisations in this area should continue to be pursued.

80. The Pre-Budget Report announced a series of further measures aimed at promoting financial inclusion. In an attempt to improve access to affordable credit for low income households the Government is considering allowing lenders to apply for repayment to be made by deduction from benefit payments in certain circumstances. The Chancellor acknowledged to us that “there are two views on this” proposal but told us that deductions from benefits would suit many claimants because “it gives a continuity to the commitments they have to make”; nevertheless, he was “willing to listen” to other views. We welcome the indication by the Chancellor that he is prepared to look further at the proposal to allow lenders to apply for repayment to be made by deduction from benefit payments in certain circumstances.

81. Further Pre-Budget announcements in the area of promoting financial inclusion and encouraging savings related to the implementation dates of previously announced initiatives. The 2004 Spending Review announced plans to lower repayment rates for loans from the Social Fund from 15% of claimants’ benefits to 12% of claimants’ benefits and the Pre-Budget Report announced that this initiative will be implemented in April 2006. The Pre-Budget Report also confirmed that, as announced in Budget 2004, the threshold above which savings will reduce entitlement to a range of income-related working age benefits will be raised from £3,000 to £6,000 with effect from April 2006. In our report on the 2004 Budget we recommended that the treatment of capital in assessing retirement benefits as well as working-age benefits should be kept under review. When we asked the Chancellor why the changes currently proposed were being held over to April 2006 he told us that this was in order to give the relevant departments “time to adjust to this change and make provision for it.”

The Committee welcomes the announced doubling of the
threshold above which savings will reduce working-age income related welfare benefits. It would be helpful to have an indication of how substantial the obstacles are (financial or otherwise) standing in the way of both this and other measures designed to help the less affluent in society being introduced earlier than the proposed date of April 2006.

**Improved childcare provision**

82. The Government has an ambitious long-term goal\(^\text{211}\) to eradicate child poverty by 2020. In the near term, however, the Pre-Budget Report confirms that “the Government is on course to meet its Public Service Agreement target to reduce the number of children in relative low-income households by a quarter between 1998–99 and 2004–05.”\(^\text{212}\) The Pre-Budget Report also reiterates the new Public Service Agreement target announced in the 2004 Spending Review “to halve the number of children in relative low-income households between 1998–99 and 2010–11.”\(^\text{213}\) A key part of the Government’s strategy to reduce child poverty is “providing more help for parents to work and guaranteeing affordable, good quality childcare for those who need it.”\(^\text{214}\) The Chancellor told us that he saw tackling issues such as improved childcare as important “for reasons of economic success and social justice.”\(^\text{215}\) The Pre-Budget Report thus announced measures aimed at ensuring “that all families with children aged up to 14 who need it can find an affordable, flexible, high quality childcare place that meets their circumstances”\(^\text{216}\) including the creation of a “Transformation Fund worth £125m each year from April 2006 to invest in high quality, sustainable, affordable provision.”\(^\text{217}\)

83. Mr Chote told us he questioned “whether that amount of money is large enough given the number of local authorities you are looking at”\(^\text{218}\) and that greater targeting, particularly of free childcare provision, “on those perceived as being most in need”\(^\text{219}\) may have been appropriate. The Chancellor told us “people want both the supply of childcare places, which has not been available, and the quality to give them the assurance that when they are working or away from their children that their children are properly taken care of.”\(^\text{220}\) The Government’s objective of guaranteeing affordable, high quality childcare for all those who need it is welcome and it is important that the expansion of childcare provision is adequately funded if the parents are to be assured of the quality of the care their children will receive.

---

\(^{211}\) Pre-Budget Report 2004, p 90, para 5.6  
\(^{212}\) Ibid., p 90, para 5.7  
\(^{213}\) Ibid., p 91, para 5.8  
\(^{214}\) Pre-Budget Report, p 91, para 5.9  
\(^{215}\) Q 371  
\(^{216}\) Pre-Budget Report, p 93, para 5.19  
\(^{217}\) Ibid., p 94, para 5.20  
\(^{218}\) Q 96  
\(^{219}\) Q 93  
\(^{220}\) Q 373
Tax avoidance

84. As this report indicates above, it is important that the flow of revenue from the tax system as it stands—that is, the tax structure and the rates set—is maximised and that tax avoidance, although legitimate in itself, does not reach levels where the public finances are endangered. In the 2004 Budget, the Chancellor announced that he would be introducing legislation to establish a new regime whereby tax avoidance schemes would be required to be disclosed to the revenue departments. Expert witnesses told the Committee at the time that they had no objection to a regime along these lines, although there were potential concerns about the details of defining the schemes which would come under the regime and other details. In our report on the Budget, we concluded that:

“We agree ... 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.”221

85. The proposed scheme was enacted as Part 7 of the Finance Act 2004. The intention is that, by giving the authorities early notice of schemes, they can form a relatively quick view as to how to respond. The response could be to note the development but to take no action, or to announce that action will be taken to legislate against the scheme; if it was judged appropriate, it might be indicated that the proposed legislation would take effect from the date of the announcement. In practice, a number of such announcements were made with the 2004 PBR.

86. In evidence to us, Mr Whiting of PricewaterhouseCoopers indicated that the new tax avoidance disclosure regime appeared to be working well, noting that “a huge amount of effort has gone into [the regime] and I think the number of avoidance-blocking measures which have come in is testament to the fact that the system is working. The Inland Revenue is, by all accounts, perfectly happy with it”,222 although he added that “There are rough edges within all of it and there are problems still and I hope the dialogue will continue as to making it work…”223 Another tax expert, Anne Redston of Ernst & Young, told us that “Anecdotal evidence suggests that [the provisions] are having a widespread preventative effect—there is little point in designing and implementing a complex arrangement if it will be stopped soon after disclosure.”224

87. Treasury officials confirmed to us that “The disclosure rules have only been running for a few months, but they are working well”,225 and the Chancellor indicated that “the new

221 Sixth Report of Session 2003–04, The 2004 Budget, HC 479, para 42
222 Q 72
223 Q 83
224 Ev 77
225 Q 165
rules... are working as intended.” 226 As for the possible wider disincentive effect of the scheme on the tax avoidance industry, we note that Mr Whiting felt that:

“To that extent it has slowed the whole industry up; it has created a little more uncertainty. Has it stopped people trying to think of tax efficient products? No, I do not think it has, you would not expect it to have done. Has it caused a slow down in the marketing of them, a slow down in the attempts to devise new products, yes it has because obviously things have closed down and you have to bear in mind that the tax authorities are going to know somewhat sooner.”

Asked whether creativity was still “alive and well” in the industry, he indicated that “the creativity is still alive but whether it is as well as it was, I do not think it is.” 227

88. We note and welcome the evidence that the new tax avoidance disclosure regime put in place at the time of the 2004 Budget is working well and is having an effect both in terms of allowing the revenue departments to close off avoidance schemes earlier than was the case previously and in having a measure of disincentive effect on the tax avoidance industry. Without wishing to challenge the legitimate right of individuals and businesses to manage their tax affairs in the most effective way for their purposes, we regard it as an equally legitimate objective for the government to seek to protect the tax revenue against inappropriate avoidance schemes.

89. One of the measures announced with the PBR appears to some commentators to go further than this. The Paymaster General announced:

“This Government is determined to ensure that all employers and employees pay the proper amount of tax and NICs on the rewards of employment, however these rewards are delivered. Despite the efforts of successive Governments, we continue to be presented with ever more complex and contrived attempts to avoid paying tax and NICs on rewards from employment, particularly in relation to bonuses in the City…

The Inland Revenue will be challenging such arrangements in the courts where it is appropriate to do so. We cannot however await the outcome in the courts before taking action. We intend that from today both tax and NICs legislation should achieve our objective…

To that end we will be including legislation in Finance Bill 2005, effective from today, to close down the avoidance schemes we know about…

However, experience has taught us that we are not always able to anticipate the ingenuity and inventiveness of the avoidance industry. Nor should we have to. Our objective is clear and the time has come to close this activity down permanently.

I am therefore giving notice of our intention to deal with any arrangements that emerge in future designed to frustrate our intention that employers and employees should pay the proper amount of tax and NICs on the rewards of employment.

226 Q 322
227 Q 107
Where we become aware of arrangements which attempt to frustrate this intention we will introduce legislation to close them down, where necessary from today.”

90. The indication in this statement that the Government will continue to announce proposed legislation, effective from the day of the announcement, to stop schemes which come to their attention is nothing new. What is new is the declaration that future schemes, not yet devised or which have not yet come to the Inland Revenue’s attention, may be stopped as from 2 December 2004. This amounts to a general anti-avoidance rule in this area of taxation of income and rewards, although no new powers are being taken by government.

91. Tax experts expressed some concern about this and felt there was an issue of retrospectivity in the rule. Mr Whiting told us that “...the system of tax we have in this country is that you are taxed on the basis of what the law says. If, therefore, there is a possibility of retrospectively altering your tax bill, then it does have very interesting human rights implications and it has been mooted that this idea of retrospectivity could now be vulnerable to human rights challenges if we go that far.” Ms Redston noted that “Enormous discretion is being proposed under which the executive… can decide whether or not the ‘proper’ amount of tax has been paid, and if it considers this is not the case, to exact it retrospectively.”

92. The Chancellor defended the announcement in his oral evidence, stating that if it is accepted that there is a loophole which needs to be closed “whether it is of a specific nature or in a number of different areas... then it should be closed immediately... Once you accept that a scheme is wrong, that as a form of avoidance it is unacceptable, then I think it is reasonable to close it on the day you have announced you want it to stop. We are confident, I may say, that this does not conflict with the ECHR.” The Government’s view, therefore, it appears that the problem which has been identified is one which is sufficiently clear and specific now to justify a blanket announcement of this kind, even if the details of the ways which may be devised to avoid tax are not yet known.

93. The Paymaster General’s announcement that future legislation to outlaw income/NIC avoidance schemes not yet identified will be backdated to 2 December 2004 raises significant issues. We support the Government’s determination to tackle unreasonable tax avoidance schemes, which can have the effect of penalising the general public, but we recognise that some experts have indicated that their approach could lead to challenge in the courts. This can only finally be tested as and when the Government introduces any legislation on the basis of the announcement. It would be helpful if, at this stage, and without jeopardising their position, the Inland Revenue were to publish a paper setting out their thinking on the principles which will guide future decisions as to whether a scheme is reckoned to be within or outside the terms of the announcement.

---

228 Written Ministerial Statement, Paymaster General, HC Debates, 2 December 2004, col 44WS
229 See evidence of Mr Ramsden (Director, Tax and Budget, HM Treasury) Q 165
230 Q 74
231 Ev 77; see also statements by Ernst & Young (Tax Journal, December 2004) and by KPMG (5 January 2005)
232 Q 325
94. A range of other tax announcements was made at the time of the PBR. We received a limited amount of evidence on these, and draw attention to just one further issue, in connection with the consultation process. The Code for Fiscal Stability states that “The PBR shall be consultative in nature, and shall include, so far as reasonably practicable, proposals for any significant changes in fiscal policy under consideration for introduction in the Budget.” For those announcements which are not tax avoidance measures designed to take immediate effect, it is usually both fair and mutually beneficial to both the revenue authorities and practitioners that there is the opportunity for proper consultation. It was drawn to our attention that a significant announcement on taxation of life assurance companies contained both routine tax avoidance elements and other elements—in particular provisions relating to ‘free assets’ which could have significant consequences for some life companies—but that all the elements were due to be brought in by statutory instrument after a consultation period of just three working days. In the event, it was announced a week later (9 December) that the non-tax avoidance elements would be proceeded with instead via a lengthier consultation period and by primary legislation in the 2005 Finance Bill. Mr Whiting indicated to us that this change was “very welcome” noting the importance of the consultation now being approached with an “open mind” and querying whether it would be appropriate for the changes to have effect from 1 January 2005 given that the concession of a lengthier consultation process implied that there might be more uncertainty about the proposals than originally envisaged. We welcome the Government’s decision to reconsider its plans for the introduction of some of the proposed changes for taxation of life assurance companies, and look forward to a full consultation process in line with the principles set out in the Code for Fiscal Stability.

---

233 Qq 110–113, Qq 237–241, Ev 88–91
235 With some question as to whether this would be an appropriate use of the particular statutory power involved
236 Ev 90
Conclusions and recommendations

The Pre-Budget Report

1. We reiterate our view that this is an unsatisfactorily short period of notice for what is meant to be an important event in the economic calendar. (Paragraph 2)

UK presidencies of the G7/8 and EU

2. The Committee believes that the UK’s joint leadership of the G7/8 and the EU in 2005 puts the Government—particularly as the international community comes together to address the consequences of the tragic earthquake and tsunami in the Indian Ocean—in a strong position to play a positive role in advancing discussions with our international partners on the reform of key global economic institutions and ensuring fairer treatment of developing countries by the world’s major economies. We welcome the Chancellor’s commitment to pursue reform of the major international economic institutions and hope that solid evidence of progress here will emerge over the coming year. (Paragraph 5)

The economy: the recent past

3. The Committee welcomes the fact that 2004 has proved to be another year of solid economic activity in the UK, marking a long period of sustained quarter-on-quarter growth. The combination of 3%-plus growth, rising employment, modest inflation and evidence of some re-balancing of the economy away from household consumption towards investment is particularly welcome. (Paragraph 9)

The economy: the outlook

4. While the Treasury’s economic growth forecast for 2005 is more optimistic than the external consensus, the majority of the experts we asked suggested that the gap between the Treasury’s growth forecasts and those of other major forecasters lay within the bounds of forecasting error. In any case, the Treasury’s recent forecasting record in the area of economic growth has been good. (Paragraph 10)

5. The evidence the Committee received in the course of this inquiry indicates that there is little to suggest that the UK current account deficit is moving into unsustainable territory in the near term, although the volatile nature of currency markets does create risks. (Paragraph 11)

6. Recent signs that the housing market may be cooling and that the household sector is beginning to rebuild its saving ratio are welcome. In the longer term, the evidence we have received on the Pre-Budget Report highlights the importance of work being done in restoring consumer confidence in long-term savings and reforming the UK’s pension system. (Paragraph 15)

7. The Committee notes the evidence we have received suggesting that migration into the UK has played a useful role in relieving skill shortages in the labour market and
boosting non-inflationary growth. We welcome efforts to improve the functioning of the UK labour market by raising participation rates and agree that raising the UK’s skill base is vital to meeting the competitive challenges posed by the global economy. The long term nature of labour market reform nevertheless means that in the near term the evidence many experts detect of a tightening labour market needs to be monitored extremely carefully. The amount of slack left in the UK labour market is likely to be a key determinant of how long the UK economy can continue to grow above trend without generating inflationary pressure and is thus an essential element in judging the timing of the cycle and whether or not the Government has met its fiscal rules. (Paragraph 21)

The fiscal balance and the fiscal rules

8. The fiscal rules are an important part of the framework for macroeconomic management and in the Treasury’s view will be met over the current cycle. However, the margin for meeting the golden rule in the current cycle on the Treasury’s forecasts has nevertheless fallen further since the Budget and now stands at £8bn, or 0.1% of GDP. On current Treasury forecasts, the golden rule will be met—by a narrow margin. Many independent forecasters believe that this is too narrow a margin to be confident that the golden rule will be met. The Chancellor has assured us that he could foresee no circumstances in which the Government would not meet its fiscal rules. We note, however, the narrow margin by which the golden rule would be met on current Treasury forecasts, particularly given recent data. (Paragraph 27)

9. The Committee believes it is important that the operation of the fiscal rules should be as transparent as possible. Given the significance for the fiscal rules of dating the beginning and the end of the economic cycle we believe the Treasury should clearly inform Parliament in a timely fashion of its preliminary analysis that the cycle has ended. To delay making an announcement, potentially for several months, to the next Budget or Pre-Budget Report, would not be in the interests of informed public debate. (Paragraph 30)

10. The Committee believes that clear, well designed and well understood fiscal rules have an important role to play in lending credibility to economic policy. The current rules have generally worked well since their introduction but are likely to be capable of further improvement and refinement in the light of the practical experience accumulated over recent years. With the start of both a new cycle and a new Parliament likely within the next year or so we believe that it is now appropriate to review the current fiscal rules with a view to initiating any changes that are found to be desirable early in the next cycle. It should be made clear from the start that such a review will not consider any proposals that lessen the UK’s commitment to sound public finances or that unduly limit the ability of fiscal policy to support monetary policy in delivering economic stability alongside low inflation. (Paragraph 34)

Revenues: overall tax receipts and forecasting

11. Despite strong economic growth and record employment, tax receipts are for the fourth consecutive year below the Treasury’s forecast. The growth in receipts has
been strong by historic standards but has not matched the Treasury's optimism at the time of the Budget. (Paragraph 35)

12. We note that the Treasury continues to project a rise in the ratio of tax receipts to GDP over the forecast horizon, from 36.2% in 2004–05 to 38.4% in 2009–10. We also note that the Treasury is projecting the fastest growth in receipts over the next two years since 1997. This forecast implies an acceleration in receipts growth in the final four months of this year and even stronger growth in receipts in 2005–06. While there are grounds for optimism, there are significant risks to this forecast and the Treasury needs to monitor developments closely. (Paragraph 37)

13. We would welcome a clearer explanation of how the Treasury forecasts the cyclical components of tax receipts and how this has influenced their current projections. This should include how the Treasury estimates the long-term averages of components such as corporation tax and financial company profits, what factors it bases these estimates on and how quickly it expects them to return to their long-run averages. (Paragraph 38)

14. We recognise the Treasury's statement that it bases its forecasts on cautious assumptions. However, following a prudent start in the run up to the year 2000, we note that the Treasury has now over-estimated the growth in tax receipts in four consecutive years. Many other countries and outside forecasters have also over-estimated the growth of tax receipts during the world economic downturn. However, given that the economic recovery is now under way it is important that official forecasts for tax receipts are accurately constructed and avoid an over-optimistic trend. (Paragraph 41)

Corporation tax

15. We ask the Treasury to review the assumption that financial company profits grow as a share of GDP, given the contrast with the assumption used for the FTSE All-Share index which is that it grows only in line with GDP. We also ask the Treasury to publish data on the backlog of unused losses and allowances in the financial sector which the Treasury notes have “temporarily depressed taxable profits”. (Paragraph 44)

16. There are widespread doubts amongst experts and outside commentators about the Treasury's corporation tax forecasts. While it is true that corporation tax receipts have grown by over 30% in some previous years, this has typically taken place when the economy was recovering strongly, or where there was a significant stock market boom. To reinforce the credibility of the corporation tax forecasts, we recommend that the Treasury publishes a breakdown of its corporation tax forecast, differentiating between the various sub-sectors involved. In the absence of further information, the evidence we have received suggests that the balance of risks to the Treasury's corporation tax forecast is to the downside. (Paragraph 48)
Expenditure: current expenditure, end-year flexibility, investment spending, local services

17. The Treasury’s forecast for central government current expenditure in 2004–05 requires substantial spending restraint by government departments over the last four months of the financial year. This illustrates the importance of the recent reforms aimed at ensuring a smoother profile of spending over the course of the year. This is an area we will expect to examine further at the time of the 2005 Budget. (Paragraph 51)

18. We welcome the continued use of the End-year flexibility arrangements and the move away from potentially wasteful year-end surges in spending. We note, however, that the build up of EYF entitlement by departments has reached the point where it poses at least a theoretical risk, should there be major calls on their entitlements across departments, to the achievement of the Government’s fiscal targets as the end of the cycle draws near and the available margin is small. The Treasury should make clear what arrangements are in place to ensure that this will not happen. It would also assist transparency and debate if the figures for outstanding entitlement for each department (following drawdowns in the Winter and Spring supplementary estimates) were updated and published at the time of the Pre-Budget Report and the Budget. (Paragraph 54)

19. This Committee attaches the highest possible importance to ensuring that the Government’s plans for historically large increases in public sector investment are delivered efficiently. However, despite recent improvements it is apparent that some departments, local authorities and public corporations are still failing to deliver capital spending at the planned level. We first identified this problem during our 2003 Pre-Budget Report inquiry and the Committee is disappointed that it has not yet been resolved. It seems inconsistent to say that reforms will enable departments to manage current spending more smoothly throughout the year but yet rely on a very large surge in public sector net investment in the final quarter to meet the forecast. We recommend that the Treasury take further action to improve the management and delivery of public sector investment and to monitor its effectiveness closely. (Paragraph 58)

20. We ask the Treasury to provide us with a comprehensive note outlining the sources, with a breakdown, of the £512m re-allocated from central programmes to local authorities. We also ask for more detail of the areas where reduced ring-fencing and increased charges will reduce the pressures on council tax by £½bn. (Paragraph 60)

21. We welcome the announcement that in 2005 there will be an additional £50 payment to pensioners over 70 to help with council tax and other living expenses, but the level of this payment should be reviewed at the time of the Budget. (Paragraph 61)

Reporting issues; the National Audit Office

22. We commend the Treasury on the publication of the End of year fiscal report. It could usefully be expanded to provide updates on certain other data which would help debate and scrutiny. (Paragraph 63)
23. We recommend that the Treasury provide more detail on the process by which key assumptions are referred to the National Audit Office, including how they decide which assumptions to refer, and how much notice they provide to the NAO of the assumptions that are due for audit. We note the comment of the IMF that it would be worth considering whether such outside scrutiny of other key variables would enhance transparency and credibility. This is an issue to which the Committee will be returning. (Paragraph 66)

Departmental efficiency savings (‘Gershon’ savings)

24. We are surprised that advice from the NAO and the Audit Commission on each [department’s] Efficiency Technical Note does not appear to have been provided directly to the department concerned. It is not clear what the role of the central scrutiny panel was in the process, but we consider that its existence sits uneasily with the evidence we received that it is departments that are accountable for this process and that individual efficiency proposals are not a matter for the Treasury to take a view on. (Paragraph 73)

25. It is not possible under the procedure adopted to determine what advice was provided by the National Audit Office and the Audit Commission nor the extent to which this was acted upon by departments. We welcome the Chancellor’s assurance that this is an evolving process and that the National Audit Office and the Audit Commission will be asked to provide further advice. We recommend that this advice and each department’s response be published. (Paragraph 74)

26. Given the size and importance of the overall efficiency programme, we believe consolidated progress reports [across government] are required. We therefore welcome the Chancellor’s undertaking to provide further details in the Budget and we recommend that this become a regular feature of forthcoming budget and pre-budget reports. (Paragraph 75)

27. The Committee welcomes the Government’s clear statement that it remains committed to ISAs, a commitment which is in accord with our previous recommendations in this area. But given the lengthy public debate about the future of ISAs we do not see that any useful purpose will be served by more consultations on extending the limits on ISA savings. A clear statement of intent in the Pre-Budget Report to keep the current higher ISA limits would have been preferable. (Paragraph 76)

Savings and welfare: ISAs, Saving Gateway, financial inclusion, childcare

28. The Committee is encouraged to hear that the initial evidence suggests that the Saving Gateway has been successful in encouraging new, sustainable saving among the less affluent. Given the importance of encouraging saving among the less affluent we look forward to the Government moving as quickly as possible, subject to evaluation of the initiatives, to national availability of the Saving Gateway scheme. (Paragraph 77)
29. The Committee welcomes the funding assistance the Financial Inclusion Fund will give to the provision of basic financial advice to consumers and looks forward to rapid progress on tackling financial exclusion by the Financial Inclusion Taskforce. But the problems created by financial exclusion and poor access to basic advice when consumers get into debt or other financial difficulties are entrenched. We reiterate our earlier recommendation that the possibility of securing additional funding from the financial services industry to support the activities of non-profit organisations in this area should continue to be pursued. (Paragraph 79)

30. We welcome the indication by the Chancellor that he is prepared to look further at the proposal to allow lenders to apply for repayment to be made by deduction from benefit payments in certain circumstances. (Paragraph 80)

31. The Committee welcomes the announced doubling of the threshold above which savings will reduce working-age income related welfare benefits. It would be helpful to have an indication of how substantial the obstacles are (financial or otherwise) standing in the way of both this and other measures designed to help the less affluent in society being introduced earlier than the proposed date of April 2006. (Paragraph 81)

32. The Government’s objective of guaranteeing affordable, high quality childcare for all those who need it is welcome and it is important that the expansion of childcare provision is adequately funded if the parents are to be assured of the quality of the care their children will receive. (Paragraph 83)

Tax avoidance

33. We note and welcome the evidence that the new tax avoidance disclosure regime put in place at the time of the 2004 Budget is working well and is having an effect both in terms of allowing the revenue departments to close off avoidance schemes earlier than was the case previously and in having a measure of disincentive effect on the tax avoidance industry. Without wishing to challenge the legitimate right of individuals and businesses to manage their tax affairs in the most effective way for their purposes, we regard it as an equally legitimate objective for the government to seek to protect the tax revenue against inappropriate avoidance schemes. (Paragraph 88)

34. The Paymaster General’s announcement that future legislation to outlaw income/NIC avoidance schemes not yet identified will be backdated to 2 December 2004 raises significant issues. We support the Government’s determination to tackle unreasonable tax avoidance schemes, which can have the effect of penalising the general public, but we recognise that some experts have indicated that their approach could lead to challenge in the courts. This can only finally be tested as and when the Government introduces any legislation on the basis of the announcement. It would be helpful if, at this stage, and without jeopardising their position, the Inland Revenue were to publish a paper setting out their thinking on the principles which will guide future decisions as to whether a scheme is reckoned to be within or outside the terms of the announcement. (Paragraph 93)
35. We welcome the Government’s decision to reconsider its plans for the introduction of some of the proposed changes for taxation of life assurance companies, and look forward to a full consultation process in line with the principles set out in the Code for Fiscal Stability. (Paragraph 94)
Formal Minutes

Monday 17 January 2005

Members present:
Mr John McFall, in the Chair
Mr Nigel Beard
Mr Jim Cousins
Angela Eagle
Mr Michael Fallon
Norman Lamb
John Mann
Mr George Mudie
Mr James Plaskitt

The Committee deliberated.

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

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

Paragraph 1 read and agreed to.
Paragraph 2 read, amended and agreed to.
Paragraphs 3 to 8 read and agreed to.
Paragraphs 9 and 10 read, amended and agreed to.
Paragraphs 11 to 14 read and agreed to.
Paragraph 15 read, amended and agreed to.
Paragraphs 16 to 23 read and agreed to.
Paragraph 24 read, amended and agreed to.
Paragraph 25 read and agreed to.
Paragraphs 26 and 27 read, amended and agreed to.
Paragraphs 28 and 29 read and agreed to.
Paragraph 30 read, amended and agreed to.
Paragraphs 31 to 33 read and agreed to.
Paragraph 34 read, amended and agreed to.
Paragraphs 35 and 36 read and agreed to.
Paragraph 37 read, amended and agreed to.
Paragraphs 38 to 40 read and agreed to.
Paragraph 41 read, amended and agreed to.
Paragraph 42 read and agreed to.
Paragraph 43 read, amended, divided and agreed to (now paragraphs 43 and 44).
Paragraph 44 read, amended and agreed to (now paragraph 45).
Paragraphs 45 and 46 read and agreed to (now paragraphs 46 and 47).
Paragraph 47 read, amended and agreed to (now paragraph 48).
Paragraphs 48 and 49 read and agreed to (now paragraphs 49 and 50).
Paragraph 50 read, amended and agreed to (now paragraph 51).
Paragraphs 51 to 56 read and agreed to (now paragraphs 52 to 57).
Paragraph 57 read, amended and agreed to (now paragraph 58).
Paragraphs 58 to 61 read and agreed to (now paragraphs 59 to 62).
Paragraph 62 read, amended and agreed to (now paragraph 63).
Paragraphs 63 and 64 read and agreed to (now paragraphs 64 and 65).
Paragraph 65 read, amended and agreed to (now paragraph 66).
Paragraphs 66 to 69 read and agreed to (now paragraphs 67 to 70).
Paragraph 70 read, amended and agreed to (now paragraph 71).
Paragraphs 71 to 74 read and agreed to (now paragraphs 72 to 75).
Paragraph 75 read, amended and agreed to (now paragraph 76).
Paragraphs 76 and 77 read and agreed to (now paragraphs 77 and 78).
Paragraph 78 and 79 read, amended and agreed to (now paragraphs 79 and 80).
Paragraph 80 read and agreed to (now paragraph 81).
Paragraph 81 read, amended and agreed to (now paragraph 82).
Paragraphs 82 to 91 read and agreed to (now paragraphs 83 to 92).
Paragraph 92 read, amended and agreed to (now paragraph 93).
Paragraph 93 read and agreed to (now paragraph 94).
Summary read, amended and agreed to.

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

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

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

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

[Adjourned till Tuesday 25 January at 9.15 am]
Witnesses

Thursday 9 December 2004

Mr Robert Chote, Institute for Fiscal Studies, Professor Peter Spencer, York University, Mr David Walton, Goldman Sachs, and Mr Martin Weale, National Institute of Economic and Social Research

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

Tuesday 14 December 2004

Mr Jon Cunliffe, Managing Director, Macroeconomic Policy and International Finance, Mr Jonathan Stephens, Managing Director, Public Services, Mr Nick Holgate, Director of Welfare Reform, Mr Dave Ramsden, Director, Tax and Budget, and Mr Chris Martin, Head of the Productivity Team, HM Treasury

Thursday 16 December 2004

Rt Hon Gordon Brown, a Member of the House, Chancellor of the Exchequer, Mr Jon Cunliffe, Managing Director, Macroeconomic Policy & International Finance, Mr Nicholas Macpherson, Managing Director, Budget & Public Finances, Mr Jonathan Stephens, Managing Director, Public Services, Mr Michael Ellam, Director, Policy & Planning, and Mr Dave Ramsden, Director, Tax & Budget, HM Treasury

List of written evidence

British Bankers’ Association
British Retail Association
Confederation of British Industry
Professor David Heald, Sheffield University Management School
HM Treasury
Ms Anne Redston, Ernst & Young
Professor Peter Spencer, University of York
Mr David Walton, Chief European Economist, Goldman Sachs
Mr Martin Weale, National Institute of Economic Affairs
Mr John Whiting, PricewaterhouseCoopers

Ev 60
Ev 61
Ev 63
Ev 71
Ev 74; 91; 93
Ev 77
Ev 79
Ev 83
Ev 86
Ev 88; 90; 91
Oral evidence

Taken before the Treasury Committee

on Thursday 9 December 2004

Members present:

Mr John McFall, in the Chair
Mr Michael Fallon
Mr Jim Cousins
John Mann
Mr James Plaskitt
Angela Eagle
Mr Robert Walter

Witnesses: Mr Robert Chote, Institute for Fiscal Studies, Professor Peter Spencer, York University, Mr David Walton, Goldman Sachs, and Mr Martin Weale, National Institute of Economic & Social Research, examined.

Q1 Chairman: Good morning. May I start this session by welcoming you and asking you to introduce yourselves for the shorthand writer, starting with Robert?
Mr Chote: I am Robert Chote, Director of the Institute for Fiscal Studies.
Professor Spencer: Peter Spencer from the University of York.
Mr Walton: David Walton of Goldman Sachs.
Mr Weale: Martin Weale from the National Institute of Economic & Social Research.

Q2 Chairman: May I look at the UK economic outlook first in an international context. How does the UK’s likely broad economic performance in terms of growth, inflation and unemployment over the next couple of years look relative to the rest of the G7?
Mr Walton: I think it looks reasonably favourable. The UK economy seems to be reasonably close to trend. There are no great imbalances in the economy in contrast to economies like the United States. There seems to be a reasonable amount of momentum in domestic demand in contrast to the euro-zone area and there is a lot of flexibility as far as monetary policy is concerned with interest rates of 4.75%. The Monetary Policy Committee is able to cut interest rates aggressively or raise interest rates aggressively as needs be depending on just how the economic environment unfolds and that is not a luxury available to the US Federal Reserve or to the European Central Bank. So I would say that the prospects for continued and steady growth in the UK are actually pretty good relative to most other countries.

Q3 Chairman: Even on relatively cautious UK growth forecasts, such as those from the OECD, the UK looks set to remain in the top half of the G7 growth table over the next couple of years. How unusual is that historically speaking?
Mr Weale: Obviously it depends what period you look at. From about 1950 until about 1980 the United Kingdom was one of the poorest performing economies. In the 1980s we stopped growing more slowly than our major particularly European competitors and since the early Nineties we have tended to grow faster than our major European competitors. At the same time, of course, Japan was the star economy really from soon after the Second World War until about 1990 and now I think many of us look at Japan and think we are glad we do not have its economic problems.

Q4 Chairman: Robert, does the UK’s fiscal position look anomalous by the standards of other G7 countries?
Mr Chote: No. In terms of the debt to GDP position, the UK is relatively in the middle of the league table as far as the older industrial countries are concerned. I think the contrast, if you wanted to say that we are very much out-of-sync, would be to look at countries like Australia and New Zealand, for example, where the debt to GDP position is much smaller, but by the standards of the G7 as a whole it would be hard to say that the UK is an outlier, although we tend to look less favourable compared to Anglo-Saxon economies than to the Continental European ones.

Q5 Chairman: What about the debate on other G7 countries, does that mirror the debate in this country?
Mr Chote: Over the fiscal position?
Q6 Chairman: Yes.
Mr Chote: Martin may have a clearer idea on the comparison. I guess the US would be a fairly obvious recent comparator where you have concern about the size of the deficit there and the turnaround that one has seen following a period of consolidation under the Clinton administration, but now things have gone very sharply in the other direction, so that would be a markedly larger change than the UK.

Q7 Chairman: The need for further fiscal consolidation, Martin, is that debate relevant elsewhere in the G7?
Mr Weale: I think it is. The sort of question one asks looking at the countries that have broken the Stability and Growth Pact is whether their fiscal problems are cyclical, as they seem to hope, or structural. If they are cyclical then it is sensible to
wait for an upturn to solve those fiscal problems. If they are structural, as I must say I think they are and I think Britain’s deficit is, then the sooner you do something about it the better.

Q8 Chairman: Peter, the Treasury’s growth forecasts for 2005 are higher than most independent forecasters and so were their growth forecasts this time last year for 2004, but they turned out to be correct. You are now quoted as saying that if you believe the Treasury’s assessment of the outlook “you will believe anything”. I think that is what was on the front page of the Financial Times recently when we woke up. Are the Treasury’s growth forecasts for 2005 any less credible than the original forecasts for 2004 that ultimately turned out to be correct?

Professor Spencer: Obviously there is a margin of error around any forecast. Last year the Treasury’s forecast came in bang on the nose of 3.25% growth. This time the odds are against the Treasury’s forecast coming in correctly for a variety of simple arithmetic reasons. Last year growth accelerated through the previous year, 2003, and that made it relatively easy to get the growth in 2004. This year the growth has decelerated through the year and we are looking at very weak figures already for the third quarter and possibly for the fourth quarter as well. Arithmetically it is very difficult to get the year-on-year averages growing at 3.25%.

Q9 Chairman: So the Treasury is living in “fiction land” according to you?

Professor Spencer: No, I am not saying that.

Q10 Chairman: To say if you believe this you will believe anything sounds very robust.

Professor Spencer: I stand by those words. That was an instant reaction on the afternoon in question.

Q11 Chairman: Is there a difference between instant reactions and measured reactions?

Professor Spencer: Yes. As you can see from my note, when you delve into the Treasury forecast there are a lot of things which do not really make much sense to an economist. For example, the Treasury are taking a lot of tax revenue apparently from the North Sea, £1.7 billion, but all of the models, including their own, tell us that for every pound of tax raised in the North Sea when the price of oil rises there will be something like a pound lost in the rest of the economy, most obviously, as Digby Jones keeps on reminding us, through the effect of high energy prices on the non-oil company sector. When you then go and look at all the consequentials that you would normally expect from an oil price rise, including the deleterious effects on overseas economies, it is very difficult to find those in the Treasury forecast. They are simply not there. You can go through a variety of influences like that, including the dramatic slowdown in government current spending in the last five months of the year which is highlighted when it comes to the fiscal arithmetic. When you look at the consequentials for the economy you find that, miraculously, public sector managers are able to increase the investment at a rate that they really have found very difficult to achieve in the past. That actually means that the public sector gives an even bigger boost to demand next year, 1.25% on GDP rather than this year’s 1%. Miraculously, despite the problems with the dollar and the fact that it seems we have got no benefit from higher world trade this year, world trade next year, which is slower, produces a 7% rise in exports.

Q12 Chairman: We will have to call in the Pope because there is nothing but miracles needed here.

Professor Spencer: I am not saying it is not going to happen; I am saying that this is not a coherent forecast.

Q13 Chairman: Our expert witness, Professor Heald, said to us, “The Treasury’s recent forecasting track record means that it would be unwise to bet against it.” Do you think that was an instant response from Professor Heald or a leisurely, more measured response?

Professor Spencer: No, I do not believe it was an instant response. Unfortunately some of us are in the business of giving a reaction on the day and that was my reaction and it was a considered one.

Mr Weale: Our forecast for next year is for growth of 2.75% and we give estimates of the margin of uncertainty round that. I put the chance of growth being as the Treasury forecast or better as probably being about one in three. If you are forecasting exactly their growth rate then the chance of something better would be one in two. So a sensible assessment of the Treasury forecast is that it falls well within the margins of uncertainty that other, I hope, reputable forecasters have round their forecasts. In that sense I do not think it is sensible at this stage in the year to get terribly excited about differences of half a point.

Mr Walton: I wanted to say something about the framework in which the forecasts come together. The Treasury essentially takes a view of what the economy’s ability to supply output is and it also takes a view of where the economy is at the moment relative to potential, and on those two things it thinks that potential growth is around 2.75% a year and growth on average over the past decade has been around that rate, if not fractionally faster, and the Treasury also thinks that the output gap is about 1% below potential. If you buy into those, and I certainly buy into the first very fully, the second I would question a little bit more, then the Treasury view would be that unless monetary policy is set then in order to deliver these kinds of growth projections that they have the concern would be that inflation would tend to undershoot persistently the 2% target. To put it another way, if the Treasury were on the Monetary Policy Committee it would probably be a dove at the present time thinking that you could run a more expansionary policy in order to achieve this faster growth and in order to take up the slack that it believes exists in the economy. It is a judgment as to whether you think there is slack and what you think the potential growth rate is.
Q14 Chairman: Robert, could you answer that point and include the issue of the Treasury’s comment because that argues that both HM Treasury and independent forecasts have tended to under-predict GDP growth more often than they have over-predicted it in recent years. Do you agree there has been a general tendency to underestimate growth? 

Mr Chote: That is not really our territory as we are not macro forecasters. I would have thought that would have been the case, although colleagues will correct me. As to David’s point about the crucial question being whether you believe there is this still remaining amount of spare capacity which then obviously gives you the scope to have relatively strong growth next year without there being an inflationary problem, the Treasury clearly thinks that is the case. One question is that if the Bank of England does not believe that there is that same spare capacity then it is not going to set interest rates in such a way that would allow the economy to grow that quickly as its ideal outcome. You do have this slight problem in that that may be what the Treasury is predicting, but if the Bank does not believe it then they are unlikely to ratify that with interest rate policy. As Martin said, the difference of half a% is well within the bounds of forecasting error and the fiscal implications of whether growth turns out to be half a% higher next year or lower is not enormous.

Q15 Mr Walter: We have had a pretty dull period in export growth: in 2003 there was no export growth, it is forecast for this year that the outturn will be about 2.25% according to the Treasury, but then for the next 3 years, 2005–07, they are all over 6%, it is 6.5 to 7% in 2005 and so on. The Treasury are forecasting this sort of fairly strong growth fuelled by strong willed trade growth and also sterling’s decline. You have suggested this is implausible. I wonder if you would like to expand on that.

Professor Spencer: I believe it is hard to see that kind of growth given what we have seen this year. This year we have seen world trade growing at around about 8% and normally we would expect UK exports to rise by a very similar percentage amount. In other words, our share of world markets tends to be fairly stable. For example, if you go back to the Millennium year, 2000, you had a huge 13% growth in world trade and UK exports rose by 11 or 12%. That is the normal kind of relationship that you would expect even if the exchange rate is relatively high, as it was during the Millennium year. It is quite surprising that this year we have seen such large growth in our world market and our share has been cut back to produce the 2%, 2.25%, 2.5% rise in exports. Against that kind of background, which I think is explained by our producers deciding that they cannot really manage to supply those markets competitively and therefore making various adjustments in the UK and elsewhere, off-shoring, re-engineering, these sorts of things, I think that makes it clear that the weaker growth that we see in our world markets next year, down to 7%, will not generate anything like a 7% rise in exports. For that to happen we would have to hold on to our market share and in the current environment, particularly given what has happened this year, I think that is very unlikely.

Q16 Mr Walter: How much of a factor is the relative strength of sterling against the dollar and weakness against the euro?

Professor Spencer: I think that may be a factor going forward, although the high exchange rate was not a big factor in the Millennium year when we held on to our share of export markets. I think what may be more important is the composition of our export markets. This year we have seen very weak growth in Europe and that depends on exactly how you define “in Europe”. If you look at the European Union, it takes 58% of our exports and I think going into next year what would worry me would be that this combination of a high oil price, a high euro and very weak domestic demand will mean that we continue to see very slow growth in our major market and consequently very slow growth in our exports.

Q17 Mr Walter: I wonder if I could just look at the UK’s current account position. Alan Greenspan has warned that the US current account deficit is “increasingly untenable”. The Treasury expects the UK deficit to stabilise at around about 2.5% of GDP, which I think equates in money terms to about £40 billion, half the US figure in terms of GDP. How far away do you think the UK is from having an untenable current account position?

Professor Spencer: I think we are some way from that point at the moment. Historically we have been able to run current account deficits at 2 or 3% of GDP for several years before there was a problem. The regrettable feature is that these deficits are sustained by capital inflows, as in the US, and the problem comes when the overseas investors decide to invest somewhere else and at that point the adjustment comes and unfortunately, certainly in the UK context, these adjustments have been quite rapid and quite dramatic. When confidence turns in the foreign exchange markets the currency can fall quite rapidly.

Q18 Angela Eagle: Are you saying that the deficit that we are running at the moment, which is historically low, the lowest in the G8, is somehow a big problem?

Professor Spencer: No, I am not. I am saying that we are quite some way from an unsustainable situation.

Q19 Angela Eagle: We are further away from an unsustainable situation than anyone else in the G8, are we not, if you look at the figures?

Professor Spencer: Certainly Germany and France have smaller current account deficits than we have.

Q20 Mr Walter: David, did you want to add something?

Mr Walton: Although export performance has been disappointing, import growth has also been a lot weaker than you would typically have expected and so net trade volumes have actually contributed
slightly positively to growth in the second quarter and it appears that they contributed slightly positively to growth in the third quarter as well. You have to go back a long time before you find two quarters in which net trade volumes have contributed positively to growth. In terms of the way the dynamics have been evolving, there is certainly not really a sustainability question in the sense that things appear to have stabilised in volume terms. Since the summer the pound has depreciated on a trade weighted basis by about 3% and so that would tend to support export growth next year.

Q21 Mr Walter: Just looking a little bit at that export growth, we have talked about the euro-zone being fairly sluggish and I think 58% of our exports are going there, but obviously we have a booming Asian market. Both exports and imports from China have risen by 30% in the past year, but sterling has risen against the dollar and the Chinese currency is pegged to the dollar. Is that going to pose a threat to the Chinese trade position?

Professor Spencer: The UK’s exports to China are very low. We only export 1.2% of our exports to China and a similar percentage to India. Even if you include Japan and the East Asian tigers, you are still scratching around to get 10% of our exports going to that area. Regrettably we have missed out on a lot of that growth and I think we probably will continue to do so if those economies continue to grow strongly next year. But by the same token, if the Chinese economy slows dramatically then we will not be a big loser, certainly in terms of exports.

Mr Weale: Could I make two points? First of all, some work that we have done has suggested that the appreciation of sterling over the medium term has been greater than the official trade weighted index shows. The question is how you take account of trade of services as well as trade of goods and when you do that then sterling looks higher than the published Bank of England figures show. It does not explain what David said about the slow growth in imports, but it may be a factor behind why exports have apparently been disappointing. The second point I wanted to make is a much more general one. My view is that the question is not whether the balance of payments deficit is unsustainable but fundamentally whether the country is saving enough. You then have the question of whether those savings are invested at home or abroad. If we are doing the investment we need and we are not saving enough there will be a balance of payments deficit. If we are saving enough to pay for it there will not be a balance of payments deficit. In the United States people have started to realise that the United States has a problem with aggregate saving and I think Britain is in the same position.

Q24 Mr Plaskitt: We are seeing exactly that, are we not?

Mr Walton: Absolutely.

Q25 Mr Plaskitt: There is evidence of deceleration in house price inflation and acceleration in the savings ratio?
Mr Walton: Absolutely, which is why I think policy is on a plateau at the moment, because what is not yet evident is whether or not consumer spending growth is going to maintain this slower growth path that we have seen in recent months. If it does then rates are high enough. There is also a risk, particularly if the world economy does reasonably well next year, that people get used to interest rates at 4.75%, which historically is still very low, and that you could start to see the housing market begin to recover again next spring. I do not think that would be out of the question either. If that were to happen the MPC would probably turn hawkish again quite quickly. I suspect we are in this period where rates are somewhere closer to neutral and they may not be quite at neutral yet. The economy is a little bit uncertain as to how things are going to develop, the world is a bit uncertain and the MPC has got a lot of flexibility to move in either direction on interest rates depending on just how things turn out in the next few months.

Q26 Mr Plaskitt: Do you think, after such a long period now of low inflation, that there has been a significant change in the transmission effect and that now we might be in a situation where quite small changes in interest rates could quickly have an effect on consumer activity?

Mr Walton: I think the economy is more stable, I do not think that could be denied at all, and I think inflation expectations are very stable as well. The Bank of England, by achieving that stability in inflation expectations, has the ability to signal intentions to do things and it does not have to carry out the threat in quite the same way as used to be the case when by and large people did not believe policy makers and so policy changes had to be that much more dramatic in order to get the desired effect on expectations. I am not sure the economy itself is necessarily any more or any less interest rate sensitive than it used to be, but I think the stability in inflation expectations is such that if you get a shock you do not tend to get thrown off course quite as easily as used to be the case in the Seventies and Eighties.

Q27 Mr Plaskitt: It is clear that inflation expectations have shifted dramatically. If you look at wage settlements, for example, and how people now react to that, there has been a marked change. So why should you not also expect to see that resulting from various changes in interest rates, the same quick sensitivity? Monetary people used to say to us it took two years to get an effect visible from the movement of interest rates, but have we not seen the recent four small upward steps quite quickly producing an over-reaction in the housing market and in consumption?

Mr Walton: You have seen a slowdown, but the slowdown has not been as dramatic as the survey data have been suggesting and at the same time you have seen, arguably, a more pronounced slowdown in Continental Europe where you had the economy growing pretty strongly in the first quarter, at around 3%, and it slowed towards 1% in the third quarter. I think you have seen some marked slowdown in Britain’s main export markets at the same time which has also probably had some effect, ie there has been some synchronised global slowdown in the industrial sector during the course of this year. I do not think anyone doubts that if you raise interest rates you do not have to wait one or two years before you see the effects, you tend to see the effects coming through after three to six months or so. So that has certainly played its part. You have had this synchronised slowdown in industrial activity and in the world economy since the summer and that has also played its part. If you look at where the slowdown has been in the UK, it has really been in the industrial sector. The service sector has continued to grow pretty strongly during the course of this year.

Q28 Mr Plaskitt: How should we read the substantial under-shooting of inflation on the consumer index? It has come close to the point where the Bank would have had to lick a stamp and write a letter to the Chancellor because it was so far under target. What should we read into that?

Mr Walton: If you take the Treasury view in the Pre-Budget Report, they read that as evidence that the economy is operating below trend and therefore there is scope for growth to be stronger.

Q29 Mr Plaskitt: Is that right?

Mr Walton: I think the shortfall is slightly more fortuitous. If you look at other measures of inflation, they do not look to have undershot quite so dramatically. Unit labour costs growth is running at just over 2%, the GDP deflator is running at over 2%, and RPIX is running at just over 2%. On a broad range of inflation measures the undershoot looks to be a little less marked as on the CPI. You do tend to get a little bit of divergence in these measures from one month to the next.

Q30 Mr Plaskitt: Finally, I wanted to ask about the savings ratio which is now back up to about 6.5%. Do you think, given everything else going on in the economy, that that is about the correct level for it to sit at?

Mr Walton: If you look at the very long-term average for the savings ratio, it is more like 8% and quite probably we will get to that level again, particularly if these other bits of the economy which have been quite depressed in the past few years grow quite strongly and policy may well need to be set to get the savings ratio to rise a bit more. There is also a more fundamental question that I am sure Martin has more of a view on, which is that particularly when you looking at pensions there is a savings shortfall. I do not think people have necessarily realised that companies are making a much smaller provision for their future retirement than was the case just a few years ago and to fill that gap is almost certainly going to require people over time to devote more of their income into savings. That would tend over time to push the savings ratio up. Whether it
will happen next year or whether it is something that will happen over the next 5 or 10 years is a much more uncertain point.

Q31 Mr Plaskitt: They either have to save more or they have to save in different ways because there are lots of means of saving. Maybe it is the proportion of total saving going into pensions that needs to rise at the cost of other forms of saving rather than the overall level of saving having to go up.

Mr Walton: I think the basic problem at the moment is that that bit of income that is left and that is going into savings is not sufficient given the likely prospective returns on assets, both financial and housing for that matter. The flow of savings is not sufficient at the current time to keep people’s net wealth stable as a share of income.

Professor Spencer: I would agree with that. I think it is very telling that the number of hours worked in the economy, which has fallen back quite dramatically, they have to save in different ways because there are lots of means of saving. Maybe it is the proportion over the last couple of years, has not yet picked up. Some of the indicators coming from Incomes Data Services that are surveying the pay scene is that wagesettlements are now picking up, but whether we are collecting enough taxes to pay for the government spending and the prospective growth in government spending that is described in the Pre-Budget Report and my view is that I do not think we are. So in that sense I do not think that the rate of growth of government spending is desirable.

Q32 Mr Fallon: Martin, maybe I could probe a little further into this rather rosy Walton-esque view of the balance of the economy. Government spending was originally scheduled to contribute 0.75% in 2005 to GDP. That is now increasing to 1.25% and it now looks as if the rate of growth of spending will be higher in 2005 than it was either in 2003 or in 2004. Is that sensible at this stage of the cycle?

Mr Weale: I think the fundamental question is wages in the economy: one is the government fiscal position and the other is the low level of overall saving.

Q33 Mr Fallon: So the economy is not now better balanced as the Pre-Budget Report claims? The Chancellor’s claim is that it has already undergone a significant degree of rebalancing. Would you not accept that?

Mr Weale: It obviously depends what you mean by rebalancing. There are two related major imbalances in the economy: one is the government fiscal position and the other is the low level of overall saving.

Q34 John Mann: Gentlemen, I want to ask a couple of questions on something that does not seem to have been too prominent in what you have said and in the papers you have presented, which is that in my area, which is a former coalfield area, it is not in a large city, it is not growing as fast as the rest of the economy, the only issue that employers raise with me is the problem of the labour market and the fact that people are having great problems in finding sufficient people to work. I wonder whether you would like to comment on this. Certainly the biggest problem in my area is that the economy is rather too strong at the moment.

Mr Weale: Obviously in particular areas there may be local labour shortages. In the economy as a whole if there was a genuine excess demand for labour we would see wage pressure accelerating. There are just possibly the very beginnings of that happening, but I am comfortable with the position that overall supply and demand are roughly in balance at the moment. I do not see the output gap that the Treasury recognise as being there to be filled, but equally I do not think we are yet at a position where there is substantial excess demand.

Professor Spencer: I would agree with that. I think it is very telling that the number of hours worked in the economy, which has fallen back quite dramatically over the last couple of years, has not yet picked up. So there are quite a few indicators that you would expect to see turning before you saw serious shortages of labour working through into higher wages and salaries. Part-time working and relatively low hours worked are all things which could improve and which employers who want to increase output could adjust in order to get the extra output before they actually have to go and recruit new staff.

Q35 John Mann: In other words, the flexibility of the labour market allows the labour market to expand without necessarily working through in the official statistics?

Professor Spencer: This is an uncertain situation and it is curious that hours and part-time working have not picked up more than they have. Some of the indicators coming from Incomes Data Services and people like that who survey the pay scene is that wage settlements are now picking up, but we do not know whether or not that is in response to the tight labour market or to the relatively high retail price index inflation.

Q36 John Mann: I have not received any suggestions of any industrial relations problems from any of my local employers. Is there not a void in the economic analysis in that if people are working two or three part-time jobs that is not being sufficiently taken account of in terms of the way the economy can suck in additional labour? Mr Walton: I think in the end it is going to be wages that is the determinant of whether or not there is slack in the labour market. Hours worked have been on a declining trend in the UK since the Industrial Revolution with very few pauses in between and indeed since the introduction of the Working Time Directive in October 1998 there has been a bit more of an acceleration in the pace of decline. One area where I would question whether or not there is slack in the economy is whether there really is the ability to get people to work more hours. Certainly when they are asked in the Labour Force Survey hardly anyone says they are working part time because they cannot get a full-time job. My own view is that the labour market is pretty close to balance. There are the first signs of wage pressures beginning to creep through. January and April are the key months for pay settlements, so it is a little bit early to know for sure. If you look at non-bonus average earnings, that has been keeping up towards the 4.5% level. All of that suggests that the labour market is just beginning to tighten and it is at a point where if it were to tighten much more you could potentially generate a bit more inflationary pressure.
Q37 John Mann: My final question is about the ability of the economy to bring in migrant labour and the economic consequences of that. Is that something we can continue to do?

Professor Spencer: The new accession countries to the European Union are countries which have very high educational standards and a very highly skilled workforce. It would be very surprising if companies who were short of specialist staff, like the National Health Service, were not able to organise themselves to recruit from those areas. It is a fact that that is what they are now doing very successfully and in very large numbers.

Q38 John Mann: Are there any economic consequences of doing that in your view?

Professor Spencer: It does not really help the housing market, particularly since migrants tend to come to London in the first instance and that adds to pressure on the London housing market and social infrastructure, hospitals, schools, that sort of thing. In London and the south-east where, of course, the pressure is already at its greatest. These are problems that can be managed. They do not really offset the benefits to the economy from that highly skilled labour coming in.

Q39 John Mann: Do you agree with that?

Mr Weale: I agree that obviously if there are areas which are congested. If the south-east has more people working in it it becomes more congested whether they move from the north of England or from Poland. To attract an efficient and effective addition to the labour force is a good thing for the economy.

Mr Walton: Quite often people hold up the United States as being an economy that grows very rapidly. A large part of that is because it has a lot of immigration. If you look at EU accession, the UK was one of very few countries which allowed migration to take place from the word go. There are anecdotes. In the hotels in Berlin your laundry gets shipped 50 miles across to Poland to be done and it gets shipped back in the morning. In the UK the people are brought in from Poland in order to do the laundry. There is a different way in which the labour market works here than in Continental Europe.

Q40 Chairman: The Bank of England Inflation Report indicated that business orders were increasing around the country, that factory output prices were increasing, but that prices on the high street were coming down. What are the implications of that?

Mr Walton: I think a lot of this is China again. If you look at what has happened to the terms of trade in the UK, they have improved substantially. People often say there has been a consumer boom in the UK. Well, nominal consumer spending growth last year was only 4% which was the lowest at any time in the post-war period. Real consumer spending for some time has been growing at pretty healthy rates and a lot of this is basically imports coming in from China which each year cost less than the previous year, so people with their own fixed budgets, with their own incomes, are able to buy more and that is a positive thing for the economy. It is terrible if you happen to work in the clothing manufacturing sector, that part of the economy has been decimated in the UK, but the consequence for everyone else, which is 98.5% or 99.5% of the population, is that they are able to buy clothes a lot more cheaply than used to be the case.

Professor Spencer: It not just procurement in areas like China that has enabled our retailers to keep their costs down but very good supply chain management is another factor in that equation.

Q41 Angela Eagle: Obviously people are able to buy more goods and prices are being kept down because of international trade and the development of a sophisticated manufacturer in Asia, et cetera. The Monetary Policy Committee did note at some length how well the terms of trade in our comparative advantage as an economy had helped this process. Do you think that the Chancellor’s announcements on a knowledge economy, looking forward to specialising for future strategic placing, are in the right kind of area to maintain that comparative advantage going forwards as manufacturing in Chinese and Indian economies rises? Do you think it is strategically in the right place?

Mr Walton: I do not think anyone can argue that it is wrong. In principle, if you can have the most highly educated skilled workforce that is going to make you the most adaptable to anything that happens in the future. Clearly you have countries which have got rapidly growing populations. In the case of China a very large population is in agriculture waiting to add a lot of this is basically imports coming in from the UK, they have improved substantially. People often say there has been a consumer boom in the UK. Well, nominal consumer spending growth last year was only 4% which was the lowest at any time in the post-war period. Real consumer spending for some time has been growing at pretty healthy rates and a lot of this is basically imports coming in from China which each year cost less than the previous year, so people with their own fixed budgets, with their own incomes, are able to buy more and that is a positive thing for the economy. It is terrible if you happen to work in the clothing manufacturing sector, that part of the economy has been decimated in the UK, but the consequence for everyone else, which is 98.5% or 99.5% of the population, is that they are able to buy clothes a lot more cheaply than used to be the case.

Professor Spencer: It not just procurement in areas like China that has enabled our retailers to keep their costs down but very good supply chain management is another factor in that equation.

Q44 Mr Walter: I wonder if we could move on now to the public finances and look at borrowing, the fiscal rules and the Golden Rule. Mr Chote, your organisation said that you thought at best the Chancellor had a 62% chance of success, but given the trends of the first seven months it was probably a 34% chance of keeping borrowing within the Golden Rule limit. I wonder if perhaps you could tell me whether or not you think the fiscal rules will be met in the current cycle.

Mr Chote: In the current cycle my guess is it is touch and go and I would put the probability at somewhat lower than 50%. As you say, the Chancellor was expecting at the time of the Budget to narrowly meet the Golden Rule over the first seven months of the financial year rather than halving compared to where it was last year. The current budget position has been roughly in line with where it was last year. If that continued through the whole year then you would be probably borrowing about £12.5 billion more this year than was expected at Budget time on the Golden Rule measure and that would have wiped out the room for manoeuvre which the
Chancellor had said he had at Budget time. The Treasury has obviously said that they do not expect the deterioration to persist at anything like the rate it has done over the first 7 months of the year. They are expecting both the pace of spending to slow and the tax revenues to pick up in part because of the lagged effect of oil prices. Given that you would expect the Treasury to have better knowledge than independent forecasters about the detailed breakdown of the tax take and of the profile of departmental spending, I think you have to take those claims seriously. On the other hand, I think it is important to note that in the past three years when the Budget has been over-optimistic about the public finances so, too, has the PBR. The percentages you referred to were simply an exercise saying, “Forget what the IFS or anybody else may think, let’s just look at what the Treasury’s forecasting errors have been in the past and basically what will the situation be when we get to the Budget and there is one year still to go”? If the PBR forecast is right and the borrowing projection they have this year is correct, they will get to the Budget and with the standard forecasting errors they would have a 62% chance then. If, however, the trends we have seen since March were simply to continue, ie the PBR was wrong entirely and we simply take an extrapolation of what has happened to date, then you would be at the lower figure. It seems sensible, therefore, to say that true probability is somewhere between the two and I would put it at somewhat less than 50% at this stage. We will do a proper forecast next month.

Professor Spencer: I think it is very hard to see how the Chancellor can make the Golden Rule in this cycle starting where we are with the data for the first 7 months. The improvement in the last 5 months of the financial year and going into the next financial year would have to be very dramatic indeed for him to meet his figures. For example, to get the £12.5 billion current account deficit projected for this year we would have to see a surplus on the last 5 months of £4.7 billion when last year we had a deficit over those last five months of £5.5 billion. Now that is a turnaround of over £10 billion which means that each of those months have to come in at around about £2 billion better than last year, which I think is possible but highly unlikely. Again, as we go into next year it is not just the growth in the economy that is looking a little bit shaky, the 5.7% growth in GDP next year he may well get, but he is saying it will lead to an 8% growth in tax revenues which implies a very large rise in the share of tax in GDP, which again is hard to see. As you build one thing on top of another you are looking at everything having to go absolutely right indeed for the Chancellor to make the Golden Rule. As you go out in time from this year into next year and then ultimately into the next cycle everything has to go right for the Treasury’s forecast to be met.

Q43 Mr Walter: Do you think we have a credibility problem here? The Golden Rule is to some extent determined by the Chancellor. He determines when we start and when we finish the cycle and he determines what the sustainable investment is and so on. Do you think that perhaps it would be better if we could get to a measure that was more like the inflation targeting which we give the Bank of England and the Monetary Policy Committee, a sort of independently measured Golden Rule or whatever we want to call it?

Mr Weale: My view is that the Golden Rule should be replaced with a similar but distinct targeting scheme. There are a number of problems with the Golden Rule. One is that, as you have drawn our attention to and indeed as the Treasury mentions in box 8.3, the timing of the cycle is inherently uncertain, it can be established only with the hindsight of several years and that strikes me as an arrangement which is of almost no use for running fiscal policy in real time. Secondly, you have the issue of the uncertainty surrounding budgetary forecasts which is very real. I am always impressed when I hear the certainty that emanates from the Treasury, but I do wonder why they are so certain and it is never explained. Given that uncertainty and given the uncertainty over the cycle, my view is that a rule defined to achieve a target over the medium term would be more suitable. Obviously if it is defined in as vague a way as the medium term then it becomes even more unsatisfactory if the Treasury or the Chancellor are defining what balance over the medium term means, so it would then be desirable to have some sort of independent interpretation. Finally, I would mention that with the inflation target it is widely described as a good thing that there is a central target and a band round it. With the fiscal rule, instead of having a central target and a band round it we have an asymmetric target. Again, I have not come across an account of why symmetry is a good thing for the inflation target but is a bad thing for the fiscal target. You could call those changes revisions to the Golden Rule or replacing the Golden Rule with something that was more flexible. I think what we are seeing at the moment are the problems created by a framework which is flexible at the start of the economic cycle but becomes very rigid as you get to the end of the economic cycle. For example, comparing it with the Stability and Growth Pact, in the Stability and Growth Pact you are allowed to miss your target for 2 or 3 years before anything very much happens. With the fiscal target, if the target is missed this year or next year then the rule would just be broken. What happens after that no one quite knows except that we have moved on to a new cycle so perhaps it does not matter. Given those problems, I would welcome it if the Chancellor were to take a long hard look at the Golden Rule and think about how it could be refined into something more useable in the real world.

Mr Walton: Can I just add to that because I agree with a lot of what Martin said there and I think it is time actually to look fundamentally again at the fiscal rules. They really did serve their purpose. When Labour came into office in 1997, they inherited quite large budget deficits and it was absolutely imperative to put the public finances on to a sustainable path again. Public finances are on a completely sustainable path at the moment. I would argue that you have got one of the best fiscal
positions in the G7 and if the Golden Rule is missed, and my own estimate is that on the Treasury’s definition of the economic cycle, it will be missed by 0.02% of GDP on average over that 6-year period which is about £5 billion, which is about the money which has been committed to the Iraq war, the code for fiscal stability just says that if you miss, you have to explain. It would be quite straightforward to say, “We’ve missed because we have had to set aside this money for this unforeseen war”. If you do miss, the economic consequences of that are almost negligible, it seems to me, and, as you look forward, and perhaps I could draw an analogy from the monetary policy framework, when inflation at the moment is running at just over 1%, nobody really says to the Monetary Policy Committee, “You must cut interest rates aggressively in order to get inflation back up to 2% as soon as possible”, nor indeed do they say, “Because inflation has been running at around 1%, you must aim for inflation to be around 3% at some point in the future in order to keep the average close to 2%”. I think you could actually aim for something similar in the fiscal rules. Just because last year you had a current budget deficit of 1.9% of GDP and this year it is likely to be just fractionally over 1% of GDP, so it is moving in the right direction, if to the extent that these errors are just genuinely due to forecasting errors, and the Monetary Policy Committee makes forecasting errors as well on inflation, if they are genuinely due to forecasting errors and if these errors are symmetric in both directions, then the aim should be to aim back to a current budget balance. If you get that, then you are going to have a perfectly sustainable fiscal position over the medium term.

Q44 Mr Fallon: Robert Chote, could we just look at some of these assumptions that are audited by the National Audit Office and one that is not. Would it not strengthen the credibility of the Golden Rule if it was independently audited by the National Audit Office or some other outside body because at the moment we are in a position where the Chancellor is a bit like a football manager in that he decides when the match ends?

Mr Chote: Well, you are talking there specifically about the point about the economic cycle.

Q45 Mr Fallon: Yes, the timing of the cycle. Would it strengthen the credibility of the rule if the timing of the cycle was independently audited?

Mr Chote: Yes, I think the first point to make is that both with determining where the cycle is and determining the forecast itself, there is not a magic group or potential committee out there that is going to come up with the right answer if we assemble them in a way in which the Treasury has not managed to do, so the justification is to say that this is an independent group of people who are coming up with a view to which the Treasury commits itself rather than a group of people who are necessarily more likely to be right than the Treasury, so in that sense I think there is an argument for saying that you could have an independent scrutineer to which the Treasury makes a commitment. Whether the NAO is equipped to do that job in its current form is not that clear. I think more important though is the fact that—

Q46 Mr Fallon: But the Bank could do it, could they not?

Mr Chote: Well, it would be interesting to ask Mr King whether his enthusiasm for the output gap is sufficient that you could tie him down to reaching a commitment on the two ends at that time. I think the other important point of course is that credibility is generally improved the greater the transparency of the system is, so the more we know about how the forecasts are being generated, the more we know about some of the assumptions, for example, which are not publicly announced. The Treasury does not tell us what it is assuming about average earnings growth, for example, and nor have previous governments of course in the same position, and that is crucial to knowing what your income tax projections are going to be, so a greater transparency, where that is possible, for everybody might be just as important or more important as having some new group that is sort of burnedish and given the official title as the scrutineer, not to say that would not be an improvement on the status quo in itself.

Q47 Mr Fallon: Can we turn to revenues now. Professor Spencer, in your memorandum, you point out that the PBR projects an undershoot in revenues of about £3.9 billion. You say it is going to be nearer to £6 billion. We have got growth faster than the Treasury’s initial estimate and you have spoken about record levels of employment, so why is it for the fourth year running that tax revenues look like coming in short of forecast?

Professor Spencer: I believe that it is because the Treasury’s assumptions are just too optimistic on the revenue side and it does not surprise me to see, for example, that the Treasury forecast of 21% growth in corporation tax, which was discussed here at the time of the Budget, is being undershot. What does surprise me, however, is that despite everything that we know about onshore companies being hit by higher oil revenues and all the rest of it, despite the very weak outturn for the first 7 months, the Treasury are now forecasting another very strong growth in the last 5 months, another 21%, and, as we go into next year, another 25% growth again. So I think it is fairly clear ex ante that these forecasts are not still too optimistic and will be undershot.

Q48 Mr Fallon: Why does the Treasury believe that corporation tax receipts will suddenly jump in the last 5 months? There is a commentary on their table B14 where they talk about recovery in receipts arising from financial company profits. That is the same as corporation tax, is it, or is it a wider definition?

Professor Spencer: No, it is the same definition. What happens is that companies that have made losses over the last few years apparently in the financial sector can basically claim those losses against profits that they are making currently and
thereby reduce their tax bill. We actually had a good look at financial company profits a few months ago and certainly I was very surprised to see what the Treasury wrote about this because if you go through all of the major clearing banks, and we looked at the top 10 clearing banks in this country, they are saying that they are going to be giving the Treasury an extra £1.6/£1.7 billion of revenue this year. So unless something has gone very badly wrong in the investment banking sector, I do not see how the Treasury argument about unused tax losses applies. It certainly does not apply to the major clearing banks of this country.

Q49 Mr Fallon: What they always tell us is that they construct these forecasts bottom-up from information which you do not have, but which they have company by company, sector by sector. Is there any evidence by which we can challenge that kind of approach?

Professor Spencer: Yes, that is precisely why, when the Chancellor said that is how they were forecasting corporation tax revenues in his evidence to this Committee after the Budget, I started to look at individual company reports and the kind of spreadsheet analysis that is done in the City by equity analysts. Looking at those projections, it is very hard to see where the Treasury or, in this case, the Inland Revenue are coming from with their spreadsheet models. If you speak to any City analysts who cover the major companies of this country and ask them what their profit and of course tax projections are and try and start to add them up in the way that I did for the clearing banks, you get quite a different picture.

Q50 Mr Fallon: Perhaps we should ask the Treasury to publish them. They cannot publish the individual forecasts, but is there a case for asking them to publish some of these assumptions about sector receipts?

Professor Spencer: I think it would be a very good idea to start to ask the Inland Revenue to break down past data within financial companies between investment banks, which I suspect are not paying very much and never have, and the domestic clearing banks who, when you talk to their CEOs, see it as part of their social responsibility to pay taxes in this country. It would be nice to have a breakdown, there and within non-financial companies of course we already have a non-North Sea/North Sea breakdown and a breakdown of the onshore companies between manufacturing and services.

Mr Cousins: Just to follow that up, Professor Spencer, if, as you say, people are very keen to pay their taxes in this country, and here we are talking about the financial services sector which you were referring to, why do you think the shortfall arises?

Professor Spencer: It is very hard to know without the kind of detail that we have been talking about. It is entirely speculation, but I strongly suspect, seeing the way the economic models work and hearing what Digby Jones and others are saying about the effect of high energy costs in industrial and other companies, that what has happened is that yes, the higher oil price is generating more corporation tax, petroleum revenue tax royalties from the North Sea sector et cetera, but that has been offset, possibly more than offset, by lower profits and lower corporation tax revenues in industrial companies.

Q51 Mr Cousins: We were talking about financial service companies.

Professor Spencer: Well, as I said earlier, I cannot really see where the shortfall is coming on the basis of the analysis that I have done. I do not think there is any shortfall when it comes to the sorts of clearing banks that you and I would use. If the Treasury are right, it must be that investment banks are using the losses of previous years to cover their profits of this year. That is the only way that you could make it add up arithmetically.

Q52 Mr Cousins: What do the rest of you think about the reasonability of the projected increases in corporation tax receipts, non-North Sea of course?

Mr Chote: I think we have pointed out for some time that if you look back at what corporation tax revenues you would have expected to get as a share of GDP from the current set of tax rates and tax rules, so you have to extrapolate that back to imagine what history would have looked like if policy had been the same over that period, the Treasury is projecting a move to levels of corporation tax receipts as a share of national income which have only ever been achieved in the past either when the economy has been clearly overheating or when the financial sector has been doing particularly well in the height of the Stock Market boom. My sense is that there may be a problem of having been lulled into a false sense of security by how things were moving at the time of the Stock Market boom and, therefore, the Treasury may be over-optimistic about what it thinks of some sort of steady-state position to which we are going to return. The other point to bear in mind, which comes back a bit to Mr Fallon’s question, is that the Treasury in part bases its long-term optimism for corporation tax on an assumption that the profits of financial sector companies are going to rise as a share of national income on a straight-lining trend looking forward, and that is clearly a debatable question. We would certainly see the corporation tax revenue forecasts both in the short and the medium term as being one of the most questionable elements of the fiscal projections.

1 Note from Witness: In replying to Mr Fallon I suggested that the Inland Revenue should be asked to disaggregate past data for corporation tax. This is partially done already—Table 11.1 on their website gives data up to 2003–04. This can be seen at: http://www.inlandrevenue.gov.uk/stats/corporate_tax/table11-1.pdf. However, it would be useful to have the “other financial” category broken down between clearing and investment banks for the reasons I suggested. It would also be useful to have more detail on the Treasury forecast.
Q53 Mr Cousins: Of course over longish periods of time, say, over 15 years, income tax receipts have risen by about 250% and corporation tax receipts have risen by about 30%, so this is a very profound trend that the Treasury is trying to wrestle with. I just wondered whether you or your colleagues had any accounts for the reason for this.

Mr Weale: Sorry, this is not directly answering your question, but late last year the Inland Revenue did do a study comparing bottom-up and top-down forecasting. I do not know whether it was published or not, but I should have thought that study would be the place to look to answer your question about how the two relate.

Q54 Mr Cousins: I wonder if I could tempt you to regard this not as a forecasting issue, but a behaviour and receipts issue. What do you think the causes are of this shortfall in corporation tax revenues and do you think it is something that the Government can put right in a short period of time? It is not just an issue of forecasting; it is an issue of long-run patterns of behaviour.

Mr Weale: Yes, my inclination is to agree with what Robert Chote said on that, that the late 1990s were a very unusual period. We know that Stock Market booms only happen when the people who remember the previous crash have, if not died, faded out of the business scene and I agree with Robert Chote that that was probably a factor behind considerable buoyancy and, therefore, it is relative to that sort of perception of normality that we are, therefore, likely to see continuing shortfalls.

Mr Walton: The other thing on a longer-term perspective is that throughout the European Union corporation tax rates are coming down. If you want to attract companies and if you want businesses to grow, I do not think, as a government, you are going to be able to tax them more heavily. The prospect, if anything, is that governments are probably going to have to accept lower taxes from companies or else they will lose those businesses.

Q55 Mr Cousins: Of course, as you will, I am sure, recollect, Nigel Lawson’s great contribution in understanding tax receipts was that you could reduce corporation tax rates and increase revenues, the great 1984 corporation tax reform which I think of constantly! Against that background, let’s not talk rates or forecasts, but let’s look at this long-run behavioural trend that leads income tax receipts to increase so much faster than corporation tax receipts. What could possibly be the explanation for it?

Professor Spencer: Well, in part, if we switch the discussion to income tax and the buoyancy there, in part that is our old friend, real fiscal drag. Quite simply, if you do not index the personal allowances and the various thresholds, in particular, the threshold at which you move up to 40% tax, if you do not index those to earnings, but you index them to the RPI, then you are going to see a rise in the number of people in the higher tax bracket and you are going to see a rise in the average rate of tax paid generally, so that, I think, is why you get the up-trend in the share of personal incomes going to the Inland Revenue.

Mr Walton: Also, and more fundamentally, if you are going to spend more money as a government, then under the fiscal rules you have to match that through increased tax revenue and realistically there is a limit to how much you can raise from companies. Most of this in the end, if not all of it, is going to fall on individuals either through income tax or through VAT, so I do not think it should be a surprise if public spending is starting to rise as a share of GDP that it is going to be individuals that in the end are the people who are actually paying for those extra services.

Mr Weale: I think we have seen a number of specific measures, of which perhaps the most obvious one was the reintroduction of double taxation of dividends, which have supported the income tax base and I cannot think of analogous measures that would have supported the corporation tax base.

Q56 Angela Eagle: One of the things that we knew people had not had a lot of practice in by 1997 was the public sector being able to invest because it had not had much chance to do so. We have now been in a period where large amounts of money have been sent the public sector’s way and there are year-on-year shortfalls in the amount of money that they are being able to use in the time allocated, and we see another one of £2.5 billion this year. Do you think, first of all, is there any sign that the public sector is getting better at investing in a timely fashion because it has got this opportunity to do so and, secondly, why is there not more work being done to measure more sensibly public sector efficiencies, since the measures we have got at the moment are clearly totally inadequate, so that we can try to get some idea of value for money?

Mr Chote: Picking up on the first part of your question, in terms of why it is that the Government has promised or said or intended to increase public investment and yet year after year has not managed to do so to the degree it would like I think has been a genuine puzzle and I wonder whether the hurdles that have to be gone through to consider PFI schemes, for example—

Q57 Angela Eagle: But it is not only PFI though.

Mr Chote: No, but the fact that any investment scheme might have to be thought about in that context before it goes through, so maybe there is some sort of grit in the machine from that source, which would be a possibility.

Q58 Angela Eagle: Do you think it is just lack of experience with investing because prior to that the public sector just spent all of it on cutting things and did not actually.

Mr Chote: Yes, clearly you were moving from a position where the share of public investment as a share of GDP had dropped enormously to the point at which the Government came in. Now, the big explanations for that are the fact that we have much less social housing and fewer utilities in the public
sector which have big investment needs, so moving those out of the public sector would in any way shift down the amount of net investment you would expect in the public sector, but even then central government investment was relatively low and this was one of the reasons, coming back to the earlier question, why I think that the realpolitik behind the Golden Rule was to try to say, “Well, here they are ring-fenced and it won’t be the easy option to cut back net investment in the future when savings are necessary”, but, as you point out, it has been a tougher climb getting that to come up. I think in the latest figures and the downward revision for this year, the Treasury has said that local authorities and public corporations are to blame for the lion’s share of the investment which is not happening this year that they thought might, so whether there are develop macroeconomic statistics generally, but in particular when you are trying to aggregate and average out over all of the various different indicators for something as nebulous as the output of the healthcare industry, it is very, very difficult to produce one number which is as solid as the number of cars produced by the car industry and we are never going to be in that situation. We can do our very best and there is plenty of room for improvement and there are all sorts of new methodologies that could be tried. Ultimately this comes down to the consumer test and that is why the kind of focus groups that are being set up right the way across the country to look at the experience of ordinary people with the National Health Service to monitor their reactions to those improvements are important. That may be a little bit more informal, but that is the kind of measure, that is the kind of information that is going to tell you whether we are getting value for money or not.

Q59 Angela Eagle: Does anyone else have an insight?  
Mr Weale: Could I say on the question of measuring public sector performance that both the Atkinson Review and work that the Department of Health has commissioned at the National Institute and the University of York are addressing these questions. That said, there are very real conceptual questions, so, if I can give some examples, what is the function of the Health Service, how much of it is to cure people and how much of it is to have shorter waiting lists, they are not necessarily the same thing, nor do you have any clear idea of how much people value the one relative to the other. In order to produce single measures of efficiency, eg is the efficiency of the Health Service increasing or decreasing and by how much, then there have to be, I suppose, not completely satisfactory answers to these questions, but some sort of consensual way of addressing them.

Q60 Angela Eagle: But it is not necessarily the case that there would be one measurement for the very reason that you are talking about. There is also a balance surely between measuring quantity by which often efficiencies are measured and quality is often an issue rather than merely throughput and it is not production in the same way as you might measure manufacturing, so clearly we have to have a more sophisticated approach to measuring efficiency and outputs in the public sector. It seems such a neglected area of endeavour for economists.  
Mr Weale: Well, quality issues also arise in the as well, so, for example, changes in the nature of computers, but certainly I would welcome any more effort that the Government and the research councils do put into encouraging work in this area and I agree with you that measurement issues are terribly important and it is very difficult to establish any sort of consensus before you have got on to a consensus about measurement. I think the Minister of Health has said that measuring the output of the Health Service is one of the most important issues facing us and I agree with that.

Q61 Angela Eagle: Does anyone have any view that we will be able to come to a fairly sensible approach to this measurement issue since £13 billion of extra money is being spent investing in the public sector this year, although not all that was allocated has been used, and it is clearly important that we can get a handle on how well that money is being spent and some views of value for money that enable us to have confidence that this investment is being used properly and efficiently?  
Mr Weale: Well, I agree with that.

Q62 Angela Eagle: When are we going to be in a situation when we can make some of that assessment?  
Professor Spencer: It is inevitably very difficult to develop macroeconomic statistics generally, but in particular when you are trying to aggregate and average out over all of the various different indicators for something as nebulous as the output of the healthcare industry, it is very, very difficult to produce one number which is as solid as the number of cars produced by the car industry and we are never going to be in that situation. We can do our very best and there is plenty of room for improvement and there are all sorts of new methodologies that could be tried. Ultimately this comes down to the consumer test and that is why the kind of focus groups that are being set up right the way across the country to look at the experience of ordinary people with the National Health Service and to monitor their reactions to those improvements are important. That may be a little bit more informal, but that is the kind of measure, that is the kind of information that is going to tell you whether we are getting value for money or not.

Q63 Angela Eagle: Yes, the Holy Grail might not exist in the form of one number.  
Professor Spencer: Yes, exactly.

Q64 Angela Eagle: What do you think of the technical efficiency, the efficiency technical notes that departments have been asked to produce? Have you had a chance to look at them to see whether they are assisting and casting light on this area?  
Mr Chote: They do not go to some of the fundamental problems that Peter has mentioned, and I think another one is that with many public sector services there is obviously a social and redistributinal element in the quality of the output as well, so, for example, it is quite hard to think about how would you define the output of a library service. You could well imagine that if you did have some sort of clear idea about what the output of it was, presumably politically you would not be indifferent between one possibility which had one large library serving a very large area, but marketed very heavily at people around it, so heavy use was made of it, versus having small ones that people could access closer to them. Now, the latter might be less efficient, but you would presumably value its output more highly for social and equitable reasons, so I am not sure that any measurement will get you
away from those sorts of trade-offs which are inevitable in deciding what you actually want out of these services.

Q65 Angela Eagle: But perhaps it just highlights them, so at least people would know about the implications of the choices they are making.
Mr Weale: I think also in many cases we do not have a completely clear consensus on what, say, the Health Service is for. For example, there is increasing pressure on it to provide alternative therapies. Now, I am not a doctor, but one could quite easily imagine that some of those have no medical value at all, but, nevertheless, the focus groups that Peter described suggest that consumers are happy with them because these treatments are available. Now, is that money being wasted or is it a sensible use of taxpayers’ money? It is a difficult judgment.

Q66 Angela Eagle: Do you have a view on the efficiency technical notes?
Mr Weale: I am afraid I do not, no.
Chairman: On Martin’s point about the Health Service, I was at a meeting a couple of years ago when someone advocated that we have suntan cream for people going out to Spain just in case they get any illnesses, so what the Health Service is used for is a big question. Thank you for that and now we will move on to the micro issues.
Mr Cousins: Or insect cream if they go to Scotland!

Witnesses: Mr John Whiting, PricewaterhouseCoopers, examined; and Mr Robert Chote, Institute for Fiscal Studies, and Mr Martin Weale, National Institute of Economic and Social Research, further examined.

Q67 Chairman: Mr Whiting, could you introduce yourself, please.
Mr Whiting: I am John Whiting. I am a tax partner with PricewaterhouseCoopers and also Chair of the Chartered Institute of Taxation’s Tax Policy Committee.

Q68 Chairman: We have got a few issues on tax, but the ones for Martin and Robert I think we will start with. Following the PBR, there has been wide discussion of a number of tax announcements mostly to do with anti-avoidance, which we will come to shortly, but apart from those, Robert, what struck you as the most important elements of the non-macroeconomic parts of the PBR?
Mr Weale: Well, I suppose what struck me was in some senses what did not bark. I mentioned earlier the issue of savings, which is tied into the issue of incentives, the provision of pensions and so on. Now, obviously the Chancellor is likely to say that he is waiting for the final report on the Pension Committee, but on the whole issue of savings and incentives to save, there is really very little discussion beyond sort of tinkering here and there. I thought in some places there was actually a misunderstanding of what saving actually is and I suppose I would have liked to have seen perhaps a more thorough look at the combination of incentives to save and incentives to work. We have built up over this period of government a range of specific ad hoc measures and one gets the impression of something of a patchwork where there is a coherence and the aim is to lift people out of poverty and so on and a lot of progress has been made with that, but I still think that there is no coherent view about essentially where the high marginal withdrawal rates apply, how they affect incentives and structuring the tax benefit system in a way that minimises the disincentive effects without increasing its costs. What struck me most was what was not there rather than—

Q69 Chairman: The sort of medium- to longer-term issues which have not been sorted out.
Mr Weale: Yes, but the PBR would be a place to air discussions on those.
Mr Chote: I guess the package of childcare measures was interesting. I do not know whether you want to pick up on those specifically, but obviously there were a variety of elements to those and there are pros and cons to the different parts of it. In terms of what is important in the sense of impact on winners and losers—

Q70 Chairman: Angela is coming to that at the end.
Mr Chote: Okay. The key measures would be the £50 one-off winter payment for the over-70s, the raising of one of the tax credit thresholds in line with inflation, an increase in the limit on the childcare credit and the postponement of the fuel duty measures. All of those add up to create a not untypically progressive pattern in the sense of being of relatively greater benefit to people towards the bottom of the income distribution than at the top. Then there is also the issue about the allocation of extra money for local authorities on council tax and obviously there is a debate there about how much of that would actually feed through into lower council tax bills or whether it will get swallowed up elsewhere, so I guess in terms of monetary magnitudes, those would be the important ones.

Q71 Chairman: I wonder if somebody could give me a short answer to the proposed property investment funds. As you know, they have been delayed further and I think the Government have promised a further discussion paper in 2005. What are the differences of opinion between the industry and the Treasury on this, if any exist?
Mr Whiting: This is the property investment funds, or real estate investment trusts, as they are sometimes termed, REITs. I think generally industry is keen on them and, frankly, picking up something Martin said, in a sense it is one of the dogs that did not bark and it was disappointing that they were not at least committed to. So whether they are now seen as something that might cost the Treasury a significant sum and, therefore, they are just
slow down progress. I am not sure, but I think you would find generally that the property industry is disappointed that they are not coming forward and also from the savings industry because they are seen as a good vehicle for getting more money into property in a more flexible format, so I think there is disappointment that there is not a commitment. All right, at least there is another document to come.

Q72 Chairman: On the Chancellor’s announcement about his plans not to introduce a general anti-avoidance rule, that has been followed by statements in the PBR with the Treasury saying that they will intervene to stop any avoidance scheme related to rewards from employment. Is that just another way of putting the anti-avoidance in place?

Mr Whiting: I think that could be a very shrewd observation, Mr Chairman. It is one that we are slightly concerned about because, as you are well aware, because we have not had the general anti-avoidance rule, the route followed was tax avoidance disclosure which a huge amount of effort has gone into and I think the number of avoidance-blocking measures which have come in is testament to the fact that the system is working. The Inland Revenue is, by all accounts, perfectly happy with it. However, as you point to, we do seem to have this threat of retrospective legislation which very much flies in the face of how we do law and tax in this country and one of the concerns, apart from whether this is a slippery slope into retrospection in all places, is whether this sounds a bit like general anti-avoidance rules.

Q73 Chairman: You are on record as saying that there is at least one other area in terms of retrospection. What is that area?

Mr Whiting: Well, there was some discussion over interest allocations with that area as one where the Revenue could look at it, but the out-and-out statement by the Paymaster General was in terms of employment law. In past history there has only been one actual use of retrospective legislation which I think was 1978 with a particularly artificial scheme, known as the “Commodity Carry Scheme”, so that is the only example I know where it has been used, but the threat we have here is clearly something that is very worrying about the principles in which we do tax.

Q74 Chairman: The legislation emphasised that the avoidance schemes would be closed down “where necessary from today”. First of all, is that sufficient time for the tax planners and, secondly, what about the Human Rights Act here?

Mr Whiting: There is never any objection to the Government, the Minister, standing up and saying, “As of today, we are going to block such and such”, so let’s get that clear, that is known. The idea that you can stand up and say, or put a written statement down and say, “Right, if something turns up in the future, we don’t know what it is, but we reserve the right to come back to today and basically change the way the tax law operates”, let’s be clear, the system of tax we have in this country is that you are taxed on the basis of what the law says. If, therefore, there is a possibility of retrospectively altering your tax bill, then it does have very interesting human rights implications and it has been mooted that this idea of retrospection could now be vulnerable to human rights challenges if we go that far.

Q75 Mr Cousins: Who has that been mooted by?

Mr Whiting: I have seen plenty of commentators.

Q76 Mr Cousins: By people like PricewaterhouseCoopers?

Mr Whiting: We have certainly sort of speculated, but we are not experts in it, though I have certainly seen plenty of commentary.

Q77 Mr Cousins: Who is faster on their feet in dealing with avoidance issues—firms like yours or the Inland Revenue?

Mr Whiting: I think all of us—

Q78 Chairman: Is not the nub of it, as Jim said, that the Inland Revenue feel, “There are some really smart guys out there. You are a bit smarter than us and you’re always a yard ahead of us, so this is why we are announcing this”?

Mr Whiting: Well, of course I am very pleased that we are deemed to be extremely fast on our feet.

Q79 Mr Cousins: No, I was asking you, do you consider that you are faster than the Inland Revenue?

Mr Whiting: We do not think we are faster now. We will think up ideas, we will put planning ideas to our clients, and of course now we have tax—

Q80 Chairman: Yes, but you are not dim, are you? You are pretty clever.

Mr Whiting: Thank you. I will take that as a compliment, Mr Chairman.

Mr Chote: It was not intended to be!

Q81 Mr Cousins: Do any of these ideas for your clients involve recasting figures to the previous year?

Mr Whiting: No. We would never go into something that would depend on concealment or on rewriting history as that is not appropriate. You just cannot do that. What we have to do of course now is if we think of an idea, if I bring to you an idea, Mr Cousins, then I have to tell the Inland Revenue about it, and I would be very pleased to bring you some ideas.

Q82 Mr Cousins: What—for free?

Mr Whiting: Possibly so, but we would have to disclose it to the Inland Revenue within five days and that gives the Inland Revenue the ability to close the device. They have tax avoidance disclosure, they have all the information that flows in there, and there is evidence from the Pre-Budget Report statement that they are acting on that and acting comprehensively, so one has to say why do we then need the threat of retrospective legislation?
Chairman: I think you want to ask some questions, Jim, but I would just like to know that we are getting Mr Whiting for free this morning!

Q83 Mr Cousins: Just to follow up on that, what is your view on the disclosure provisions of tax litigation and tax avoidance schemes which were introduced in this year’s Budget. Are they working?

Mr Whiting: I think they are working. It has taken a lot of work to make them work and I think we are actually quite pleased with the way that the tax authorities have engaged with us and I think there has been a very constructive dialogue between practitioners, advisers, business and the tax authorities to try and get a good working system. There are rough edges within all of it and there are problems still and I hope the dialogue will continue as to making it work, but disclosures are going on and, as I say, the fact that there are a number of blocking measures in this year’s Pre-Budget Report, I assume that shows that the tax authorities are happy the system is working.

Q84 Mr Cousins: Do you have any view yourself or have you done some exercise that looks at the revenue involved potentially in the group litigation order cases that are being brought to the European Court of Justice?

Mr Whiting: Yes, we have.

Q85 Mr Cousins: What would the total amount of revenue involved be, do you think?

Mr Whiting: Inevitably it is speculation and I would stress that and it is back of the envelope, but that is a very important feature. Again it is something that one wonders why there is no comment on it, but a guess might be £10–20 billion on some of these cases, but of course it could be beyond that spectrum.

Q86 Mr Cousins: So in these items, we are talking about something that is non-trivial?

Mr Whiting: Very much so. That is of course a potential one-off hit, but it is undoubtedly a non-trivial amount of tax and might be something that I would have expected to see commentary on within the Pre-Budget Report.

Q87 Angela Eagle: Surely you do not expect them to comment on cases before the courts in the Pre-Budget Report? That would be nonsensical.

Mr Whiting: What I would expect, and I totally take your point in terms of you cannot comment on litigation, but in view of the challenges, in view of the number of areas where the UK corporate tax system does look to be out of line with European law in terms of the freedoms in the European Treaty, I would have expected to hear more about basically what are we doing about it to make the system robust.

Q88 Mr Cousins: But you do recognise that a sum like £10–20 billion, which you have given to the Committee and which I think is an interesting one, is a significant item in the tax base of the country?

Mr Whiting: Very much so.

Q89 Mr Cousins: And it would not be unreasonable to expect the Government to attempt to defend its tax base?

Mr Whiting: I fully expect the Government to do so and that guestimate is on the basis that the various challenges, and of course these are not just UK challenges, but there are challenges to all, or virtually all, Member States’ tax systems and aspects of them, that was on the basis that most, or all, would go against the State rather than against the taxpayer. It is quite possible that some will be found in favour of the State and, therefore, my £10–20 billion would come out considerably lower.

Q90 Angela Eagle: I wonder what your view is, Mr Chote, about the announcements on the ten-year strategy for childcare, particularly if you could consider what you think its impact will be on labour market flexibility, employment and work/life balance?

Mr Chote: The key elements we are thinking about are the extension of paid maternity leave, the extension of free nursery provision, reforms to the childcare elements of the working tax credit, more children centres and improvements in quality of childcare and early-years provision. I would say we are obviously concerned about the two things you describe, but also—

Q91 Angela Eagle: And the increases in nursery entitlement which are factored in as well.

Mr Chote: We are also of course concerned for the outcomes of children as well, so we are taking the balance of those things together. For example, the extension of paid maternity leave, there is strong empirical evidence that the sort of one-to-one care in the first years of a child’s life is an important determinant of future outcome, so in that sense that would seem to be a sensible move. The ability to transfer from mother to father would potentially be a more flexible arrangement and transferability could presumably reduce the incentives for employers to discriminate against women if it reduces the extent to which they think they are more likely to take up that option than fathers are. The extent to which in practice that balance does change and whether that section changes is of course perhaps rather more debatable, so it is not going to remove that entirely. Obviously not all families would benefit there as some mothers do not qualify for statutory maternity pay anyway if they gave up work after a first child, so there would be limitations on the extent to which people would benefit.

Q92 Angela Eagle: But presumably they would, in theory, benefit from being able to think about getting back into the labour market even with subsequent children and with some of the support that is available?
Mr Chote: They will benefit, yes.

Q93 Angela Eagle: That ties into the labour market flexibility and hopefully it gives them options that they did not have before because of the impracticality of maybe doing quite modestly paid jobs, but having high childcare costs.

Mr Chote: As you say, you have to see it as part of the overall package of measures. On the extension of free nursery provision, there is an interesting issue there about the extent to which you are trying to target these issues specifically on those perceived as being most in need versus more generally. That extension of free nursery provision is not a particularly targeted measure.

Q94 Angela Eagle: No, I think it is for everybody.

Mr Chote: Exactly, and it would have a broader effect on families as a whole. It is not clear necessarily what the costs of those reforms would be. Reforming the childcare element of the working tax credit, so increasing both the amounts of childcare that the childcare tax credit would cover and also the proportion of subsidy, you would expect, I think, that increasing the limits on childcare that can be supported in this way might have a relatively modest impact because an awful lot of people who are claiming the working tax credit do not exploit the full amount of that anyway, so increasing it further—

Q95 Angela Eagle: Is that a supply problem though?

Mr Chote: That is an interesting question. I do not know to what extent that would be and if it is obviously a supply problem, the supply problem is not addressed.

Q96 Angela Eagle: Well, the supply problem is addressed surely in the new duty on local authorities to ensure a sufficient supply of childcare to meet the needs of families and there is a modernisation fund of £125 million a year from 2006 which will give 150 local authorities the chance to do that. That should begin to address surely some of the supply issues. Obviously you have to train and recruit, but the supply side is being addressed by that, I would have thought.

Mr Chote: Whether that amount of money is large enough given the number of local authorities you are looking at and whether extending the amount of time for which childcare is supposedly being offered makes it more difficult, for example, if you have a situation where a facility is used for 3-year-olds in the morning and 4-year-olds in the afternoon and whether that no longer becomes a viable model and, therefore, there are significantly greater costs, so I think the question of how quickly supply can be brought on and at what cost remains an important one, notwithstanding the £125 million.

Q97 Angela Eagle: And what about in terms of labour market flexibility and unemployment because we have a tight labour market at the moment?

Mr Chote: Yes, we have not looked specifically at the implications on that. Clearly there is the issue over the labour market for the providers of childcare themselves and, as you say, whether both in terms of physical capacity and the capacity of available qualified people to do that, there are obviously question marks there, but in terms of the general impact, I do not know whether Martin might have any views on the wider economic benefits of that, but my guess would be that they would be very hard to quantify at this stage.

Q98 Mr Cousins: Could I just ask for your views about the likely extension of the ISA, the present higher ISA limits for a further 3 years—do you welcome that?

Mr Weale: Could I come to that from the general proposition that taxes have to be collected and one could imagine a society where people were subsidised to save and subsidised to go out to work and, taken to its extreme, there would not be any tax base, so I am rather nervous about this, and the ISAs are an example, the existence of these tax reliefs for particular activities which seem to be a good thing, but people might be doing anyway. That said, given the way I drew attention to the overall shortfall of saving, I am pleased that that is being addressed to some extent, but I suspect that it would be more fruitful to go to the root causes of why people are not saving very much. For example, should the Government diversify the sort of savings media that it offers and could offer at low charges? I would rather see a more holistic view taken to address the questions of what is it that deters people from saving, whether it is that they cannot afford to save, whether it is that they are playing essentially a game with the Government where they know that if they do not save for their old age, then future generations will have to bail them out and will bail them out, so there is rather little incentive to save. Against that backdrop, the extension of the current limit on ISAs I think is rather small beer. There is of course the general observation at least with equity ISAs that the only people who get benefit are those who pay 40% tax because dividends are taxed at the standard rate anyway, so there are questions about whether the distributional effects of it are desirable or not. I would rather the Government took an overall view of savings, savings structures and savings incentives instead of this piecemeal approach.

Q99 Mr Cousins: When somebody says to me, “I think we need a holistic approach”, I always translate that in my mind as meaning, “I don’t know quite what to do right now, but come back in three years”. In your earlier remarks to the Committee, you see, it was a rise in the aggregate savings rate in the country, if I understood your argument, that was actually going to sort out the structural deficits on the balance of payments, so I would have thought that this would have been an important issue for you, and the only practical thing that you have said, which is interesting of course, is an increase in the range and robustness of National Savings products, if I have understood you correctly.
Mr Weale: Well, could I air another, and probably rather unpopular, suggestion, that until the early 1980s the charges on some financial media, say, unit trusts, were regulated by the Department of Trade and since they were deregulated, they have become much higher. I do not think the performance of the products has improved relative to the market and there is, therefore, a very substantial question whether, and how, the industry is actually serving the saver. Now, people like Sandler have looked to that to some extent and recommended simple products that can be sold without giving people expensive advice about how they work and so on, but I think fundamentally a look at why the industry is so expensive and more expensive than it used to be, whether the Government could introduce competition in the industry, say, by selling index-linked pensions through post offices as just another means of national saving, another way of financing government borrowing, and I suspect that if you look at the sorts of charges that appear in the industry, whether ISAs are extended or not has relatively little impact except for the cash ISAs where the amounts that people are allowed to save are relatively small.

Q100 Mr Cousins: Well, the deregulation of charges in the financial services sector and the renationalisation of savings—how does that grab you, Mr Whiting?

Mr Whiting: Being instinctively something of a free market enthusiast, I am not too keen on regulations, so, therefore, I would not particularly wish to see charges regulated totally. Some sort of government oversight structure is very sensible to make sure it is properly run, but, going back to your original question on ISAs, I found the announcement a little disappointing because why not just get on and say, “All right, ISA limits will go this way until 2009”, because, as Martin says, it is a relatively small thing and it removes uncertainty, and actually now start to think of what is going to happen post-2009 when ISAs possibly come to an end.

Q101 Chairman: On that issue, as a Committee we did push on that, for a limit and, like yourselves, we would like some clarity on it.

Mr Whiting: It would seem to be a fairly simple and easy thing to say “the limit goes ahead to 2009, let us think about the bigger issue”.

Chairman: We will raise that with the Chancellor.

Angela Eagle: There is an interesting little development which I think could be significant and I would be interested in your view on what I have called wealth benefits rather than income benefits. The Child Trust fund, for example, there is now a consultation on whether to introduce a payment at seven and the first payment will go into the fund this coming April. There is also an extension of the saving gateway pilot where the Government matches pound for pound savings of people on very low income to try to allow them to build up a very, very modest but perhaps important amount of wealth in an area of the income distribution, the lower end, where there is almost no saving since it is very, very difficult to save and the financial services industry has virtually abandoned doing anything for people at that end of the potential market. Any views Martin, Robert or John on whether this is a good development which ought to be extended?

Q102 Chairman: Could we have brief answers because we have a number of questions to ask you.

Mr Weale: I think the question for people on low incomes is how much you want to give what is a very high rate of return created by a subsidy rather than just make sure they have more income available for saving and their other needs. I do not buy the argument that climbing on the saving ladder is difficult; it is quite different from climbing on the housing ladder because you can go into a building society and open an account and put a very small amount of money into it. It does suggest that the policy does encourage people to think more about saving but I would like to know more about the balance of costs and benefits.

Q103 Chairman: Are you really pressed, do you want to answer it?

Mr Chote: No.

Angela Eagle: It is a very negative answer, is it not?

Q104 Chairman: John, on the tax issues, on the avoidance disclosure requirements, including the June 2004 Finance Act, what has been the Authority’s typical response to disclosures and how often have they announced an intention to legislate against this scheme and how often have they indicated that the announcement will take immediate effect? Give us very brief answers to a half a dozen questions.

Mr Whiting: The disclosures that have been put in as a result of the Finance Act 2004 started effectively to go in during August but really September. The announcements that we had with the Pre-Budget report were the first time that we had any action on them. I think we were all slightly surprised that nothing happened immediately in October, after the first tranche of disclosures went in. This may come back to something Mr Cousins was tackling me against, the speed of response, I do not know. This was the first tranche on 2 December and of course all of them were to take effect from that day.

Q105 Chairman: Okay. Is there any evidence though that the new disclosure rules are having a significant disincentive effect on the tax industry’s efforts to devise new tax avoidance schemes or is it Popeye getting spinach “Phew! They are off again!”?

Mr Whiting: I think it is having an impact because there have been some very clear signals both with disclosure and the statements that have been made that the Government, the tax authorities, are very determined to crack down on what it sees as unacceptable avoidance, and in particular totally artificial avoidance. Genuine routine planning, advising somebody—

Q106 Chairman: Yes, but does industry get energised with that, that is what I am saying?
Mr Whiting: It has caused us to sit back and think very hard about where is the dividing line. To that extent it has slowed the whole industry up; it has created a little more uncertainty. Has it stopped people trying to think of tax efficient products? No, I do not think it has, you would not expect it to have done. Has it caused a slow down in the marketing of them, a slow down in the attempts to devise new products, yes it has because obviously things have closed down and you have to bear in mind that the tax authorities are going to know somewhat sooner.

Q107 Chairman: Creativity is still alive and well in the industry?
Mr Whiting: I think the creativity is still alive but whether it is as well as it was, I do not think it is.

Q108 Chairman: Following the problems of introduction and withdrawal of the 0% corporation tax, as you know the Treasury has now published a discussion document on small companies, the self-employed and the tax system. Now we have discussed this with you previously in your visits here but what is your view on the discussion documents? Does it affect and address the right areas? What factors is it important for the Treasury to consider when proposing changes to the tax system for small businesses?
Mr Whiting: If I am honest, Chairman, it does not really address anything. It starts the debate and I think that is helpful. I had a sudden phone call a moment after the Chancellor had sat down from somebody in the Treasury explaining to me that this was meant to be a very wide ranging document. In the conversation I said “What is the timescale for any changes?”; but it was emphasised to me that there is no timescale because it is gathering the evidence. I think, to be fair, that is constructiv: let us have a big, wide ranging debate. I think it is good that we have at least got it. I think an important parallel step is within the Revenue & Customs, a new body having a dedicated small business unit to focus on small businesses. I would hope that in the debate that follows this we will be able to look at things like the 0% corporation tax, like many of the other burdens but not just the simple amount of tax burden.

Q109 Chairman: Do you think the Treasury could learn from that and avoid any debacles that they have had in the past?
Mr Whiting: I would hope it is. As I say, the slight disappointment that I have with this is simply that it is nothing more than starting the ball rolling but providing the intention is to range widely, I think it is constructive.

Q110 Chairman: On the tax regime for leasing, that has attracted particular criticism from experts, others have claimed it is a loophole widely abused by multinationals. What is your view?
Mr Whiting: I think leasing is a perfectly sensible way of funding people’s acquisition of plant/buildings. The competitive nature means that if there is an attempt to go into a lease because it moves the capital allowance benefit from the putative buyer to the bank or finance house, the benefit of that lease capital allowance is always passed back in the rates. I think it is worrying that the tax authorities’ attitude has always been or seemed to be that this is an avoidance device rather than just part of a way of doing business. If we are to have further changes, one merit of them is at least they are to only change for leases following the introduction of the rules. I think we are all a little disappointed because of the possible international implications.

Q111 Chairman: Last question, Legal & General have said that the changes in insurance company taxation will cost them £20 million this year. Do you believe the new regulations have been announced in a way that is appropriate for such far-reaching changes? Secondly, the Revenue has indicated that these proposals are still in draft form and that they are open to comment from the industry. Is there an opportunity for adequate consultation or is it fait accompli?
Mr Whiting: There are a lot of questions. You may have seen, also, that Norwich Union have commented on the impact on them. There are a number of changes affecting the life assurance industry under the banner of anti-avoidance. Within those is something affecting shareholders’ funds and what are known as orphan assets that is very definitely not anti-avoidance and it is that which has aroused the concern. Frankly that was slipped in to the package under a power which allows regulatory changes by Statutory Instrument. There was indeed the possibility of consultation on it but given that the announcement was on Thursday, the consultation period has closed already because we were allowed three working days for what was a substantive change rather than the blocking of an avoidance measure. Frankly, this seems inappropriate. It is interesting to note that it is proceeding under a power introduced some years ago to bring in Statutory Instruments and when that power was mooted and brought in, in 1990, the then spokesman for the Opposition really did object to the potential wide range of this power to bring in regulation. The then Treasury Minister gave him assurance that it would never be used in a wide ranging way. The then Opposition spokesman was a very promising young MP, Mr Paul Boateng.

Q112 Mr Cousins: He has done well since then.
Mr Whiting: I believe he has moved on.

Q113 Chairman: He gets slick answers and moves on, does he?
Mr Whiting: That is a power to make tweaks and twiddles, it is not a power there to make substantive changes to the rules. The consultation is minimal and frankly not real and it is of deep concern to the industry.
Chairman: On the bell, I think we will finish. Can I thank you for your attendance and Robert and Martin for staying the whole course this morning. Thank you.
Tuesday 14 December 2004

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard
Angela Eagle
Mr Michael Fallon
Mr David Heathcoat-Amory
Mr George Mudie
Mr Robert Walter

Witnesses: Mr Jon Cunliiffe, Managing Director, Macroeconomic Policy and International Finance, Mr Jonathan Stephens, Managing Director, Public Services, Mr Nick Holgate, Director of Welfare Reform, Mr Dave Ramsden, Director, Tax and Budget, and Mr Chris Martin, Head of the Productivity Team, HM Treasury, examined.

Q114 Chairman: Mr Cunliiffe, welcome to you and your team in this Pre-Budget Report session. Can I ask you for the sake of the shorthand writer to introduce yourself and your colleagues please?

Mr Cunliiffe: Jon Cunliiffe, Managing Director, Macroeconomic and International Directorates. On my right is Jonathan Stephens, Managing Director of the Public Services Directorate and Chris Martin, who is Head of our Productivity Team. On my left is Dave Ramsden, Director, Budget and Taxes, and on his left is Nicholas Holgate, Director, Welfare Reform.

Q115 Chairman: The general view of the experts we have asked is that the Treasury continues to have a very good record relative to independent analysts when it comes to forecasting the economy but has been less successful than most outside experts when it comes to forecasting the public finances. Give us your view on that please.

Mr Cunliiffe: First of all I think that forecasting the public finances and forecasting the economy are different to an extent. If you look at our long term history of forecasting public finances and compare it against other countries and other international institutions we come out quite well. Not only is the average absolute error, ie, whether we forecast above or below, pretty good compared to others, but the bias in the forecast is also quite good. Since the new fiscal framework was introduced in 1997 the actual bias on the forecast has been that we have tended to be conservative so that we have under-forecast surpluses and we have over-forecast deficits by about 0.2%. If you look at us on economic forecasting we are pretty good compared to the independent consensus and we are pretty good compared to other countries and other institutions. On the fiscal side I do not think that is very different. Again, the ECB rated us on the fiscal side one of the most accurate in the European Community.

Q116 Chairman: In March last you told us that you were at the end of a process which had seen revenues undershoot forecasts in 3 successive years, but in spite of an additional £1.5 billion of tax from higher oil prices this year revenues are now expected to undershoot for a fourth year, by some £3.5 billion. At what stage will you begin to ask if there is something fundamentally wrong with your forecasting models?

Mr Cunliiffe: First of all I would stand by the statement that I made last time. If you look at the revenue shortfalls that we are seeing, they are getting smaller and smaller and they are concentrating particularly on one tax, corporation tax, and we might say a little bit more about that later on. This comes back to the issue which is discussed in the PBR, that when we forecast the cyclical components of the economy we use long term averages and what we know is that every cycle is different. We also know that some sectors of the economy come back more quickly or more slowly than the average. What we have seen in the corporation tax area is receipts coming back much faster than economic growth. I think they have grown by 12.5% in the first 7 months of this year, so we were forecasting quite a large increase in the rate of growth of corporation tax. We have seen a large increase but not as large as we thought. The question is, how long does it take for those taxes to come back to the long term average? The history is quite clear that there are long run averages in these things and the taxes do come back. Deciding, if you like, how sharp or how shallow that line is back to the average is where the judgment is, and there we were right in forecasting a faster bounce-back in corporation tax but it has not been as fast as we thought. On the oil point, I would say that £1.5 billion is the increase in oil related taxes but you have to offset against that the fact that what we are getting from fuel duty will be reduced because as petrol prices go up people will buy less petrol, so there is a demand effect on that side. The other effect, which is difficult to disentangle, is that because oil is an input price to the economy generally that means that it will affect producers and therefore corporation tax and work its way through more generally.

Q117 Chairman: We will come on to corporation tax with a number of questions later. The PBR notes that both the Treasury and outside forecasters have tended to underestimate GDP growth in recent years. The MPC has also indicated that it has tended to overestimate inflation. Does that imply that economic policy has consistently been too cautious about what the UK economy can deliver, perhaps resulting in missed growth opportunities?

Mr Cunliiffe: First of all I would say on the public finances side that we are deliberately cautious in that we use a lower growth forecast than our central
forecast to forecast the public finances and that is to build in a measure of caution. We normally forecast a quarter of a per cent below our central estimate for the public finances. On the economy more generally the evidence that we have had from the last cycle is that the economy grew faster than we thought it would and that supply potential was greater. One has to be careful just assuming that what will happen in this cycle is the same as the last cycle, but it seems as if trend growth in the last cycle, the rate at which the economy could grow without creating inflation, was pretty close to 3%. We have not rolled that forward. That evidence suggests to me that some things have happened on the supply side. If you look at what is happening in the economy now, the rate of growth, the behaviour of inflation and the behaviour of earnings and the like, it also suggests that that trade-off between output and inflation may have changed structurally for a number of reasons. A lot of the reasons will, I think, have to do with government policies on employment which have put more people into the workforce, government policies on competition, which have made firms and companies react faster, and government policies on immigration, which have brought in more skilled people. What we do not do though, and it is always tempting to do it but it is dangerous, is try and estimate in advance how much a particular government initiative will add to the growth potential of the economy. For example, there is a government initiative on inactivity which will see the rolling out of the pilots on inactivity to about a third of the country. We could make an assumption on that about how many extra people that will bring into the workforce and then we could do our growth arithmetic and factor up the growth rate of the economy, and then that would change all our economic forecasts and finally would change our tax forecasts. We do not do that. We change the growth rate of the economy by observing what has happened in the past rather than attaching some forecast to government policies and pushing that forward. My guess is that over time, yes, it has helped the supply side of the economy and the supply side of the economy has become much stronger.

Q118 Chairman: We have heard in the recent past about the issue of poor data quality. Rachel Lomax of the MPC made a recent speech on that issue. She mentioned that it continues to be a challenging area. You have also highlighted how inaccurate some of the recent GDP data have been. What implications does that have for the economy and what do you intend to do about it? Perhaps you could bring in Chris Martin afterwards, particularly on the issue of productivity and how much we believe the productivity figures.

Mr Cunliffe: It is an issue and I have a lot of sympathy for the Office of National Statistics and the National Statistician because very often you have to make judgments on the data and the data are not good. It means that when you are forecasting the economy you have to have quite a good feel for where the data are strong, when in the past forecasts have been reliable and when they have not. There are a few particular areas that are worth mentioning. One is public sector output, where we have had the Atkinson Review which has now got down to quite a level of detail on measuring the outputs from the public sector, and there have been some big revisions last year to previous years’ output. Those are the first conclusions from Atkinson, and of course there will be more coming forward. This question of measuring public service output is something which is challenging statisticians worldwide. The second area I would mention is around the trade statistics where we have had some big problems with fraud, the missing trader in the community fraud, which has distorted both imports and exports. Though the ONS give trade figures net of the effect of that fraud, trying to observe the amount of fraud and project it forward is by its very nature a difficult and uncertain thing to do, and where, for example, Customs have introduced new methods for recording some exports, which also distorts the figures. Finally, I would say that a lot of the statistics have just been very erratic. We have seen that in the third quarter of this year with the drop in manufacturing, where we have had a drop in manufacturing activity that does not line up with the survey evidence. In the past it has tended to come back in line with the survey evidence but it is an example of where you have to try and make adjustments to the data where you know in the past they have been a bit misleading.

Mr Martin: The productivity stats tentatively bear out the message Jon was just talking about in terms of looking at the supply side of the economy. The figures that we published in box 3.1 in Chapter 3 set out our current view of productivity growth over the last cycle compared with the cycle beforehand. The underlying rate we think is round about 2.7% compared to 2.2% in the previous one. We are deliberately being cautious about that at the moment in terms of looking forward. At the moment in terms of the outturn data there are some pretty positive signs of a potential increase in the productive potential economy overall and that is very positive.

Q119 Mr Beard: When we were talking about fraud, Mr Cunliffe, and you were just talking then about it affecting the trade figures, what sort of fraud are we talking about? Are we talking about cigarette smuggling and alcohol smuggling or missing trader fraud?

Mr Cunliffe: I was talking about the missing trader fraud because that distorted both imports and exports.

Q120 Mr Walter: I would like to look at the trade figures but look at the quantum of them. You have got a very bullish statement in the Pre-Budget Report: “Export growth is forecast to gather more momentum in coming quarters as the recent pick-up in external demand continues”, but actually October
saw our second worst ever trade deficit and 2004 looks like seeing the worst annual deficit since records began in 1697. Is that a source of concern? Mr Cunliffe: If I could start at the end of the question and work my way back to the beginning, I think you need to express these things as a percentage of GDP because in all of the ratios we look at it is the size of the current account, it is the size of the thing you are looking at as a percentage of the size of the economy. Looking at nominal figures for trade deficits and comparing them back to the 1690s, particularly given the effect of inflation, I do not think you very much. We had larger trade deficits in the 1980s than we have now, so I am not sure that the nominal figures expressed in that way get you that far. The point is well made that on the planned forecasts for trade how optimistic is it? It is lower than the OECD’s forecast for UK trade. It is lower than the European Commission’s forecast. It is lower than Peter Spencer’s ITEM club forecast, so I would not say that this is a wild forecast. There are a number of commentators out there. It is a bit higher than the consensus forecast. Perhaps I can make two points about that. First, the thing that contributes to GDP is not just exports; it is the relationship between exports and imports. We are forecasting quite a high import growth, round about 6%, and we are forecasting exports to grow a bit faster, round about 6.75%. Because imports are about 10% higher than exports, what does is it takes the net deficit, the drag, from trade to zero and it is the difference between those two things that matters, not just our exports forecast. It is the forecast of the two that matters and on that the independent consensus on trade is not that different. The second point I would make is that one month’s export figures can be erratic and there is what Mervyn King calls some statistical fog around the trade figures. We have looked at what has happened to UK exports when UK export markets have grown in the past. When our traditional export markets have grown our exports have grown but not as fast as those export markets. We have had a declining share for a number of years, particularly fast in Asia. In the EU our share has been declining at a slower rate. Last year the share of EU exports markets declined much more than you would have expected from historical averages. We come back to this question now of how do you interpret the statistics or what view do you take? On the view of what has been happening in the last five to 10 years it is reasonable to expect that if our export markets grow by 8.5% we will see this growth in UK exports and that the Eurozone grows by 2%, and its trade probably grows by double that, we will see what we are expecting. If you look at the actual figures, three month on three month, exports in the last three months I think are up about 3.5% on the year earlier, so you are seeing some comeback. If you look at our exports to Germany, to Ireland, to Spain, they are up by large amounts. Germany is over 10% and Spain is about 7.5. If you look at surveys, like the recent CIPS survey, they suggest that export orders in November are back to July levels. So, yes the one month figures do show that. The three month figures, if you look at a longer period, suggest a more robust position. The normal relationship between growth in our export markets and our export share suggest that they will come back and our forecasts are not that far out of line with the consensus but there is uncertainty in these.

Q121 Mr Walter: You have talked there all the time about export growth but imports are growing as well, not quite as fast but they are growing. Even on your figures, therefore, in your projections of the trade deficit, the trade deficit stays consistently over £40 billion out to the end of your forecast period of 2007. Historically we have gone up and down; there has been a cyclical movement, but we now seem to have a trade deficit that is sitting at that level. Is that sustainable in the long term? Mr Cunliffe: I am trying to remember in my mind the picture of the graph going back. I think historically we have gone up and down but for the last 15 years we have not taken us very much through zero, so there have not been very strong periods of trade surplus and there is a trend. They are growing in nominal terms. As a percentage of GDP I think it is easing up a little bit above 2.5. That is not as high as it has been in the past. As to the cyclicality, I venture that having taken a lot of the amplitude out of the UK cycle, so that the UK economic cycle is nowhere near as volatile as it was over the last 6 or 7 years, the trade cycle has been much flatter compared to, say, what happened in the eighties and nineties. I am pretty sure that a less volatile economic cycle means a less volatile current account.

Q122 Mr Walter: But can we permanently have a structural trade deficit out into the future? Mr Cunliffe: This is an interesting international question because the question is asked of the US where their trade deficit is over 5% and all of the received wisdom has been that when you get over 5% it has to correct. Maybe we are seeing some of the correction now. There are examples in history of trade deficits persisting for a very long time. Because the counterpart to the whole current account deficit (of which trade is a part) is the capital account surplus, and if there is investment in the UK, if people are prepared to put their money into the UK, then you can keep a current account deficit of 2.5% for a very long time. What I suspect may have changed a lot since the past is that with liberalisation and global capital markets it is much easier for savings anywhere in the world to go to the world to think that is a return. Our trend growth rate is high compared to the rest of Europe. The UK is a good place to put savings and we are seeing that, so I would not have thought 2.5% of GDP current account deficit is that far out of line with the past or is unsustainable.

Q123 Angela Eagle: We had a recent lecture by Mr Dyson, the well known manufacturer, who was commenting on how we had to revive manufacturing and become the centre of manufacturing excellence again, not necessarily assembling but doing all of
that value added work to create goods. Do you think that that can persist with that kind of view of a trade deficit?

Mr Cunliffe: I do not think the two are exclusive. I heard him on the radio and I think he was saying the same thing, that in some industries you can design and have all the know-how but manufacture abroad.

Q124 Angela Eagle: As he does.

Mr Cunliffe: In Malaysia, I think, for his excellent vacuum cleaners. In other industries, both design and manufacturing go abroad and in some you keep both. The buzz word seems to be modularisation but as the global production line gets chopped up into different components which can be moved abroad, the key is, do you have the science base, do you have the research base, do you have the skills in your workforce to enable you to continue keeping those activities in this country while manufacturing activities might go abroad? Although I would not want to argue that what we are seeing in China and India is the low value work, manufacturing, going to those countries and to other Asian countries, because there is some high value work going there and their skills level is going up, I would argue that it is action on skills, action on education, action on science that enables you to do exactly what Dyson suggests for those industries and keep the leading edge know-how, where all the value is, in this country.

Q125 Chairman: Box A3 of the Pre-Budget Report discusses the difficulties of estimating the output gap and suggests that if the economy comes out to be nearer full capacity currently than the Treasury thinks the cycle will be declared to have ended earlier than the 2006 which you have currently pencilled in. Since declaring an earlier end to the cycle will make it easier to declare that the Golden Rule has been fulfilled, is this the Treasury making sure it has a way out if the Golden Rule will be missed over the year ending in 2006?

Mr Cunliffe: We have done our best to set out how we have measured the cycle. We have published papers when we dated the cycle as to why, and we have published papers on our methodology, and it is there for everyone to see why we think the cycle will end in 2005–06, probably somewhere between those two years. In Annex A we explain why we think that view still holds. If we change that view and decide that the cycle has ended earlier we would have to have good evidence of that and we would have to show why the evidence for that was very different from the evidence that we have now. At present it remains our view, and I think it will remain our view going forward, but one does not know what happens in the economy. If we move the date of the cycle, if we put it forward or put it back—and if our economic growth forecasts were lower than they are now we would be pushing the date of the cycle back, not bringing it forward—then we will have to justify that in line with what we have published on the methodology and the evidence and we would have to show what has changed, and it would be a professional decision in the same way as the decision to date the cycle and to forecast the end of the cycle have been.

Q126 Mr Fallon: I think you just said that you might expect the cycle now to end at any point during 2005 and 2006. Is that right?

Mr Cunliffe: No, I did not say that. I did say 2005–06. Dating the end of the cycle is difficult enough but precisely saying when it will end to a month is very difficult. We say 2005–06.

Q127 Mr Fallon: As a year?

Mr Cunliffe: As a year, so it is somewhere towards the end of 2005, beginning of 2006.

Q128 Mr Fallon: It is about a year from now when you expect the cycle to end?

Mr Cunliffe: Yes.

Q129 Mr Fallon: And when technically do you make the declaration? As it ends, three months after it ends, or what?

Mr Cunliffe: What we do, and you can see some of this in the PBR, is that we look at capacity indicators, we look at inflation, we look at earnings. We also look at economic growth and how that has performed since the last on-trend point because that gives us our view of the output gap, and we report on those in the PBR. When we get to the point that we think the cycle has ended we will do what we did in 1999–2000, which is to issue a paper on that, but I expect that as we get closer to it you will be able to read in the PBR and Budget documents what our view is, as you can read in this PBR. If our forecast is correct and we hold to it you would expect to see some more information in the Budget which would show how we think spare capacity in the economy is behaving in line with our view, and you would expect to see it again in the PBR on the other side.

Q130 Mr Fallon: That was not quite my question. My question was, when do you declare that it ends? Do you declare it ends as it ends or do you declare two or three months after you think it has ended?

Mr Cunliffe: Unless the economy behaves in a very volatile way you declare that you think it is going to end when you said you thought it was going to end as you get closer to it, and then we would probably use the next Budget or PBR to do the detailed report.

Q131 Chairman: Sorry; I did not understand that. Mr Cunliffe: It is not an approach where there is radio silence from us and then one day we come out and publish a document saying we have decided the cycle has ended. What we are saying is that as we get closer to the date that we think it will end, and as our forecast is confirmed (if it is confirmed), you will see increasing certainty on that forecast coming through the PBR and the Budget. I think we would probably do the analysis of the end of the cycle, and we would probably release that analysis on a Budget or a PBR because that is when we release most of our economic analysis, but as to the view that the
Treasury thought the cycle had now closed, you would have some sense of that outside the PBR and Budget process.

Q132 Mr Beard: Why do you differ from the Bank of England in this in that they say that the economy has returned to trend and the cycle has virtually terminated now?

Mr Cunliffe: First of all, we use a different methodology from the Bank of England and we forecast for a different purpose. They forecast for a month-on-month monetary policy decision. Their view of spare capacity in the economy, if you track it over the last two inflation reports, has changed quite a bit. In the summer they felt there was less spare capacity than they feel now, although they still feel that there is very little in the economy. Their view of the output gap moves around. They do not use the output gap in the way that we do as a central driver of their forecasts. They forecast the individual components from that they derive an output gap and they come back again. There is nothing in the Bank of England’s forecasts that compares directly to what we have put out. That said, you can take different views about the amount of spare capacity in the economy. It is very difficult to observe an output gap; you certainly cannot observe it directly, so you have to look at different factors in the economy. We have looked at survey evidence, which the Bank looks at. We have also looked at inflation and we look at earnings. Then we look at our methodology which is different from the Bank’s, by saying, “When the economy was last on trend and how has it grown since then?”, and that tells us how a gap has developed and I think that is probably the biggest reason for the difference, but you can take different views on these things.

Q133 Chairman: You mentioned the output gap but the Treasury and the MPC seem to be taking very different views of growth prospects and the output gap. Is there a risk that rate rises from the MPC will frustrate your growth forecasts? Is not the acid test for the output from the Bank obvious. If you look at the dating, we dated this cycle of England in this indicator as starting in 1997 because we thought, and if you look at it you can see it on the charts, that the economy completed a cycle between 1997 and 1999. It just dipped down through the trend and came back up again. You could take a different view on that and say that the current cycle started in 1997. It is difficult and it is not something you can observe directly. Nonetheless, if you have a fiscal policy that is based on trying to ensure that over the cycle you borrow only to invest, you have to make some effort at this and you have to explain why you are doing it and you have to allow for some fluctuations in it.

Q134 Angela Eagle: This is a bit like reading runes and entrail gazing. Mr Cunliffe: I think my colleagues in the Treasury will feel there is more to it than runes and tea leaves.

Q135 Anna Eagle: It is fairly obvious. Mr Cunliffe: If you had a very peaky cycle it is fairly obvious. If you look at the dating, we dated this cycle starting in 1999 because we thought, and if you look at it you can see it on the charts, that the economy completed a cycle between 1997 and 1999. It just dipped down through the trend and came back up again. You could take a different view on that and say that the current cycle started in 1997. It is difficult and it is not something you can observe directly. Nonetheless, if you have a fiscal policy that is based on trying to ensure that over the cycle you borrow only to invest, you have to make some effort at this and you have to explain why you are doing it and you have to allow for some fluctuations in it.

Q136 Angela Eagle: But also we have to know that this is not a certain science, is it? This is about runes reading and entrails gazing. Mr Cunliffe: I think my colleagues in the Treasury would feel there is more to it than runes and tea leaves.

Q137 Angela Eagle: It is fairly obvious. Mr Cunliffe: It is reasonably obvious. If you look at the dating, we dated this cycle of England in this indicator as starting in 1997 because we thought, and if you look at it you can see it on the charts, that the economy completed a cycle between 1997 and 1999. It just dipped down through the trend and came back up again. You could take a different view on that and say that the current cycle started in 1997. It is difficult and it is not something you can observe directly. Nonetheless, if you have a fiscal policy that is based on trying to ensure that over the cycle you borrow only to invest, you have to make some effort at this and you have to explain why you are doing it and you have to allow for some fluctuations in it.

Q138 Mr Walter: I would like to move specifically to the Golden Rule. There are an awful lot of commentators who do not think you are going to meet the Golden Rule. Are you going to meet the Golden Rule?

Mr Cunliffe: Yes.

Q139 Mr Walter: You are absolutely certain?

Mr Cunliffe: Yes. We have forecast to meet the Golden Rule.
Q140 Mr Walter: What are the consequences if you do not?
Mr Cunliffe: As I recall the code for fiscal stability, if the Golden Rule is not met then the Chancellor has to explain why it has not been met, but our forecast is that we will meet in this cycle and the next and I see no reason to doubt that.

Q141 Mr Walter: So it is just about credibility? There are no other consequences of not meeting it? It is not like not meeting the Growth and Stability Pact in the EU where you might have to pay a fine?
Mr Cunliffe: We do not fine ourselves, no.

Q142 Mr Walter: Is it just about credibility if you fail to meet it?
Mr Cunliffe: Can I try and answer that question on two levels? Let me answer on what happens if you over-achieve it or under-achieve it, because both are possible. It would depend by what amount, so let us assume we over-achieve the Golden Rule by five billion. People could argue that in economic terms five billion is not very much. It will reduce the debt stock by an extra five billion but is that going to have a big impact on the economy going forward? The economic effect is probably quite small. I have seen a number of the commentators that you have interviewed have said, “Well, it does not really matter because if borrowing is five billion less or five billion more these are not huge amounts, particularly given some of the overshoots we have seen in public finances over the last 30 years”. I can accept that the economic significance of being right or wrong by less than a billion is small. What I would say, though, on the credibility point is that it is very difficult—and a number of countries face this and we have faced this with the Growth and Stability Pact and we face this with the fiscal frameworks—to have a framework in which you allow yourself the flexibility to deal with economic circumstances as they transpire because they never behave as you think from memory the borrowing amount that is being financed out of the surplus and one and a half out of borrowing. If you make assumptions on inflation at around 2% and interest rates being in line with that and economic growth (the economy is on trend here) being at 2.75%—and it drops to 2.5% here actually because of demographics—then you can borrow 1.5% of GDP annually without increasing the debt stock because the economy is growing and interest rates and inflation allow that to happen. I think from memory the borrowing amount that stabilises the debt stock is about 1.9, so I would not expect this to lead to the net debt stock increasing. It would probably stabilise or come down a little bit.

Q143 Mr Walter: I am not quite so concerned about the pure economic terms, although that is obviously significant in the long term in terms of credibility but, having set that target, having put a lot of political capital into having that target, to over-achieve I think everybody would say is jolly good, but to miss it surely dents the credibility of the Treasury quite considerably, does it not?
Mr Cunliffe: First of all, the target is not set up to be over-achieved; the target is set up to be met. That is quite important. To the extent that we over-achieve it is because we build caution in in the ways I have described and we always have, and I think it is important to be clear on that. Secondly, I cannot comment on political capital.

Q144 Mr Walter: Your professional opinion then.
Mr Cunliffe: I think it is important, having set a medium term framework, that that medium term framework is seen to work over the cycle.

Q145 Mr Walter: Can I go on to the sustainable investment rule within that of net debt to GDP? Throughout the forecast period you have got this below 40%, but are the OECD right to suggest that without, in their words, a “spontaneous tax rise”, there is a danger we could move into more difficult territory?
Mr Cunliffe: I have not looked in detail at the OECD forecast but if you look at table B9 on page 204 you can see that what is happening as we go forward in the projections here is that net borrowing is stabilising at about 1.6 or 1.5% of GDP. That is financing part of net investment. Net investment is 2.25% so you could say that by 2009–10 three-quarters of a per cent of GDP’s worth of investment is being financed out of the surplus and one and a half out of borrowing. If you make assumptions on inflation at around 2% and interest rates being in line with that and economic growth (the economy is on trend here) being at 2.75%—and it drops to 2.5% here actually because of demographics—then you can borrow 1.5% of GDP annually without increasing the debt stock because the economy is growing and interest rates and inflation allow that to happen. I think from memory the borrowing amount that stabilises the debt stock is about 1.9, so I would not expect this to lead to the net debt stock increasing. It would probably stabilise or come down a little bit.

Q146 Mr Walter: In percentage terms?
Mr Cunliffe: Yes, as a percentage, as a ratio of GDP, which is how we have set the rule.

Q147 Chairman: You have suggested that significant progress has been made in terms of rebalancing growth, but on your own forecast the two biggest drivers of GDP growth in 2005 will still be private consumption and government spending and the economy will still be running a current account deficit, as you mentioned earlier, of 2.5% of GDP. Rather than rebalancing would it not be fairer to say that the economy has stopped becoming more imbalanced?
Mr Cunliffe: The rebalancing judgment is based not just on what we think is going to happen but what we now think has happened, and this comes partly back to statistics. When I first came before this committee in 2002 the latest data showed that
business investment had reduced by 10.5% over the year. The latest figure for that is that it actually grew by 0.6%. Investment did decline with the economic cycle, so from about 2000–01 business investment did decline, but it did not decline anywhere near as sharply as we thought it had. I think it declined by about 6.75 or 7%. Troughed before it started recovering. At the same time we thought consumption, both real consumption and nominal consumption, was higher than it has turned out to be and so, looking at the past, the revisions have suggested that since 2000 household consumption has grown probably in line with, maybe just a little bit less than, the trend rate of GDP, whereas we thought it was growing a bit faster, and business investment has grown faster than we thought and is now growing at twice the rate of GDP growth. Looking at in the past, the economy is less imbalanced than we thought it was. Going forward, it is important to bear in mind that for all economies the share in the economy of consumption is normally very large, 60–70%, and the share of investment has grown faster than we thought and is now growing at twice the rate of GDP growth. We have it at 2.5% and dropping for 2005 going forward. The rate of growth of business investment we have coming down from nearly 6% this year to about 4.5% next year and 3.5% the year after, but still growing faster than consumption. Over time, if business investment grows faster than consumption the shares in the economy will rebalance.

Q148 Mr Fallon: May we turn to the revenue side and perhaps give Mr Ramsden a chance to shine. Can I first of all ask you about table B11 on page 207 of the PBR? I notice that two years ago in the PBR 2002 social security contributions were listed separately. You have now put them in alongside income tax, in the top line there, “Income tax, NICs and capital gains tax”. Is that an admission finally that national insurance contributions are a tax on income?

Mr Ramsden: I will try and shine but I lost a tooth yesterday. I will try and speak clearly.

Mr Mudie: Was it a wisdom tooth?

Angela Eagle: It does not look like it.

Q149 Chairman: Do not listen to them, Mr Ramsden. Just you settle down and answer the question.

Mr Ramsden: Thank you, Chair. Looking at the presentation in table B11, my understanding is that we have rolled the elements together that are shown in the first line because of some issues that we have had with capital gains tax forecasts and also the apportionment of national insurance contributions in the monthly data that we have been getting, so in terms of making a comparison for the first seven months of the year compared with the last five months of the year we felt that it gave a more comprehensible picture if we put all the numbers in one line.

Q150 Mr Fallon: But national insurance contributions are a tax on income, are they not?

Mr Ramsden: National insurance contributions are part of the contributory system.

Mr Cunliffe: I think they are listed separately in tables B12 and B13.

Q151 Mr Fallon: I am just dealing with table B11 but they are a contribution on income, are they not?

Mr Ramsden: As I explained, we have had problems with the profiling and in order to give as clear and comprehensible a picture as we could in table B11 so that everyone could understand the position to date and what we were forecasting for the remainder of the year, it made sense to put them together although, as Jon has pointed out, in other tables they are shown separately given their specific nature.

Q152 Mr Fallon: Okay. Let us turn to the position about the first seven months of this year. They increased, I am told, by 6.9% in the first seven months and you expect that to increase—this is taxes net and social security contributions—to 7.8% in the last five months. Is not the 6.9% growth for the first seven months pretty strong by historic standards?

Mr Ramsden: The growth of 6.9% in the first seven months is consistent with our forecast which shows a pick-up in receipts relative to GDP in 2004–05. We were always expecting there to be a strong pick-up, particularly from corporation tax, but also to a much lesser extent from income tax. This is the stage in the cycle where you would expect the growth in receipts to be rather stronger than the growth in money GDP.

Q153 Mr Fallon: Even so it is strong by historic standards, is it not?

Mr Ramsden: As you can see, it is consistent with our forecast.

Mr Cunliffe: I do not think it is particularly stronger for that stage of the cycle than it has been in the past.

Q154 Mr Fallon: You now admit in the PBR that the tax and national insurance contributions receipts will undershoot by £3.9 billion. That is your latest forecast, but Professor Spencer told us that he now thinks that the shortfall will be much larger, around six billion. Why do you think he says that?

Mr Ramsden: I would not want to either represent or misrepresent Mr Spencer’s forecast. What I would say about our forecasts and why we are forecasting the undershoot relative to the Budget that we are is because we expect in the last five months of this year to see a particularly strong pick-up in non-North Sea corporation tax receipts but also a particularly strong pick-up in North Sea receipts relative to the first seven months of the year.

Q155 Mr Fallon: And for next year you are predicting a rise in current receipts of 8%. When did we last have a percentage increase of that kind?
Mr Cunliffe: The speed at which we have corporation tax coming back is less than at other points. In the mid eighties and the mid nineties it came back faster. Corporation tax is a very volatile tax that drops quickly and historically has come back quickly.

Q156 Mr Fallon: But you are predicting the highest percentage increase since this government started and I think a higher percentage increase than in both the years of the Stock Market boom.

Mr Cunliffe: I actually think the increase as a share of GDP is less than in the mid eighties. Is that the Stock Market boom?

Q157 Mr Fallon: The two years of the dotcom Stock Market boom.

Mr Cunliffe: Yes. It is a lower increase than 1995–96 by memory, but it is a higher increase than 1996–97 going forward. What one needs to look at is the increase when corporations are coming back up again, so the equivalent year to where we are now would probably be round about the mid nineties.

Q158 Mr Fallon: Looking further ahead to the medium term, you continue to project a very sharp rise in the tax to GDP ratio for the next few years. Why is that?

Mr Ramsden: There are two or three factors that one can point to when looking at the medium term trend in the tax to GDP ratio which is set out in table B14. If I might just add this, the maximum level that we are forecasting for non-North Sea corporation tax as a share of GDP is 3.4%, which is below the level it reached in 1999–2000, which was 3.6%, and quite considerably below the level it reached in 1989–90 of 4%, so that is where we are on corporation tax. On top of that, as we have flagged up in the text, you have got the conventional forecasting assumption on fiscal drag and what we assume about the inflation uprating of allowances, which goes back to policies that were decided in the 1970s and forecasting assumptions for successive governments that follow from that. Then we have got some pick-up, particularly driven by the recovery in equity markets, which is helping to increase the other taxes and royalties line, which is the last of the tax lines. Underpinning these increases over time there are, as well as the economic factors and the forecasting factors I have mentioned, the anti-avoidance policies. There is a package in this PBR, and there have been packages in previous PBRs and Budgets, both on the operational and the policy side which are still working through.

Q159 Mr Fallon: Okay, but, sticking with non-North Sea corporation tax receipts, and let us call them company profits for short, at Budget time you forecast they would grow by 21.5% this year. Now you are saying they are only going to grow by 14% but you are still forecasting that next year they are going to grow by 27.5%.

Mr Ramsden: As you have highlighted there, the growth that we have seen this year has been significant already and we are expecting it to become more significant. The growth rate is not as strong as we were forecasting at the time of the Budget but it was still in double digits. Yes, we are forecasting that the growth rate of overall CT will pick up next year. There will be, as I have said, the financial companies effect, but also the effect of North Sea revenues which have still to come through the system because of the lags. There was a discussion earlier about the fact that the peaks in the economy are less pronounced now generally than in the past, that volatility of cycles has been reduced, but when you look at a tax such as corporation tax, which is driven by profits where there are allowances, both for capital but also for losses, you still have a longer term trend and cycle which shows significant amplitude, so, because we expect that the effect of these losses and allowances will wear off over time, yes, we are forecasting significant growth next year.

Q160 Mr Fallon: Given that you have been wrong this year, you said 21.5% and it has turned out to be 14, and you are saying next year it is going to be 27%, would it not strengthen your credibility if you broke down some of these forecasts, and I know you break them down by sector, for example, between clearing banks and investment banks, so that some of the outside analysts can see how you have built up these forecasts and therefore conclude where you have gone wrong in order to put it right?

Mr Ramsden: As I think this committee has been told in the past, for financial companies excluding life assurance, for life assurance, for non-North Sea industrial and commercial companies and then for North Sea companies we have separate methodological models that drive those forecasts. Because of the way that some of those models are, as I think we published in an academic paper, based on micro-simulation techniques, so that they use samples of those particular groups you are mentioning that could be identified, we do not see those model outputs; those are kept with the Inland Revenue. We see the aggregate models and that is the information that is published but, as we said in a reply to your Budget 2004 report, we are continuing with the Revenue to look at what more we can publish.
Q161 Mr Heathcoat-Amory: I am afraid I am not terribly reassured by what I have heard so far. It might be thought that tax revenues are the one thing that the Treasury does control but we are in the fourth year of revenue undershoot and I think this year is becoming rather serious. Some of us were rather amazed a few Budgets ago when the Chancellor cut corporation tax for small incorporated companies and the Treasury was then amazed when a lot of small companies incorporated to take advantage of that, so he then had to unravel it and try and tax the distributions. This shows a degree of naivety about how business operates which partly explains why you are, year after year, overestimating receipts. Do you think there are perhaps some other factors at work here, that we are reaching the limit of tolerance of some of these taxes, that there is greater avoidance going on here and possibly diminishing returns? After all, if you relentlessly put taxes up eventually you hit a ceiling. Can you say a little bit more about these forecasting errors which I think are becoming chronic?

Mr Cunliffe: Can I make a point on the last point and leave my colleague to answer about avoidance? If you look at our forecasting record, forecasting receipts as a percentage of receipts, it has not changed particularly since this framework was introduced. Over the last 7 or 8 years it has had a bias towards caution and it compares quite favourably with other countries, particularly if you compare ourselves to the US. You can see those comparisons in the end of year fiscal report. The forecasting record is not to my mind out of line with the past or out of line with other countries. In fact, I would say it is probably a little bit better. Corporation tax is a particularly volatile tax. It has come back very sharply. It has surprised on the upside and downside in many cycles, as I recall, and it is a question of looking at how fast profits and taxable profits have come back in the past, looking at what is happening in the economy and trying to take a judgment on the slope of that line. The other point I would make about why it may have been particularly difficult in this cycle to compare that and why the tax might be coming back a little bit more slowly than it has done in previous cycles is that the last cycle and the downturn in 2000-01 was pretty much investment-led. It was led by over-investment in the US and here and it was then led by equity market collapses. In previous cycles, such as the very sharp cycles in the early nineties and in the eighties, they were led much more by household consumption and by the housing market, and maybe we will talk about the difference in this cycle and the last in the housing sense later on. If you have a cycle that is led by investment, by sharp reductions in financial asset prices, you would expect that the way the hit is taken by financial companies, not so much the clearing banks but the investment banks that have a lot of proprietor trading, to be different from what has happened in past cycles. For financial companies this downturn has been sharper than some of the previous ones for precisely that reason, and though it is very difficult to tie these things up because we do not have the data I would expect some of what we are seeing now on losses to be connected to the fact that this is a different cycle. To answer the parts of your question about whether our record has got markedly worse, I do not think it has. Why is the rate of growth of corporation tax not as sharp now as it was in the mid nineties or in the mid eighties; why has it not come back as quickly as it has done in previous cycles? It may have something to do with the nature of the cycle. On avoidance, I will hand over to my colleague.

Q162 Mr Heathcoat-Amory: You have been talking about corporation tax. I did not mention corporation tax. I was talking about general tax revenues and you have fastened on corporation tax. I find it alarming that for four years in a row total tax revenues have undershot.

Mr Cunliffe: A lot of the effect that we saw on income tax was to do with financial company bonuses which are a big part of income tax. They are a big part in changing the effective tax rate, so some of the shortfalls we saw were in that area. They have actually corrected. It is interesting that the bonuses have corrected more than taxable profits, which suggests that the issue is around losses and allowances. The second thing on income tax is that average earnings did not grow as quickly as we thought they would for the given stage of the recovery, and this goes back to the point we were making as to whether something has changed in the economy and the trade-off between our point and inflation has changed.

Q163 Mr Heathcoat-Amory: Do you want to answer the point about possibly increased resistance to tax and additional avoidance and perhaps even evasion? Mr Ramsden: In this PBR, as I said earlier, there was a package of anti-avoidance measures which I think do show in some aspects of them that we are taking (and this is Treasury and Inland Revenue) a more proactive approach, building on the developments that we announced at the Budget with the disclosure rules. I think it is fair to say that in the United Kingdom we did not have some of the anti-avoidance tools that some other countries have. In particular we looked at the US and their disclosure rules and thought that in certain areas, linked to remuneration but also financial products, we could add that tool to our anti-avoidance toolkit. We are already seeing the benefits of that and where we have gone further in this PBR is that we have taken what we have learned in terms of the disclosures on remuneration and introduced not only specific legislation but also making very clear via a government statement our position on future attempts to avoid paying the right amount of tax and NICs on these (financial sector) bonuses. I think more generally what we have done in the PBR is that we published an updated set of indirect tax gaps and the indirect tax strategies that Customs & Excise has been implementing that go with them and again these show the sort of modern approach that we are having to take to deal with a range of behaviours that run from just simple taxpayer error, through avoidance, through increasingly sophisticated avoidance and into the illegal behaviours of evasion.
and fraud. I think the evidence of that document on the indirect tax side is that, particularly if you look at our VAT strategy, for example, there has been a significant reduction in the tax gap, down from 15.8% in 2002-03 to 12.9% in 2003-04 and that is very much on course for the PSA target for the VAT gap. This shows how you can take a modern approach using modern tools and the kind of information that you get from things like both intelligence work but also, more recently, from the disclosure systems that we have introduced and how you can still make real progress in the modern world against avoidance.

Q164 Mr Heathcoat-Amory: What you are doing is you are taking greater powers over avoidance and, indeed, I have never known a budget without anti-avoidance measures in it, but you are meeting a lot more resistance from higher and higher taxes and the collision comes when your revenues come in below forecasts.

Mr Ramsden: On the point about powers, we have been very clear in the legislation which is going to set up a new integrated revenue department that there will be no creep of powers. There are no additional powers through that legislation. We have introduced new legislation in the PBR, but I am not sure that we have done anything in terms of the powers of the two departments in this PBR.

Q165 Mr Heathcoat-Amory: You are not considering a general anti-avoidance clause.

Mr Ramsden: The point the Chancellor made clear in the Budget speech when we announced the disclosure rules was that we had looked at the experience of general anti-avoidance rules, which I think operate in Australia, and that the position was that at this point we felt that the disclosure rules were sufficient. The disclosure rules have only been running for a few months, but they are working well, as I think you have heard in expert evidence. We will continue to keep the position under review. In the area of employee remuneration we have had to go in for a stronger position than I think we have in the past with one exception, by introducing a statement alongside the specific legislation that we are introducing on large bonuses, particularly concentrating in the City. We have introduced a statement that makes clear our intention and objective and that we will backdate any subsequent legislation to the 2 December, PBR day. But we have not done anything in terms of powers that takes us beyond where we already were.

Q166 Mr Heathcoat-Amory: I want to ask you about the macro-economic effects of high taxes. The receipts as a percentage of GDP are relentlessly increasing and will hit 38% in 2007-08 under the forecasts. Do you do any work on the effect on British competitiveness of this increasing tax burden, particularly Mr Cunliffe, with your macro-economic policy? Do you have views on our comparative position in the world, particularly with non-European countries as regards that sort of tax burden and whether it could affect the competition policy which I know is also a responsibility of the Treasury?

Mr Cunliffe: First of all, the ratios that you see and the growth that you see are not out of line with what we have seen in the past. On the question of competitiveness and the UK economy, we are very interested in international competitiveness and our ability to thrive in a world that has the sorts of challenges we were talking about before. Tax is an element of that and one of the reasons why we have resisted, for example, attempts to harmonise tax in the EU is because we believe that a healthy tax competition is a part of that, and our corporation tax rates are quite low compared to a number of EU countries and other countries. What I would say though is that tax is only one part of that equation. Skills, openness, competition, ease of starting a business and regulation are all other reasons which would cause us to thrive in that particular world. So I would not want the tax issue to be seen as the only determinant.

Q167 Mr Heathcoat-Amory: Where would that 38% put us in the world league table of our competitor economies?

Mr Cunliffe: The 38% places us reasonably well in the EU and my guess is it is above the US. Comparing our overall tax take with, say, India or China does not tell us much because those countries are developing countries, China has 200 million people on under a dollar a day, so they are much less developed and their tax take is different as a result. If you look at us against OECD countries, we are certainly lower than Scandinavian countries, we are lower than most Europeans, we are higher than the US and I suspect we would be higher than Japan.

Q168 Mr Heathcoat-Amory: And they are all increasing at the same rate as we are under this table, are they?

Mr Cunliffe: Starting points matter. So if, like the French, you have a tax to GDP ratio which is around 50%, they are decreasing and they are markedly above us. I think the Scandinavian economies run quite high tax to GDP shares and actually their competitiveness does not seem to be affected. I do not think this is a one for one relationship where an increase in tax to GDP share that somehow damages your competitiveness. For economies at a similar stage of development I think it is a much more complicated equation.

Q169 Mr Heathcoat-Amory: You have not quite answered my question. We have got a graph that increases pretty steeply. How would that compare to our main competitors? I am talking about the trend increase.

Mr Cunliffe: I do not know off-hand. I would suspect that some of our competitors who have very high shares, much higher than us, are decreasing them. I know the Germans, who have been above us, have been taking action to reduce the taxation and social insurance burden, but of course that starts from a higher point. So starting points do matter. I think
there are other economies that have considerably higher shares than us that are not reducing them and they seem to be very competitive. It is difficult just to go from this one ratio to competitiveness; you have to look at a range of factors.

Q170 Mr Mudie: I really do not think the Committee should be insulted each year by the way you come and tell us these income figures! We have had a four-year run in with you and officials from Gus O’Donnell down, you have told us every year we are wrong, you are right, you have got the models, but every year you come and you are wrong. Is it not about time you levelled with us or even apologised? I have got the November book here. You were projecting £228 billion, it is now £238 billion, that is £10 billion different. The figures just do not add up. Every year we have annualised your receipts from corporation tax, the lot and we have said they do not make sense, you are just balancing these budgets with paper figures. Each year you come to the Committee and waffle because they are always wrong.

Mr Cunliffe: I can only say to that what I may have said on previous occasions and I hope it is helpful.

Q171 Mr Mudie: And every year we have said your forecasts are not worth the paper they are written on and every year you have looked us in the eye, not you personally but Gus, in a slightly superior way, and said, “Mr Mudie, Mr Fallon, we have the models in the Treasury, this income will come in,” and every year we come back and there is no humility, no apology, no regret, we are wrong and you are right. When does it stop?

Mr Cunliffe: Forecasting does have an error rate around it. You cannot know to the pound a year ahead how much you are going to get in tax or what economic growth is going to be. If you look at the record you will find that in the last 7 or 8 years we have probably never forecasted exactly. There was a period when we were under-forecasting and revenues were coming in much higher than we forecast and now there is a period in which we are under-forecasting, although I would argue the under-forecast has been growing smaller. This is just to do with the limits of what you can do with forecasting.

Q172 Mr Mudie: So you never get them right?

Mr Cunliffe: No, we do not get it right all the time and as a result we have statistical error where you can measure how close we are to getting it right. We are quite open about it, we publish it and it is in the end of year fiscal report. We look at how good we are in this forecast compared to others.

Q173 Mr Mudie: That is almost 5% of your income.

Mr Cunliffe: The error that we publish is the sum of all the errors, so if we are out by a large amount it shows in the error and if we are out by a small amount it shows. We are quite open about how good our forecast is one year ahead or two years ahead.

Q174 Mr Mudie: There are three figures in your Inland Revenue booklet that matter and you have ten years’ figures and you can add all the factors in. We sit here without your computer, without your staff, and we say these figures do not make sense and you say, “Of course they do. We have put this through our model.” There are only three figures and you cannot get three figures right.

Mr Cunliffe: The three figures are the sum of a large number of other figures, each of which is forecast and there is error around that. I really do wish we could predict with 100% accuracy what each particular tax is going to be, but this is forecasting. The tax forecast depends on the economic forecast which has error in it. All we can do is forecast as accurately as we can the models that give you a guide as to what the future will be, but they do not tell you what the future will be any more than the Bank of England can forecast the economy. Forecasts do not give you 100% accuracy. All we can do is forecast with our models and then report to you openly and, I hope, with humility what our error has been over a number of years and how that error compares to others and that is the best that we can deliver.

Q175 Mr Mudie: I am not sure on such a central part of the budget that is an acceptable explanation. Maybe for the Chancellor it is but it is not for this Committee. Every year for the last four years we have said your figures do not make sense and every year we have been proved right.

Mr Cunliffe: For the four years preceding I would hazard that we under-forecast tax revenues. It is an area in which there will always be error.

Q176 Mr Mudie: I just take a dim view when elected Members are treated this way, with such disdain and along the lines of your model is right, so why the hell do we sit here daring to question you.

Mr Cunliffe: I would not claim that any of our models are right in that they can deliver 100% accuracy. If we have given that impression, I apologise.

Q177 Mr Mudie: We know they are not accurate. I wonder why we bother with the books. Bring Gypsy Rose-Lee next year! Let us go on to expenditure. Your current expenditure is up 6.8% for the financial year. You were suggesting growth of 4% which rather suggests you are going to rein things back slightly. Are you content that you are going to do it?

Mr Cunliffe: I think expenditure, the pattern of expenditure and the amount that has been spent in the first half of the year relative to the second is pretty much in line with what has happened in previous years, I do not think there is anything unusual there, but my colleague, Mr Stephens, can go into the detail.

Mr Stephens: Yes, we are basically expecting our plans as set out to be met. There have been some changes in the profiling of spending; over the year, the introduction of accruals-based accounting, the greater impact of end-year flexibility, which means that one would expect a smoother progression of spending through the year. We are about 58% of the
way through the year and we are about 58% of the budget spent so far. So we expect to meet our plans as set out.

Q178 Mr Mudie: You start on B75, page 218, with monthly spending outturn information that is only available for Central Government and then you say that current expenditure is up 6.8%. What percentage of the expenditure would you define as Central Government?

Mr Stephens: I think I would have to write to you another to get away from the analysed cycle, the end year surges which we all know did not lead to generally good value for money spending. This is a matter of balancing the clear advantages in terms of the management and delivery of public services, in giving departments the freedom within budgetary controls to re-profile spending from one year to another to get away from the analysed cycle, the end year surges which we all know did not lead to generally good value for money spending. This is a matter of balancing the clear advantages in terms of the management and delivery of public services with the sort of issues that you highlight. This is something that we keep under regular review. We are watching as the stock rises.

Mr Mudie: I accept that. What one has to consider with a cap is whether departments spend up to that cap.

Q180 Mr Mudie: You were introducing reforms to encourage the levelling of spending. Can you give us two or three examples and tell us how they have worked?

Mr Stephens: Those reforms involve long-term spending plans, greater certainty over the long term to enable better planning of expenditure, the move to resource accounting and budgeting and the production of 100% end-year flexibility so that departments and others are able to carry over any unspent budget from one year to the next.

Q181 Mr Mudie: The House of Commons Scrutiny Unit estimates that the remaining stock of end-year flexibility amounts to £9 billion. There is some worry that if the departments had spent that in the last two years it would have an adverse effect on you meeting the golden rule. Would you care to comment?

Mr Stephens: The figure I have is about £8.8 billion, just very slightly less. That stock has risen in a number of successive years. It rose by £1.9 billion last year, £0.5 of a billion the year before and £2.2 billion the year before that. From the introduction of end-year flexibility we see a pattern of continual increases. You would expect, having introduced end-year flexibility, that departments will want to operate with a certain level of stock in order to maximise their flexibility and freedom over the operation of their budget. I think the prospect of the £8.8 billion being drawn down in totality is remote and indeed the pattern over the past five years has been of the stock building up.

Q182 Mr Mudie: So you are not tempted to cap it, to level it in any way, because if you are building up to almost £9 billion, it is a fair bit of uncertainty being pushed forward and putting you at the mercy of spending departments. Do you not have any unease about that?

Mr Stephens: There are clear advantages, in terms of good management of public services and the delivery of public services with the sort of issues that you highlight. This is something that we keep under regular review. We are watching as the stock rises. We will keep that under review. One also has, of course, to consider the incentive effects on departments.

Q183 Mr Mudie: I accept that.

Q184 Mr Mudie: It is a question of balances. If departments have got £9 billion of money that they are carrying forward, does anyone at any stage in the exercise look at what is being carried forward? It can be very, very important if they are carrying that amount forward. I would be tempted to have a look at it to see what was genuinely sensible and what is just money that is floating about in the department looking for a reason to be spent.

Mr Stephens: We do keep it under close monitoring. We publish the available totals.

Q185 Mr Mudie: Do you ever take any back?

Mr Stephens: Yes, we do. It is a factor that can be taken into account in spending reviews and has been taken into account in spending reviews. It is also a factor that can be taken into account when, for example, a department comes with a reserve claim or a new item of spending which otherwise they might look for more central funding for and we quite frequently examine the state of end-year flexibility to see whether they can absorb it within their flexibilities.

Q186 Mr Mudie: I would be happy with that answer if you indicated in the spending review document that this £9 billion was in some way affected by the spending review that had come down to £7 billion or £5 billion because you had taken stuff out and put it back in a different way. Is there any way a Public Accounts Committee or a Treasury Committee could pick that up because otherwise that could just be words you are using?

Mr Stephens: We do publish annually the available stock of end-year flexibility by departments, so one can see the changes in the stock.
Q187 Mr Mudie: Where do you publish that?

Mr Stephens: In the outturn White Paper. There are different ways in which we can take this into account in the spending review. One does not only have to reduce the EYF stock, one can reduce the allocations to the department.

Q188 Mr Mudie: Let us go back to forecasting investment levels by government departments. In the Pre-Budget Report 2002–03 you were going for a 30% increase in investment, in the Budget this year it was down to 17 and in the Pre-Budget it was down to 15. What on earth is happening? You have come from 30% down to 15%. What is happening with these departments?

Mr Stephens: I think you are talking about investment in 2003–04 and it is worth pointing out that we are still looking at a 21% increase in overall public net investment.

Q189 Mr Mudie: You were looking at over 30%.

Mr Stephens: That is quite correct. Our forecast over public sector net investment has come down by about £2.5 billion overall. Most of that is actually lower investment outside of Central Government by public corporations and local authorities.

Q190 Mr Mudie: I am not sure about that. I would like you to give us the figures because when I look at the amount of capital expenditure in the book I would be surprised if they could have that effect by pulling back their spending, but I am happy to get figures from you on that. In the Budget book, when we come to this stage in the proceedings, you then go on to outline the state of play of the PFI finances, but this is noticeably lacking in the Pre-Budget report book. Is there a reason for that?

Mr Stephens: I do not think so. There is some reference to the mix of how investment is made up. In chapter 6 there is a chart, 6.1, and an accompanying paragraph, paragraph 6.3.

Q191 Mr Mudie: I looked at the Budget book and it is spelt out “signed deals”, “deals in negotiation” etcetera, in a fairly extensively way, but that is noticeably lacking in the Pre-Budget Report. Why do you take the PFI out of the Pre-Budget Report?

Mr Stephens: We have not covered that sort of detail before in the Pre-Budget Report. With investment, I am not sure that looking at it on a six monthly and twice a year basis will tell you an awful lot more, but we are committed to publishing that sort of information regularly.

Q192 Mr Mudie: How much compared to the capital budget is PFI?

Mr Stephens: PFI is a relatively small proportion of the overall sum, about 10% or so.

Q193 Mr Mudie: It is no great hardship to include the same figures in the Pre-Budget Report because it lets us know where you are. When you put something in the book I always think it matters, there is a reason for it. There is reference on two occasions to the NHS trusts moving from public corporations to government expenditure. When I look at the expenditure tables I do not see any violent changes to suggest that matters. What is the expenditure of the trusts, approximately?

Mr Stephens: I do not know the expenditure of the trusts offhand. I can write to let you know that.

Mr Cunliffe: The offset to expenditure will come in under the Department of Health. So when they were classified outside the public sector, they were payments from the Department of Health to trusts. Now they are classified inside. It is about the taxable income. So the taxable income of the trusts has gone but, on the other hand, that amount of the payment to the trusts for the Department of Health who has to pay the tax has also gone.

Mr Stephens: Paragraph B68 suggests that this change has reduced both current expenditure and receipts by about £1.5 billion.

Q194 Mr Mudie: It suggests it balances out. Therefore, if I am looking for National Health Service expenditure, do I look in the Department of Health and the NHS?

Mr Stephens: Yes.

Q195 Angela Eagle: Why are local authorities so bad at spending the allocations that have been given to them in this period of expanding public service investment? What I am trying to find out is, is it rules that you have put into place and hoops they have to jump through that are holding them up or is it just that they have got out of the habit of investing very much and they are just not used to it?

Mr Stephens: This is a matter for local authorities; we do not control that directly. Investment is expanding very significantly as a matter of conscious policy decision and investment by local authorities along with other elements of Central Government public corporations is still expanding significantly. In the context of achieving the sort of expansion that the Government is committed to we do also want to ensure that the quality of investment and the quality of investment decisions is maintained as well as the quantity, and if indeed people are taking a bit longer to be sure of the quality of decisions but still planning to invest in due course we would not object to that.

Q196 Angela Eagle: Is this what the end-year flexibility changes are about, and do they apply to local authorities?

Mr Stephens: Local authorities do have flexibility to re-profile their spending and we are increasing their flexibility with proposals to delegate three year budgets reflecting the three year spending settlements on which I believe the ODPM will be consulting shortly.

Q197 Angela Eagle: How are you getting on with measuring the effectiveness of public service investment and output because clearly it is very...
difficult to define and some of our definitions of this are very, very out-of-date and even paradoxical in their effect?

**Mr Stephens:** This is an issue, as you know, where Len Cooke, the national statistician, set up the Atkinson review for exactly that purpose. They published an interim report in the summer, I think they are planning to publish a final report in due course early next year and that has resulted already in some significant improvements in the coverage and quality of data, for example, in respect of health outputs. I think the Atkinson interim report points up in a number of other areas, including in education, in criminal justice, a significant programme of work going forward for the statisticians to improve the coverage and quality of data. I think it is worth noting that there are significant problems in measuring some elements of public sector output, problems that are well recognised and faced internationally, and even with the conclusion of the programme of work set out in the Atkinson report there will be significant areas of public sector output which are not covered and, indeed, some significant objectives of the Government and outcomes which the Government seeks to achieve in terms of the distribution of public expenditure and in terms of improvements in the quality of public services that are inherently very difficult indeed to measure.

**Q198 Angela Eagle:** I want to take you on to the labour market. There is some puzzlement in the MPC and at the Bank of England as to why average earnings are not growing faster given that we have what, in previous eras, would have been defined as quite a tight labour market with very high levels of participation and an extra two million jobs. Does anyone have a view on what is actually going on?

**Mr Cunliffe:** Lots of people have views on what might be going on. With all these things, you will not know until some time after it has finished what has been happening. I think there are a number of elements here. When you say we have a very tight labour market, I am not sure I would agree with that. We have more people in employment than we have ever had before, but that is partly to do with the demographics and it is because we have less people in unemployment. If you look at recruitment surveys, some show a tight labour market, some show there is some slack there and the picture is quite difficult to read as to whether the labour market is tight or not. There could be a number of reasons why the labour market can operate at this level and not see an increase in average earnings. One might be that there is some slack there. A lot of people have drawn attention to immigration and particularly immigration from the accession countries of the EU, where people can come in now and work as a way of relieving supply side constraints in the economy and there probably is something in that. The workforce coming in in that way has actually increased the supply side potential and that has kept average earnings down. Some of it might be to do with just the greater perception of external competitive pressure and the need to compete and compete internationally is more clear now with all the attention there has been on outsourcing and off-shoring and the like and that is holding it down. It could be that the part-time labour force, which is linked to the point about immigration, is influencing the NAIRU, the rate of unemployment at which inflation is stabilised.

**Q199 Angela Eagle:** It is the last remaining pillar of monetarism really that!

**Mr Cunliffe:** It is a concept which I think is intuitive that there are levels of unemployment where the market is very tight which cause wage inflation and then price inflation to accelerate, but that level has dropped and my own view is that it is probably a combination of all those things.

**Q200 Angela Eagle:** It appears from the Government’s policy particularly on labour market flexibility (I am thinking about the 10-year childcare strategy) that the view is that there is still more capacity and more potential to be had out of the labour market because surely the childcare things, the tax accounts and enabling people have not traditionally been able to work to get back into the labour market, indicates that we are quite relaxed about the possible effects on earnings.

**Mr Cunliffe:** My colleague, Mr Holgate, might want to say something on that. There is still a stock of labour to come into the workforce, eg single parents where the New Deal for single parents has clearly had an effect and then the whole disability area and the effect that these pilots, which are described in the PPI, have had. So there are some workers which could still be brought in and I think the participation in the labour market and the participation figure, which has been, through the inactivity figure, fairly flat for a while, could improve.

**Mr Holgate:** Lone parent employment has risen from 45% to 54%. We have an ambition to get it to 70% by 2010. We know that something approaching maybe 90% of those on sickness and disability benefits would like to work and, as Jon says, the Pathways to work pilots are the first significant evidence we have that we can manage a combined series of interventions to help them to get back into work quicker than they otherwise would have done. Third, I would mention older workers. The employment rate there has risen and it is very important that it carries on rising from the point of view of people being able to provide for their own retirement. The employment rate amongst ethnic minorities has shown a small but favourable closing of the gap with that of the rest of the population, but there is quite a long way to go there.

**Q201 Angela Eagle:** Maybe some of this needs to be bolstered by protections and rights given to prevent discrimination in the labour market. If we want people to come into the labour market, say if they are ethnic minorities, and there is obvious evidence of discrimination, we do need to get some protections to them to enable them to participate in a fair and equal way.
Mr Holgate: Yes, that is absolutely right. As you know, the provisions of the Disability Discrimination Act are coming in stage by stage and another stage came in recently. We mention in chapter 4 of the PBR that the Chancellor has asked the National Employment Panel and others to look again at what could be done to help with discrimination against ethnic minorities.

Q202 Mr Heathcoat-Amory: There is one very large item of public expenditure, pensions, the treatment of which I find a little bit inconsistent. The private sector has to use FRS 17 to compute its liabilities. You do this for resource accounting purposes. Then there is a very large adjustment, for next year it is £23 billion, to reduce that liability for national accounting purposes and for the calculation of whether we have met the golden rule and so on, so it is very convenient for the Treasury to make that adjustment. I am puzzled as to why you are not consistent and do yourselves what you require the public sector to do on this item of expenditure.

Mr Cunliffe: We base fiscal policy and economic policy on national accounts data and that is the norm. The national accounts data is set for us by the European system of accounts which is in turn based on the UN system of accounts. There is an internationally agreed set of statistical standards against which countries report and manage macro-economic policy. There is also a set of accounting standards which apply to the private sector and which increasingly the public sector is trying to adopt that are generally accepted accounting principles, but accountants and economists, because they look at things for different purposes, will often value them or deal with them in different ways. There is a whole range of areas where the accounting treatment and the internationally agreed statistical treatment are different, not because people are taking different views of the same thing, but because they are designed to do different things. It is no surprise that we run fiscal policy in line with internationally accepted statistical standards and I think we would be criticised if we did not, and it is no surprise to me that the way in which statisticians put together you get the answer you first thought of.

Mr Holgate: When we noted that the temporary increases in the cash and share ISAs were coming to an end in April 2006 people did comment at the time and I have the Committee’s recommendation here and, as you say, reductions in those limits appear to run counter to a policy of encouraging people to save. But the fact is that we have until April 2006 and it is just possible that when one announces something in one way, people with an interest running against that presumption speak up and there may conceivably be other parties who have an alternative point of view. So being explicit that we do this issue for another consultation when clearly the answers are plain to a blind baby?

Q203 Angela Eagle: On the international front it does not surprise me at all that governments everywhere try and hide their liabilities. To hide behind the internationally agreed standards does not impress me. Surely we ought to take a lead here and the British Government, if it believes in openness and transparency, ought to include all its liabilities, and pensions is a big one, in assessing its international balance sheet and presenting the overall fiscal picture.

Mr Cunliffe: Certainly to us international standards for statistics are not, as far as I am concerned, a way to hide anything; they are a way in which statisticians look at a number of economic variables and report on them, which are quite rigorous. They are different to what accounts do but that is because they are done for different purposes.

Q204 Mr Beard: I want to follow up on the point that Angela Eagle was making very briefly, where she was saying with so many people employed why is the savings ratio not picking up better than it is. In talking about retaining the higher level limit on the cash ISAs you say you are going to consult on the issue. There is a wealth of information on this. This Committee did not believe it was a good idea to lower the ceiling on cash ISAs, the consumer associations were united on the issue and many other people were at the same time. Why have we got to delay this issue for another consultation when clearly the answers are plain to be a blind baby?

Mr Holgate: When we noted that the temporary increases in the cash and share ISAs were coming to an end in April 2006 people did comment at the time and I have the Committee’s recommendation here and, as you say, reductions in those limits appear to run counter to a policy of encouraging people to save. But the fact is that we have until April 2006 and it is just possible that when one announces something in one way, people with an interest running against that presumption speak up and there may conceivably be other parties who have an alternative point of view. So being explicit that we do this issue for another consultation when clearly the answers are plain to a blind baby?

Q205 Mr Beard: It sounds a bit like consulting until you get the answer you first thought of.

Mr Holgate: I think if we talk about consultation then we have to have an open mind on the subject. We do note that, so far as I have heard people responding, including the Committee, there is a very heavy weight on the side of retaining the ISA limits where they currently are.

Mr Stephens: There are a number of differences in treatment between the two different accounting approaches. Some of them work one way, some work the other way and I think to pick one out in particular and focus on that exclusively does not paint a complete picture. For example, in national accounts single use fighting equipment scores as current spending whereas the accepted treatment under GAAP rules is to count it as capital investment and that obviously is quite a significant element, for example, of the defence budget.

Q206 Mr Beard: In encouraging savings like this why does national savings not have a more important role?

Mr Holgate: The policy on national savings is that they are there to help fund the Government’s deficit in as cost effective a way as possible. They do very successfully sell products even under that constraint and for the rest I think we have a financial services industry that, quite rightly and effectively, competes to see whether it can attract people’s savings.
Q207 Mr Beard: Moving to efficiency savings, you note in the Pre-Budget Report that “since the 2004 Spending Review there has been good progress both by departments in delivering efficiencies and in cross-government action to support efficiency.” How are you monitoring this progress, and how much has been saved so far as a result of the efficiency savings that have been “delivered”? 

Mr Stephens: This was the programme that was set out in the Spending Review 2004 which was primarily focused, of course, on the spending review years which only really start in April 2005, but Box 6.1, p123, in the Pre-Budget Report sets out a number of examples and areas in which departments are already making efficiency savings whether as a result of procurement savings, for example the Department of Health cutting £370 million as a result of a renegotiation of prices with the drugs industry, or reducing workforce numbers, for example the Department for Work and Pensions has already reduced numbers by over 6,000, and other examples. In the Efficiency Technical Notes which departments published at the end of October they set out how they plan to measure progress against their efficiency targets.

Q208 Mr Beard: How are these savings being reflected in the tables that are representing nominal expenditure?

Mr Stephens: We always set out from the beginning that these were not cuts to departmental budgets, they were genuine efficiency savings which were then available for re-allocation by departments to front-line services. So the efficiency savings were not assumed in the arithmetic of the Spending Review 2004 and so did not affect the departmental expenditure limits.

Q209 Mr Beard: Even so, it represents new spending by the department. Should they not be reflected in some way in the income expenditure tables in future given the role that they have got?

Mr Stephens: What it reflects is a re-allocation of spending from activities focused on headquarters, central services, administration, to front-line public services. So it is a re-allocation of priorities within the departmental budget.

Q210 Mr Beard: I understand that. There has been great emphasis on this as being the means by which you can balance the books and put money into the NHS and other departments. We are not getting any reflection of this in the main documentation that indicates Government income and expenditure.

Mr Stephens: Just to emphasise, this has not been assumed or taken into account in the arithmetic of expenditure limits or, for example, in the calculation of the golden rule. It is our intention that departments will report regularly against the efficiency targets that they have and demonstrate progress against those targets in, for example, their departmental reports and from that it will be possible to see the amounts that are being saved, the numbers of posts that are being reduced and therefore the amount of savings that are available for re-allocation to the front line.

Q211 Mr Beard: There is a certain amount of cynicism about this exercise in dismissing these savings as ‘fairy gold’, they should not enter in because they are ephemeral. Would that not be offset if you were publishing a table in here at least saying what the savings are and what they are projected to be over the period?

Mr Stephens: We did indeed do that in the Spending Review 2004 when we set out a programme allocated across different departments for savings amounting to more than £21 billion a year by 2007–08 and it is our intention for departments to report progress against those targets.

Q212 Mr Beard: And those will be published?

Mr Stephens: Yes, in departments’ reports.

Q213 Mr Beard: But in the Pre-Budget reviews or the Budget?

Mr Stephens: We are already attempting, although the programme has not properly got under way before the start of the 2004 Spending Review period, to set out in chapter 6 the early start against that efficiency programme and we aim and fully expect that in future publications we will continue to report on that.

Q214 Mr Beard: To report progress?

Mr Stephens: Yes.

Q215 Mr Beard: When we took evidence on the spending review in July we were told that the Efficiency Technical Notes setting out how the efficiency savings were going to be achieved and measured had not been published because they were to be scrutinised by the National Audit Office and the Audit Commission first. The published notes do not appear to contain any reference to having been scrutinised by the National Audit Office. Are they “audited Efficiency Technical Notes” in the same way there are “audited budget assumptions”?

Mr Stephens: They have been through the same process as we have used and has been well established for some years now on their equivalent public service agreement Technical Notes in which the underlying methodology and data quality are considered by the NAO and the Audit Commission and that was the process that was gone through before the publication at the end of October.

Q216 Mr Beard: Why is that not said? Given their importance, why have you not asked the NAO to produce a written report on the Technical Notes as you do the Budget assumptions?

Mr Stephens: As I say, the directly comparable set of Technical Notes is those that have been used for the Government’s delivery targets set out in the public service agreements. There is now a well established procedure in which the NAO and the Audit
Commission scrutinise those documents and the measurement proposals in advance of publication and that is the process that was gone through.

Q217 Mr Beard: Given that all of this was central to the Chancellor’s Budget, why are you not publishing a note in the same way as you do for Budget assumptions? Just saying you have never done it in the past is not really an answer.

Mr Stephens: We have published and Departments have published Efficiency Technical Notes in their proposals and those have been through a process of scrutiny by the National Audit Office. If you like, I am very happy to write to set out and explain the process.

Q218 Mr Beard: I would be grateful for that, but I think in future it would be beneficial, if the National Audit Office is going to pronounce on these, if they were published with the notes, not just for me but for general consumption. In a Written Answer this week given by the Financial Secretary you note that the National Audit Office and the Audit Commission provided advice on the draft Technical Notes but they were not asked to sign off the content of Notes. What does that mean?

Mr Stephens: Again, it is the same process as we went through for the technical notes on PSA delivery. The NAO scrutinise these for the underlying methodology and for the data sources that are being used. It is not, of course, their responsibility to sign off on individual targets or proposals as to how departments intend to meet individual targets.

Q219 Mr Beard: So the process is comparable with the scrutiny of the Budget assumptions?

Mr Stephens: I am sorry, I am not fully familiar with that process of scrutiny so I do not want to make a direct comparison. What it is directly comparable with is the process of scrutiny that the Government’s outcome targets in public service agreements go through.

Q220 Mr Beard: The Technical Notes do seem to vary quite considerably in quality and detail. For instance, the Department for Education and Skills’ note is quite a thick document, it is 55 pages and it covers programmes and details down to providing white-boards in schools, whereas this one is for the Home Office and it is three pages and provides little more detail than the original Gershon report. Why is the quality and detail of these notes so variable? Have they not had any guidelines as to what is expected? The other notes are some way in between. Has there not been any guidance as to what is expected to be produced as these Technical Notes?

Mr Stephens: There has been guidance. The production of the notes is the responsibility of individual Departments within that guidance and we ensure that they go through the scrutiny process that I have outlined.

Q221 Mr Beard: Has the National Audit Office been satisfied that the Home Office technical Note met the agreed criteria?

Mr Stephens: All the published notes have been through the scrutiny process that I have discussed.

Q222 Mr Beard: It does not say very much for it then, does it? This is no progress from the Gershon report and there is a vast difference in detail in all these papers. How are you going to get some sort of commonality? I think it is appropriate that the Department should use these themselves, but surely they should produce them according to some sort of template or scheme.

Mr Stephens: We have set out the general requirements that they are expected to meet. Departments can legitimately take different approaches. Although the number of departments have taken the approach of setting out in some detail some of their plans for delivering on efficiency savings, the underlying purpose of these notes is not so much actually to set out detailed delivery plans but to set out how the high level targets will be measured and how performance will be reported against that.

Q223 Mr Beard: Does that include just a straight copy of the Gershon report?

Mr Stephens: No.

Q224 Mr Beard: That is what this is virtually, this is the Home Office’s report. How does that fall within that criterion?

Mr Stephens: I am not in a position to answer.

Q225 Chairman: Could you look at it for us and write back?

Mr Stephens: Yes.

Q226 Mr Beard: The Financial Times and the CBI described the efficiency plans as “confusing and vague” and noted that some changes in policy “are being dressed up as efficiency gains and could impact on front-line services.” For instance, the MoD’s efficiency programme includes savings from cutting the number of attack submarines from 10 to 8. Why is this considered to be an efficiency saving?

Mr Stephens: I am not in a position to comment in detail on the individual plans of individual departments, but the overall programme does the number of attack submarines from 10 to 8, spending front areas that are less well directed to achieving the outputs and outcomes that the Government is committed to, to areas that are more effective in achieving that and that is, as the Gershon report sets out, a legitimate area of efficiency saving.

Q227 Mr Beard: One of the definitions of efficiency savings set out in the Gershon report is reducing inputs whilst maintaining the same level of service provision. Which definition of efficiency does this
Q233 Chairman: Okay. On council tax, the Chancellor announced a total of £1 billion for local authorities to reduce the pressure for further rises in council tax. How much of this amount is new money?

Mr Stephens: There is £125 million of additional expenditure plus £25 million of Barnett consequentials, consequentials from the devolved administrations.

Q234 Chairman: How much would, say, Scotland get of that?

Mr Stephens: I do not know the breakdown of that £25 million offhand but we can let you know.7

Chairman: By Thursday.

Q235 Mr Fallon: On this, we had the Comprehensive Spending Review back in July planning expenditure for the next three years and suddenly in the PBR we have this announcement of £512 million being reallocated, why? If you had already planned it for the next three years, why do you suddenly have to reallocate half a billion?

Mr Stephens: The original plans for 2005–06 were first drawn up in the 2002 Spending Review and the approach that we took for the 2004 Spending Review was not to reopen the 2005–06 plans which had been set already. It would have been inappropriate in that context to have reopened this particular area of those plans.

Q236 Mr Fallon: It turned out then you had to have a whip round around Whitehall, did you not? The Department for Education had to scrap the grant it was going to give as a result of the Victoria Climbie case, the Department of Health had to find another £100 million. Is that true or not?

Mr Stephens: What we are dealing with here is the delivery of public services through a mix of central and local authority led programmes and all the main delivery departments—Health, Education, those dealing with criminal justice, Transport—are delivering their programmes and their outputs through a mix of central programmes, centrally funded, and funding for local authorities to deliver local authority programmes. What has happened here, as indeed happens in advance of each local government finance settlement, is that the balance between local and central funding is reviewed. Departments collectively work together to look at the likely pressures on local authorities. A range of measures were taken, some to reduce those pressures, some to reallocate spending from central programmes to local authority programmes, and the additional new money that I have indicated was put in also. But at the end of the day this is all directed to achieving the same delivery of public services that...
the Government is committed to. It is a sensible review of a particular part of the delivery chain that it makes sense to put the resources down.

**Mr Fallon:** It sounds like a whip round to me.

**Q237 Chairman:** On the taxation aspect, originally why was it considered necessary to introduce major changes to a complex area within the taxation of insurance companies with just three working days' consultation and via a statutory instrument?

**Mr Holgate:** This is to do with applying proper rates of Corporation Tax to life companies' surplus assets. I think the Financial Secretary has now agreed that the proposal be in the Finance Bill but still with effect from 1 January 2005. We have given the industry more time to consider proposals.

**Q238 Chairman:** Three working days was not very satisfactory, was it?  
**Mr Holgate:** I think the people concerned had known about it for quite a while.

**Q239 Chairman:** Was it satisfactory?  
**Mr Holgate:** Well, we have—

**Q240 Chairman:**—allowed more time.

**Q241 Chairman:** You have learned from your mistake. Okay. On that, while the decision to hold further consultations on the changes to life office taxation seems to have been communicated to some in the industry on 9 December, the Inland Revenue website continued to indicate on 13 December that the consultation period had expired on 8 December and no press release detailing the changed consultation period was listed. If the consultation process is to be seen to be effective, should you not have made greater efforts to communicate widely the changes in the timetable?

**Mr Holgate:** I agree that the Inland Revenue website should have given the date as soon as the Financial Secretary had indicated that it would be in the Finance Bill.

**Q242 Chairman:** Last one: Financial Inclusion Taskforce, where will they be located within Government and with what ministerial input?

**Mr Holgate:** I think it will be held jointly between the Treasury and the DTI. The Treasury has taken a lead in terms of certain aspects of financial inclusion but it is the DTI, of course, that is piloting the Consumer Credit Bill and has also published an indebtedness policy.

**Q243 Chairman:** A joint ministerial input?

**Mr Holgate:** I am sure ministers from both departments will be contributing to the taskforce separately.

**Mr Mudie:** When are you going to set it up? While we are talking about it, surely if you have decided to set it up, it should be set up. When are we talking about? We have been 7 years in Government, and that is a disgraceful paper reflecting 7 years in Government. When are we setting this up?

**Q244 Chairman:** You have not been 7 years in Government, you have been there forever.

**Mr Holgate:** I am sure we will be setting up as soon as we can.

**Q245 Mr Mudie:** What does that mean?

**Mr Holgate:** For hundreds of thousands of people.

**Q246 Mr Mudie:** For whom?

**Q247 Mr Mudie:** There are 2.8 million people without them, is that not in the report?

**Mr Holgate:** As we say, and that is why—

**Q248 Mr Mudie:** 2.8 million after 7 years.

**Mr Holgate:** You have got to ask where they were some time ago. I think the number may have come down but it has proved a very intractable problem, it is fair to say.

**Q249 Chairman:** The last question: how is the £182 million planned for the Financial Inclusion Fund to be broken down over the three years from 2005–06 to 2007–08? What is the envisaged breakdown between the different initiatives it is designed to support and how does that affect the devolved governments?

**Mr Holgate:** I cannot answer the question about devolved governments, I apologise for that.

**Q250 Chairman:** Could you tell us on Thursday.

**Mr Holgate:** We will find out for you. In terms of the breakdown between the three strands, I think that the largest element will probably be the face-to-face money advice.

**Chairman:** Okay. The notes we have asked for, if we can get them before Thursday, it will be very helpful. Okay? Can I thank you for your time and we look forward to seeing you again on Thursday.
Wednesday 16 December 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 James Plaskitt
Mr Robert Walter

Witnesses: Rt Hon Gordon Brown, a Member of the House, Chancellor of the Exchequer, Mr Jon Cunliffe, Managing Director, Macroeconomic Policy & International Finance, Mr Nicholas Macpherson, Managing Director, Budget & Public Finances, Mr Jonathan Stephens, Managing Director, Public Services, Mr Michael Ellam, Director, Policy & Planning, and Mr Dave Ramsden, Director, Tax & Budget, HM Treasury, examined.

Q251 Chairman: Chancellor, welcome to you and your colleagues this morning. Can you introduce them, please, for the shorthand writer.

Mr Brown: Yes. It is Mr Ramsden, Mr Macpherson, Mr Ellam, Mr Cunliffe and Mr Stephens. I think they have been before the Committee in the course of the last few days when you were doing the preliminary assessment of the Pre-Budget Report and so we have people representing the tax budget, spending and macroeconomic divisions.

Q252 Chairman: Thank you. Chancellor, your Pre-Budget Report states quite proudly that UK GDP has now grown for 49 consecutive quarters, a record-beating performance. This will remind many people of Arsenal’s fate when they went 49 games without defeat but then were defeated in the fiftieth game and they are now 5 points adrift from the top of the league. Is this going to happen to you?

Mr Brown: No, because we are confident about the fiftieth quarter as well. I think you will be able to see the results very soon. We are also confident about the position moving forward, which is that with a low inflation environment we are capable of growing over the course of the next year as well.

Q253 Chairman: What steps are you taking to ensure that the UK economy responds positively to the challenges posed by growing globalisation of the world economy?

Mr Brown: The whole basis of the Pre-Budget Report, as many of you will have been able to analyse, is not simply to look at the economy as it is this year but to look at all the changes that are taking place, particularly the rise of Asia, but probably as important are the changing technological pressures that are placed upon British industry and British services. Clearly we have moved from a position where 10% of manufactured exports were produced from the developing countries to a position now where 25% of manufactured exports are produced from China, India, the rest of Asia, and other developing economies. According to all the independent estimates, it will rise over the next 20 years to 50% and that creates an enormous pressure on the advanced industrial economies which have been producing most of the manufactured goods of the world for nearly two centuries. It is therefore incumbent upon us to upgrade, to move into the high value added areas, to move into the technology-led processes and that is why there is so much of an emphasis in this Pre-Budget Report on science and skills and education, the fact that we are better equipped to be in the vanguard of the new technologies for the future, and, secondly, on enterprise, because so many of the new businesses are going to be small businesses that are creating jobs. On trade, I do point out in the Pre-Budget Report that only 1% of our exports go to India, only 1% go to China and yet these are two of the fastest growing economies in the world. The emphasis of the Pre-Budget Report is that in order to face up to these long-term challenges we have long-term choices that we have to make as well and that is why there was so much extra investment in education and skills, so much extra weight to our science framework and why I announced a number of small measures for small businesses and for trade.

Q254 Chairman: You recently emphasised your personal commitment to doing more in 2005 to tackle the problem of world poverty. In the PBR you placed this ahead of the UK’s agenda for its leadership of the G7 and EU next year. How much support do you think there is still internationally for your proposals and is there any sign of the US in particular taking a more active role? When the Committee went to the United States last year and we spoke to John Taylor at the Treasury we felt that in Capitol Hill there was not much enthusiasm for your IMF proposals.

Mr Brown: I am pleased you have raised this because this afternoon I am going to America to meet the IMF, the World Bank, the United Nations, the American administration and the Chairman of the Federal Reserve, Alan Greenspan. In the course of the meetings over the next few days we will be looking at the handover of the G8 and G7 presidencies from the Americans to Britain, who will be chairing these meetings from the beginning of next year, and we will be discussing not only the agenda for growth in the world economy but also how much progress we can make on 3 specific areas. The first is on debt relief itself because, as many of
you know, while 100% bilateral debt relief was offered, we have still to deal with the issue of multilateral debt relief and in some of the poorest countries 50% of the debts are owed to the World Bank or the IMF or to the African Development Bank. So we have a proposal to unlock up to 100% debt relief from the multilateral institutions. We have put forward our own suggestions about how it might be done by action on IMF gold and by repatriating to the donor countries, that is to Britain and other countries that are donor countries to the World Bank, their share of the World Bank debts on behalf of low income countries. The second issue is the international finance facility. We need a mechanism for financing the scale of investment that is necessary to meet the Millennium development goals. I believe a report is coming out from the United Nations in the next few weeks that will say that the minimum is at least $50 billion extra, but to give everybody a primary school education, for example, costs about $10 billion a year and then there are the health initiatives that have to be met by 2015. Our proposal is to use the decisions that have been made by the richest countries to increase aid, to leverage in additional funds from the international capital markets and to frontend the aid and investment to meet the Millennium Development goals. We have had support from about 50 countries for this proposal. Of the G7, France and Italy have offered their support, many of the Scandinavian and European Union members have indicated their support, but obviously we have been working to discuss these matters with our American, Japanese and other colleagues.

Q255 Chairman: In laying out your plans for the UK leadership of the G7 and EU next year no mention is made of any intention to pursue an agenda for change in the institutions that are currently responsible for managing the international economy. David Walton of Goldman Sachs said in his evidence to the Committee that you need reforms in the sense that a lot of what the G7 talks about are usually things well beyond its control, such as oil prices and whether China should revalue, etcetera. The Governor of the Bank in his evidence to us on 30 November stated that he felt it would be an opportunity to start to talk again about a set of issues that have not been talked about for a long time, such as how the international monetary system operates. Are you happy with the current arrangements for global economic policy coordination? If not, what suggestions do you have for that?

Mr Brown: It is because we believe in the need for change that there has been this discussion in the G7 during the course of this year of what is called the strategy review, that is the review of the international institutions, and that will continue into next year under our chairmanship. As the British Government we have put forward proposals to increase the independence of the surveillance work of the International Monetary Fund and to bring some of the allocative procedures of the IMF and the World Bank closer together. There is clearly a need for quite different international arrangements than those in 1945 and for there to be a reassessment of what the World Bank and the IMF does. We think the IMF should have a stronger role in surveillance but that it should be more independent in the way it does it and that you should separate off the decisions about surveillance where the views of independent experts are to be welcomed from the allocative decisions that are made by the IMF. We also believe that more should be done on codes and standards where the international community lays down standards, for example, costs about $10 billion a year and then there are the health initiatives that have to be met by 2015. Our proposal is to use the decisions that have been made by the richest countries to increase aid, to leverage in additional funds from the international capital markets and to frontend the aid and investment to meet the Millennium Development goals. We have had support from about 50 countries for this proposal. Of the G7, France and Italy have offered their support, many of the Scandinavian and European Union members have indicated their support, but obviously we have been working to discuss these matters with our American, Japanese and other colleagues.

Q256 Mr Plaskitt: Chancellor, in the Pre-Budget Report you state that you have the aim of ensuring a higher proportion of people in work than ever before by 2010 and yet we already have the highest participation rate in the OECD. How are you going to drive it even further?

Mr Brown: I think the measures that we put forward in the Pre-Budget Report can be seen to have been designed to achieve that. It is true that we have got 75% of the economically active in work and that compares with 70% in America and 65% in Germany and France and therefore the 2 million additional jobs that have come about over the last seven years have been extremely welcome. If you look at our measures in the Pre-Budget Report, first on incapacity benefit, there is a large number of people who may not be able to go back to the jobs they previously had but who want to work either part time or full time. The emphasis should be on their capacity, not their incapacity. The pathway to work pilots, which is a technical name for suggesting how we have given people additional advice, help with rehabilitation and a financial incentive (£40 a week in some cases, £2,000 a year for the first year back at work) have yielded very substantial results in the first pilots that have been done. In the first limited pilots 5,500 people went back into work. We are now extending that to areas covering 900,000 incapacity claimants, that is 30 areas with the highest number of claimants in the country. The £40 a week will be on offer to people and help with rehabilitation and the same financial offer is going to be available to single parents. I think I am right in saying that a quarter of a million single parents are going to be covered by this new offer in that if they are able to go back to work or able to work for the first time we will provide the bridging finance to assure them that they are going to be definitely better off in work and that is going to be worth £40 a week to them as well as a first year allowance for going back to work. We accept that that has got to be combined with
childcare, training and advice and the personal advisers of the New Deal are there, but all the evidence is that you actually save money by getting people who are on social security benefits back into work even with these generous incentives to help people do so. These are two examples of how inactivity can be turned into activity and why it is possible to imagine that, even with the high figure of 75%, it will rise over the next few years.

**Q257 Mr Plaskitt:** What sort of jobs are people going to take up who move off incapacity benefit? Whereabouts in the labour market are they going to make their entry?

**Mr Brown:** There are 600,000 vacancies in Britain at the moment. I think the interesting thing about the picture of vacancies is that there are vacancies in every region of the country. In the late Eighties when we had a temporary boom the vacancies were concentrated in the south-east and London. Today the vacancies are in all parts of the country. We have to make it possible for people to take up the vacancies on offer. In some cases people will need skills and in other cases there is a limited amount of training necessary. With the adult skills initiatives we took in the Budget a lot of the training that people can get for the longer term can be done once they are in work by them being involved in the national employer training programme. I have been talking to a number of retail companies over the last few days because some of them have been in to see me about how they see the economy over the course of the next year and many of them are still recruiting, but some are finding it quite difficult to recruit and certainly there are jobs available. For people who are coming off incapacity benefit sometimes it is part-time work, but the retail sector, for example, is catering for that. The retail sector is also catering for the over-50s. One of the employers was telling me how he was hiring people over 70. There is hope for us all in the future! There are jobs available at the moment and this is the opportunity, when jobs are available, for people to be encouraged to take them up.

**Q258 Mr Plaskitt:** You have often spoken about the need to increase the overall skill capacity in the economy. What about increasing the skill capacity at the higher level by, for example, looking at the graduate level of employment where there is also considerable employer demand? That is not going to be filled by people coming off incapacity benefit. How are we going to increase participation at that skill level in the economy?

**Mr Brown:** You may have noticed the formation of the National Council for Graduate Entrepreneurship. That is our attempt to help graduates to start their own businesses and become self-employed and that is being formed in the new year and I think it will give a boost to people leaving university and make them think of careers in business where they themselves are self-employed or starting a business. As far as employer recruitment of graduates is concerned, I think you will find a very large number of the work permits that are issued for people coming into this country at the moment are for graduates.

**Q259 Mr Plaskitt:** You said in a document issued alongside the Pre-Budget Report that you anticipated migrants coming into the workforce to be more likely to be qualified to degree level than the native born. Do you envisage plugging a gap in high skills in the economy by inward migration rather than by spreading skills in the native workforce?

**Mr Brown:** No. In the long run and in the medium term we plan that more skilled people will be trained in Britain to take jobs that are available in Britain and that is why there has been a very big expansion in further and higher education over the last few years, that is why it is important that the school staying on rate rises and international maintenance allowances have been introduced, and that is why organisations like Learning Direct, that have got half a million people doing computer and other courses to get higher skills, are very important to what we are doing. In the long term it is an up-skilling of the British economy that is going to be necessary if we are going to meet what your Chairman was describing as the global challenges of the future. There are people with very good skills and if they are given a work permit and able to come into this country they can be of benefit to businesses in this country. The Chairman of the Federal Reserve Board says that ¼% of additional growth every year comes from people coming into America. I think we have got to acknowledge that it has helped our growth rate as well, not at that level, of course, but the numbers of people getting work permits who are pretty skilled has risen. Then there is a provision that we have been talking about for some months now about how we can help people who study at British universities stay on and work in Britain for a short period.

**Q260 Mr Plaskitt:** So you envisage a continued role for migrant labour in helping us achieve that growth?

**Mr Brown:** This is highly qualified men and women, many of whom have studied at British universities and colleges, who wish to play their part in the British economy. I think on all sides of the political spectrum there is a welcome for the skills that the British economy gains from that.

**Q261 Mr Plaskitt:** Do you see any conflict between expanding the level of participation in the workforce and your objectives on increasing productivity?

**Mr Brown:** It is well known that in the first few months of someone's new employment the productivity that they contribute to the firm is on average lower than for an established employee and therefore it is true that the gains in employment have got to be tested as to whether we are also gaining in productivity. The evidence from last year's productivity rises and the evidence over the period from 1997 is that productivity in the British economy is rising. Obviously the measures that we
are putting in are designed to achieve higher productivity gains for the British economy and we have identified a number of sectors where we could do a great deal better, but at the same time I think we should acknowledge that even with higher employment and therefore a labour force that is rising—and that is not at the point you often get the greatest productivity gains—productivity has been rising much faster than in previous years.

**Q262 Mr Plaskitt:** Finally, do you think you can continue expanding workforce participation in an ever tightening situation in the labour market and avoid wage cost pressures?

**Mr Brown:** I think the interesting thing about the new monetary framework since 1997 is that inflationary pressures in the economy in Britain have worked in two stages. You have had an initial burst of inflation in the past and the failure to control that has often led to a second burst of inflation, which is wage pressure. You will know from your own experience, as I do, that when people thought inflation would be not 2% in the next year but 4% or 6% the wage negotiators bid on the basis of what they thought inflation would be in future years and that is why we had these two bursts of inflation, the one following the other, cost pressures, inflationary pressures and then wage inflation. I think what has been a very interesting feature of the British economy since 1997 is that particularly in the last five years the wage pressures that you might have expected to see from an economy running closer to capacity have not led to rises in average earnings that would be unacceptable given what we would think in terms of inflation and productivity. Obviously you have got to be vigilant and every time we are looking at what pressures there are in the economy. Even with us being closer to full employment than at any point for 30 years the wage pressures that have sometimes actually been seen in other economies in Europe over these last few years have not been so substantially present in Britain, but I can assure you that we will be vigilant. You will know that we have issued regional and local guidelines for the public sector pay review bodies and it is clearly important to us that we can manage a situation where we can move to full employment in conditions of low inflation and that is the best way of both sustaining growth and sustaining employment in the longer term.

**Q263 John Mann:** Chancellor, there are about 3,500 new jobs currently being created in Bassetlaw and yet we have only 970 registered unemployed. The last time we had this problem we imported people from the Durham and Fife coalfields. What is your advice as to what we should be doing now?

**Mr Brown:** I am very pleased that as a result of your tenure as a Member of Parliament the number of jobs that have been created in your area has risen so fast. To have 3,500 created in Bassetlaw, in an area that traditionally has been an area of higher unemployment, and to see the unemployment rate so low is a very good thing. I think what will happen is that people will extend their view of what is a travel-to-work area and there will be people from the surrounding areas that will consider working in the areas of your constituency where jobs are being created. I think there is a willingness to see your travel-to-work areas wider than previously you did and I think that is really what is going to happen in your area. There are people who are not registered as looking for jobs who could be attracted, as I have just said in the previous answer, into the labour force. Our single parent employment rate particularly in your area I suspect is only around 50%, whereas in America, France and Scandinavia it is about 70 to 80%. There are thousands of lone parents who might be attracted back into the labour force if the terms on which they could get jobs were right. We have just mentioned incapacity benefit but can I also mention an area which worries me and that is ethnic minority employment. It is clear that unemployment rates amongst the ethnic minorities are treble those of the British average. It is also clear that for a large number of ethnic communities the employment rate, which is 75% of the active working population, is in some cases less than 50%. There are jobs and opportunities for members of those communities. One of the things we have asked to be done in the run up to the Budget is a report that would give us some more information about how we might be able to help more people from ethnic minorities to get the jobs. In each of our communities we know that even though large numbers are in work there are still people who are not even registered as unemployed and who are economically inactive.

**Q264 John Mann:** Some of my constituents will want to travel to Mr Skinner’s constituency next year which also has had 1,000 new jobs created. All the Government schemes to get people back into work have been outstanding successes with one stark exception and that is progress to work. How many people have gone into full-time permanent employment through progress to work?

**Mr Brown:** By progress to work which particular incentive do you mean?

**Q265 John Mann:** I mean those who are current or former drug addicts.

**Mr Brown:** This is young offenders, people who have convictions and people who need to have help with rehabilitation from drugs and again it is an area where we are doing further work at the moment. You may also know that there is a White Paper on services for young people who may have these problems coming out in January.

**Q266 John Mann:** Your Department was very helpful in giving me a very detailed response to a written question I put in about the cost if an average age drug addict remained on incapacity benefit for the next 40 years. If we compute that for the number in my constituency who are drug addicts on benefits then we are talking about over £2 million on your own figures. Can the British economy remain...
competitive if we keep having this large number of people for the next 40 years who are going to be on benefits and not in work? Secondly, is it not imperative that other government departments give rather more detailed answers in terms of the success of initiatives such as progress to work so that we can monitor whether or not we are seeing a success in returning such people to work?

Mr Brown: You might wish to put questions to the other departments about giving more detail on the work that we do and certainly I am very happy to bring together figures about what is happening across government if that is of help to you. The issue on long-term youth unemployment, however, is this: 20 years ago there were 350,000 young people who were unemployed and today the figure is less than 5,000, that is an average of 8 young people registered long-term youth unemployed in your constituency. I accept there are people who are drug addicts who are not registered as unemployed and I accept there are a large number of people who fall through the net and more help needs to be available. As they have never been in work a lot of them will never get on to incapacity benefit, but they will be on other benefits and clearly the rehabilitation services for that group of people have got to be better. That is why I think you should look forward to the publication of this White Paper on services for young people which will come out in January.

Q267 John Mann: I hope you will look at this issue because all of my questions are asking how many on incapacity benefit are also on Class A drugs and have a criminal record and I get the response “we do not know” repeatedly both at a local and national level.

Mr Brown: To be on incapacity benefit you must have been working for at least two years, I cannot remember the exact figures, but it does mean that the young people who you are talking about are unlikely to be on incapacity benefit, they will be on some other benefit, if on benefit at all.

Q268 John Mann: I will be carrying out my own research just to clarify the situation.

Mr Brown: We would be very happy to look at any questions you have on these issues to see whether we can identify what more can be done for this particular group of people. We all know there is a group of people in every constituency who have fallen through the net.

Q269 John Mann: Can you comment on the wider question of whether it is sustainable for an economy like Britain to have a significant number of people on benefit in the future when we are competing with economies such as China and India rather than the classic economic model of competing with more advanced capitalist economies?

Mr Brown: The first thing is that a far higher proportion of the population in America in this category are in prison, for example, and that is why their employment rate for the economic active population is less than ours, it is 75%. I think the second thing to note is that there is a group of people who are either offenders with criminal convictions and who find it difficult to get jobs, or who are people on drugs. There are a number of programmes that we have been looking at to help this group of people, but I would not want to give the impression that this was a very high proportion of the working population but other groups of people who have fallen through the net. With the Transco experiment that is taking place in a young offenders’ institution in Reading what they do is they offer these young people, while they are still in the offenders’ institution, the opportunity to train as gas fitters for jobs that Transco as a company can offer once they leave that institution. That has a phenomenal rate of success, it is 80% and it is now being looked at to see if it can be pushed through to the rest of the country. It may be that in your area it is something that Transco can be invited to do. That is an example of a project where if you can get to work with the young people while they are in the institutions the reoffending rate goes down very substantially. I think I am right in saying they had an 80% rate of success with the people that they put through the first stages of this programme.

Q270 John Mann: If we look at classical economic theory and particularly monetarist economic theory, some economists would say that it does not matter if we have a pool of people who are unemployed because that will act as a counter-balance to the possibility of high inflation. Does that brand of economics hold any relevance today, the kind of economics which would say unemployment never matters? From an economics stance, when we are competing ourselves with economies now such as China and India where the notions of unemployment are rather different to the notions of unemployment we have got, should there perhaps be a national debate amongst economists on whether unemployment never matters from an economic stance in today’s world economy?

Mr Brown: We would see whether we can get a consensus from a national debate. If you look at what has happened in the last seven years while I have been in the Treasury, the bills for unemployment have fallen by several billions a year. Public expenditure on social security related to unemployment has fallen substantially and that has allowed us to use resources for other things, including health and education. I think the point you are making is a broader one. If we cannot ensure that people have the skills that are necessary for the modern economy then Britain itself will fall behind and if we cannot use the potential of children, young people and then adults by giving them the education that is necessary for them to be highly productive in the economy then we are not only not going to be able to compete with America and the rest of Europe but we will find trouble competing with some of the challenges now coming from China and Asia. There are 5,000 computer scientists produced a year in Britain, but there are 75,000 computer scientists produced every year in India and 50,000 produced in China. There are now two million graduates a year.
coming out of Chinese and Indian universities. So the premium on skills becomes more of a pressure on the British economy. We will have to continue to upgrade and up-skill and that is why I think the challenge is to make it possible for every potential productive member of the workforce to have the opportunities to get the education that is necessary and that is why for the first time this national employer training programme, which I hope will have all-Party support, brings employers, employees and Government together, but the responsibility on the part of the employee is to take up this offer and there is funding from the Government to make time off possible so that the skills level of that company in which that person works is increased. That is a new relationship which I think is better than the old laissez-faire attitude to training that we have seen in the past and small firms in particular have benefited.

Q271 Mr Walter: I wonder if we could now go on to public finances and look at borrowing. The Governor of the Bank of England was here a couple of weeks ago and he said that your fiscal rules are not “an optional extra” but an integral part of macro-economic policy. Earlier this week your officials were here and they stressed to us the uncertainties that are involved in forecasting tax revenues. If the revenues are as uncertain as they tell us they are, how certain can you be that your fiscal rules will be met?

Mr Brown: We have been meeting our fiscal rules and we will continue to meet our fiscal rules. It is true to say that the rules that we set ourselves were not met by previous governments in previous economic cycles, so they are challenging and they are tough and they require discipline. If you look at the figures I was able to give in the Pre-Budget Report then we will be meeting our first rule, which is that the current budget is in balance for this cycle and we were showing in the figures how it would be met in the next cycle and then the second rule, which is the sustainable investment rule, in other words that borrowing must be maintained with a prudent level of debt, we are well within the 40% limit that we set ourselves in 1997. The interesting thing I would say about the fiscal rules is that while there is a huge debate in Europe about the future of the Stability and Growth Pact and while under the previous Government every year the test of fiscal discipline changed from ‘we want a balanced budget’ to ‘we want a balanced budget over the cycle’, we are moving towards a balanced budget, all these different rules appeared every year, we have stuck to the same rules since 1997, we have not been diverted from them and we are meeting them.

Q272 Mr Walter: A number of commentators that have been before us have suggested that the chances of you meeting the golden rule may be less than 50%. Do you completely discount that?

Mr Brown: I have just produced figures showing that we are meeting both our rules.

Q273 Mr Walter: When does the cycle end?

Mr Brown: The cycle will end when the output gap is closed.

Q274 Mr Walter: You are making assumptions about when the cycle will end.

Mr Brown: Because it is an economic cycle it depends on the performance of the economy and one does not prejudge what is actually going to happen to the economy over the next few months. We expect the cycle to end next year, but that is not something that we have set in stone because one is not in a position to do so. If, for example, the commentators that you were talking to were to hold to their view that the cycle has now ended then clearly we would have met our fiscal rules and I do not think there would be any dispute about that. What we are giving you is a projection of what the fiscal position will be at the end of the cycle according to where we think the cycle is going to end and we are not only in balance, which is what we are required to be, but in surplus.

Q275 Mr Walter: How long after the end of the cycle will you be able to tell the nation that the golden rule has been met?

Mr Brown: Economic data is coming out every month. In fact, there is probably quite a bit of economic data coming out this morning even as we speak. I think people will see, on the basis of the projections we are making, that we are clearly meeting our fiscal rules.

Q276 Mr Walter: What if we do not?

Mr Brown: That is not going to happen because I have just explained that we are well within our fiscal rules. Can I just say why the situation is rather different from what you might have perceived the situation to be 10, 20 or 30 years ago? The basis on which we do our fiscal figures is a set of cautious assumptions. While we believe the trend growth rate is 2.75% (and that assessment has been audited by the National Audit Office and thought to be reasonable), we calculate our public spending on the basis of the trend growth rate being only 2.5% in other words, we take a cautious view of trend growth for the public spending projections. That in itself shows the caution that we exercise. Also, our assumptions are tested and audited by the National Audit Office. Under the previous Government what you would have had in a public spending announcement or in a fiscal announcement was “We assume that unemployment will fall by another half a million over the next few years and therefore we will assume a fall in social security costs related to that.” We do not do that. We take the estimate that is given by independent commentators of what the unemployment level is going to be. Then privatisation receipts used to be thrown in. We do not say we will definitely get £10 billion of privatisation receipts. Indirect savings as a result of efficiency measures we do not do either. Our VAT assumption about the revenues we can expect from consumer spending has been continuously audited.
by the National Audit Office and, as you know, it was changed because we wanted it to be more realistic about consumer spending. If you take the key assumptions, privatisation processes, trend growth, claimant unemployment, interest rates, equity prices, VAT and the rest you will find that our assumptions are actually cautious assumptions and it is on that basis that I think the country can have confidence which it did not have before in the fiscal framework.

Q277 Mr Walter: So you are saying that there are no circumstances in which you could envisage that you will not meet the golden rule by the end of this cycle?

Mr Brown: There are no circumstances I see coming before this Committee today that mean I believe we will not meet our fiscal rules.

Q278 Mr Walter: May I go on to the sustainable investment rule which the OECD has been absolutely critical of. In their economic outlook, November 2004, they say that the Government deficit is likely to be above 3% of GDP in 2004 and in the absence of a spontaneous rise in taxes additional action may be required to achieve a decisive and sustainable reduction. How do you respond to that?

Mr Brown: The OECD has been generally positive about the British economy. As far as the budget deficit rising above 3% of GDP is concerned, I think they are referring to the calendar year of 2004. That is not what we believe is happening and we published figures only a few days ago showing that that is not the position. I disagree with them.

Q279 Mr Walter: You simply disagree with them, they are wrong?

Mr Brown: Yes. Again, if I may say so, what people have not really understood about the British economy is that the reason that revenues have been maintained and the reason that our public expenditure position is affordable is that we have had continuous growth over these last seven years and we have had continuing rises in employment. People who were previously being paid social security benefits by the state are now paying taxes to the state as employees and at the same time our public expenditure position has been bolstered by the fact that debt interest payments have fallen quite substantially and unemployment benefits need be less because there are more people in work. The basis for strong public finances is a sound and stable growing economy and I do think that this is what has been different from the stop-go policies of previous years. On the OECD, I do not want to be accused of gloating in any way and I am not saying it for this reason, but it is a factual point that in our forecasts for the last 5 years, between 1999 and 2003, we have been more accurate than the OECD.

Q280 Mr Walter: I want to look forward a little. You have just stated that the fiscal rules that you introduced in 1997 have worked fairly well so far, but do you think there is any reason to review them as the end of this cycle approaches? The suggestion is that rather than having a precise point to target you should be looking at ranges as one looks into the future.

Mr Brown: I do not think, given these effects on fiscal policy decisions about taxation and spending, the idea of ranges commends itself to me. That is something that academic economists can debate. We are continuously looking at how we can improve the fiscal framework. You have to balance off the need for continuity so that people understand that you have a discipline framework that is being held to with the desire for change. If you take the inflation target, we held to the 2.5% even though it was not the internationally comparable measure of inflation for the first years, the target of the previous Government, because we wanted continuity. There was a case, with a new fiscal framework having come in, for sticking with it so that you can give people a certain framework and one that is stable over time. We are happy to look at suggestions that people have for change and we do so all the time and that is something that is part of the whole debate. When we had the debate about the euro we had one full paper in our euro documentation about what a fiscal framework might look like if we joined the euro and therefore we had a debate about what were the respective roles, for example, of an independent fiscal committee like the Monetary Policy Committee and the House of Commons (because the House of Lords should not have a role in this) and the Government and we decided that in all circumstances the important role of the House of Commons in deciding on issues on tax and spending had to be upheld and you could not contract that out to some independent committee, whether it was a European committee or a British committee. Fiscal policy historically has been where Parliament have insisted, and rightly so, that if people are to be subjected to decisions on tax and spending these decisions have to be made by the people who elect them.

Q281 Mr Fallon: Chancellor, I want to turn to your problem with tax receipts. Can you tell us what current receipts were in 2001–02?

Mr Brown: Are you talking about the total receipts?

Q282 Mr Fallon: Yes, current receipts.

Mr Brown: I must say, I do not remember in my head the figures for 2001–02, but I am sure we can help you. Our figures in the Pre-Budget Report on current and capital receipts start in 2003–04.

Q283 Mr Fallon: Would you take it from me that in 2001–02 it was £388 billion?

Mr Brown: Current receipts?

Q284 Mr Fallon: Yes. It was £388 billion.

Mr Brown: I will get someone to check that.

Q285 Mr Fallon: If you cannot remember that, can you remember what you forecast it at?

Mr Brown: I do not know.
Q286 Mr Fallon: You forecast it at £398 billion, so you were £10 billion out. Do you remember that?

Mr Brown: If I think of 2001, it was at a time when the world economy was turning down very substantially and I think you will find that the American deficit started to move towards 6% and the Japanese deficit started to move towards 7% and we kept our deficit around 3%. I think every economy was affected by the crash in the Stock Exchange and then by the IT collapse and then by the stalling of world trade. I do not really think you are dealing with something that was so out of the ordinary.

Q287 Mr Fallon: Do you recall what the outturn of current receipts was for 2002–03?

Mr Brown: We are in exactly the same position. We are in a world downturn where corporate profitability is being hit and I suspect that what has happened is that corporate tax revenues have fallen.

Q288 Mr Fallon: Despite the world downturn having started, in that year receipts were at £393 billion but you forecast them to be £407 billion, so you were £14 billion out that year.

Mr Brown: If you look at other countries round the world, America, France, Germany, you would find—

Q289 Mr Fallon: They were as bad as you, were they?

Mr Brown: No. I think you would find that the difference between what they projected and what they got was very substantially bigger.

Q290 Mr Fallon: What about last year? Do you recall what the outturn was last year?

Mr Brown: I have got the figures for last year.

Q291 Mr Fallon: It was £418 billion. Do you recall what you forecast it at? It was £428 billion, so you were £9.6 billion out. What was the excuse for last year?

Mr Brown: Because we are talking about a recovery from a world downturn.

Q292 Mr Fallon: So it was not the recession, it was the recovery that you got wrong?

Mr Brown: No. I dispute this, Mr Fallon.

Q293 Mr Fallon: You dispute whether this figure is wrong or you dispute the reasons?

Mr Brown: What happens during a world downturn is that the world changes, the position of companies in particular but also individuals change. I will produce for the Committee what has happened in every other country. If you have a 50% fall in the Stock Exchange and at the same time 30% of your IT industry has run into huge problems as a result of the end of the IT boom and if you have world trade stalling it is bound to have an effect. I would say that our record on forecasting receipts has been better since 1997 than the situation before 1997 and the situation as forecast by other institutions and by other countries and I do not think I need apologise for that at all.

Q294 Mr Fallon: This year you are now forecasting the outturn at £451 billion in the Pre-Budget Report whereas originally you forecast it at £454 billion, so you are £3.7 billion out this year. So for the last four years you have out by £10 billion, £14 billion, £9 billion and £3.7 billion. Is that not right? You have been wrong 4 years in a row.

Mr Brown: I do not accept, given everything that has happened to the world economy, that you can expect that every single figure one year to the next is absolutely accurate. What I think you can expect is that where the situation changes it is reflected early in the statistics that we produce. In the Pre-Budget Report what you see is an explanation for what has happened to the receipts over the last year, an explanation which I think this Committee would find interesting and an explanation which actually shows that we have been more or less accurate on income tax and national insurance and capital gains tax and we have been more or less accurate because the consumer spending has been as expected to be on VAT receipts. On corporate tax receipts what has happened is that in the oil sector there is a delayed effect from the rise in the oil price in the revenues coming through to the Government, but we expect that during the next few months and it will be proven when the oil receipts come through to the Government. As far as the rest of the corporate sector is concerned, in the industrial sector it has been as we expected but in the financial sector there has been a shortfall which has now been looked at and I think your Committee has had an examination of this during the course of the last few days. What we have is a system of fiscal discipline that locates any issue early, is able to report it and is able to examine what is at the root of it. I personally think that our record in forecasting receipts, as in forecasting the economy, bears comparison with any other country over the last few years and with any other independent forecaster. We produce in meeting the fiscal rules and in the End of year fiscal report, because there is far more transparency about these issues than ever there was before, a comparison between the forecasting record of the US Congressional Budget Office and the UK Treasury. I would have thought that the economy is going down entirely the wrong road if it feels that there was some deliberate manipulation of statistics or, alternatively, in a world downturn things are not going to change. The question is whether you can identify and report these changes early, as we have done.

Q295 Mr Fallon: You have been boasting earlier this morning about the cautious assumptions you have been making.

Mr Brown: Absolutely.
Q296 Mr Fallon: It does seem rather regrettable that four years in a row you have made mistakes in forecasting tax receipts. If you were running a business you would have been fired by now.

Mr Brown: Not at all. Before the end of this meeting I will tell you what happened to the forecasts that your Government made.

Q297 Chairman: I think we should keep off the politics.

Mr Brown: I am never going to be too political. I think in other situations you were talking about £30–£40–£50 billion out in 1992.

Q298 Mr Fallon: Let us turn specifically to corporation tax receipts where you seem to be most wrong.

Mr Brown: Can you suggest in which other area you think we are wrong?

Q299 Mr Fallon: I am coming to other areas. Let us start with non-North Sea corporation tax receipts. Originally you said these would grow by 20% this year. Now in the PBR you admit they are only going to grow by 14%. How did you get that so wrong?

Mr Brown: When people are coming out of a downturn, as in the late Eighties, the mid-Nineties and at other times, the rise in receipts has been over 20%. In 1986–87 it was 38.8%, in 1987–88 it was 33.4% and then in 1994–95 it was 30%. If you look particularly at America, the bounce back when there has been a downturn in corporation tax receipts in these years is usually very high indeed.

Q300 Mr Fallon: That was not the question. You forecast it at 21% and you are now admitting it is only going to be 14%.

Mr Brown: I have just explained what has been happening. The oil sector has seen a delayed response to the rise in the oil price, but that is money that is coming in. In the industrial sector there is no difference between our forecast and what has actually happened. In the financial sector, even though profitability has been higher in the years that we are talking about and has been rising and is not out of the ordinary, there has been an issue about whether, because of investment allowances or because of another reason, that particular sector has not been paying as much corporation tax as previously. It is not unreasonable, given past history, to expect there to be quite a big bounce back in corporation tax receipts after a world and national downturn.

Q301 Mr Fallon: Given you have been wrong this year, you are now forecasting an increase next year of some 27% in those same receipts.

Mr Brown: I have just explained why, because the oil industry is benefiting from a higher oil price, we have had to adjust the oil price expectation. Now, of course, it has got a downside for the economy in other respects because it creates inflationary pressures, but as far as corporation tax and specifically from the North Sea, these are expected to grow substantially and I do not think anybody would deny that that is going to be the case.

Q302 Mr Fallon: Overall in current receipts you are forecasting next year an increase of 8%. That is the biggest single rise since you reformed corporation tax in 1997–98.

Mr Brown: Are you talking about all taxes here?

Q303 Mr Fallon: I am talking about the current receipts generally. You are forecasting an increase of 8%, but that is the biggest rise since you reformed corporation tax that we have ever had. It is bigger than the peak of the dotcom years. If you forecast this wrong 4 years in a row, how can we be sure you are going to get it right this time?

Mr Brown: You have just given a figure of a forecast gap of £3 billion, a £3 billion figure that has just been explained not in terms of things going wrong in every sector but an issue related to the financial sector and corporation tax. The £3 billion figure has been explained precisely for you. The gap that you are talking about between the original anticipated receipts and the receipts is that £3 billion told in the Pre-Budget Report only a few days ago and explained in detail now to your Committee and work is being done on this specific thing. If you look at income tax or you look at VAT. If you look at North Sea taxes, if you look at the range of other taxes, we are on forecast for what we expect to be the revenues.

Q304 Mr Fallon: If you have been wrong four years running, how can you expect the City to think you are going to be right next year?

Mr Brown: I do not accept what you are saying here. What I have done is explain why, in a period of a world downturn, when the Stock Exchange goes down 50% and when there is an IT collapse, which is actually what happened, an IT bubble burst, it is bound to have effects particularly on the corporate sector. I think the remarkable thing about Britain is that employment continued to rise, receipts generally continued to rise and now you are saying that there is a shortfall that you have identified between the Budget and the Pre-Budget Report of £3 billion and I have now explained to you why it has happened. It seems to me a criticism on the basis of receipts of around £450 billion and the explanation given for this £3 billion change. I would have thought the Committee should be satisfied that we have gone into detail in looking at what has happened in individual sectors and I am now identifying the problems that have got to be dealt with.

Q305 Mr Fallon: You have been wrong four years in a row.

Mr Brown: I do not accept this, Mr Chairman. Our growth projections have been right over these four years, but we have had to take into account a Stock Exchange change of about 50% and an IT collapse which happened after the IT boom.
Q306 Mr Heathcoat-Amory: Chancellor, just reverting to an earlier exchange about the golden rule and in particular the definition of the economic cycle over which it is to be judged, I think you said that the present economic cycle would end when the output gap is closed, but we know that the Treasury based on the remaining slack in the economy and therefore presumably there are going to be differences over when the output gap is closed. Who is going to decide when the present economic cycle ends? Is it going to be the Treasury deciding itself that the cycle has closed and therefore deciding on which basis to judge the golden rule?

Mr Brown: When the cycle ends depends on a number of factors that are taken into account. The first is what the trend growth rate of your economy is because that dictates what you feel the output gap is. That is an audited assumption which we have put to the National Audit Office, the 2.75% trend rate of growth and they have given us the view that that is a reasonable assumption. It changes because of demographic changes in future years, but that is a reasonable assumption. As to the question of when the cycle ends, of course fiscal policy and the reports which are for that are not the responsibility of the Bank of England, they are the responsibility of the Government and so we must take responsibility.

Q307 Mr Heathcoat-Amory: Let us be clear, the Treasury will decide when the present economic cycle has ended, will it?

Mr Brown: The information will decide when the economic cycle ends. The judgment has to be made in the end by the people who are responsible for fiscal policy and that is the Treasury. I would have thought, Mr Heathcoat-Amory, that all your debates about the European Union will have led you to the view that fiscal policy ought to be a matter for national parliaments and national governments.

Q308 Mr Heathcoat-Amory: As you know, I strongly agree with that.

Mr Brown: You would not wish to contract out that decision to some independent or other body. You would accept it was a decision that only Parliaments in a democracy could make.

Q309 Mr Heathcoat-Amory: You subjected other judgments in your document to independent audit and you have boasted about the role of the National Audit Office. Are you willing to put the definition of the economic cycle out to independent audit?

Mr Brown: The trend growth rate which determines whether there is an output gap and when it will end is something that has been audited by the National Audit Office. There is a big distinction between monetary policy and fiscal policy. With monetary policy the Government can set a target of 2% for inflation and it makes sense to ask an independent body to administer that, but fiscal policy is about decisions for taxation and spending. For 500 years it has been regarded as the province of Parliament and Government and something that cannot be contracted out to another body and I would have thought that you of all people would wish to agree with that as someone who does not want the Commission to run fiscal policy in Europe but believes that that also is still a matter for national governments.

Q310 Mr Heathcoat-Amory: I am not talking about the running of fiscal policy, I am talking about the assessment of the output gap on which you are going to self-assess now the ending of the economic cycle, we have established that.

Mr Brown: For your information and for the Committee’s information we have set out clearly in advance for a number of years the criterion on which the economic cycle is judged and all that has been out there for debate, it is completely transparent. There has been a debate amongst academic economists about it. I do not think people have come to a view as to how you judge the cycle. As I have said a few moments ago, the growth rate affects how you see the cycle and that is important to this judgment as well. We have a very transparent system. In the end I put it to you that in a matter that affects whether you tax and spend there is no view in Britain that I have seen expressed before until your own party produced a policy last week that somehow you could contract out that decision and that responsibility to some other body than Parliament and the Government.

Q311 Mr Heathcoat-Amory: Reverting to the issue of tax revenues, we have established that there have been very serious forecasting errors over the last few years and we discussed with your officials on Tuesday some of the reasons for this. We were told that there are big volatilities in tax revenues which are inherent, we have been told about the uncertainties in trying to compute tax revenues and we were told by Mr Cunliffe that this is particularly difficult in the current cycle. Given these problems, how can you say with certainty that the golden rule will be met? You are adamant that your arithmetic is correct as regards the golden rule and yet your officials are conceding not only past forecasting errors but also the inherent difficulty in forecasting future tax revenues.

Mr Brown: Because of all the cautious assumptions that I have just set out for the Committee. The requirement we have is to meet the first fiscal rule, to have a current budget in balance. I have explained to Parliament only in the last few days that we are not just in balance but we are in surplus. The sustainable investment rule is debt below 40% of GDP and again I have given figures to Parliament showing that debt is a maximum of 37% of GDP, so it is substantially lower than the 40%. I have given all the information about how we are not only meeting our rules but are well within the margins that are necessary to meet these rules and the reason we can say this is that we have continuously made cautious assumptions, whether it is on the trend rate of growth for the public finances forecast of 2.5% or all the other cautious assumptions I have set out. When Mr
Fallon asked the question about corporation tax. I think I was just too generous to him because the tax gap is £2 billion. The other billion, as I explained in the Budget document, is as a result of the reclassification of NHS trusts, which is something that we have been asked to do as a result of the statistical way that we have got to present public expenditure. So £1.5 billion of the deficit that he is talking about arises from the re-classification of NHS trusts.

Q312 Mr Heathcoat-Amory: Chancellor, it is future tax revenues on which you are depending in order to meet your golden rule over the cycle and we have established you will decide when it ends. There is written into your Budget arithmetic a very steep increase in tax revenues as a percentage of GDP. It goes up from 35% last year to over 38% in three years’ time. How are you going to get that extra tax revenue without putting up tax rates?

Mr Brown: Well, I recall that when your Government left power, the fiscal projections that we inherited had tax as a percentage of GDP going far higher than 38%. Our figure is no higher than was projected by your Government. Now, the reason that we make these projections is on the basis of what we know about the growth of the economy yielding income tax receipts, the growth of wages in the economy obviously making people better off and yielding these receipts, the growth of consumer spending, which will not be as fast a growth as last year, but will continue to be at a high level of growth and, therefore, will yield VAT receipts, so in each of the different areas, as I have said, our projections about revenues have been right. Apart from this one point about corporation tax that we have just been debating, they have been generally right, so there is a growth in receipts as a result of the growth of the economy. Can I just correct you on one point. The cycle will end when the information shows that the output gap has been closed and the idea that arbitrarily without any evidence someone is going to declare the end of the cycle, it is all based on evidence and on the information we have about the economy, and that is how the decision or the judgment will be made about the end of the cycle.

Q313 Mr Heathcoat-Amory: Yes, and the judgment is entirely in your hands. We have established that.

Mr Brown: The judgment is indeed one that the Treasury has got to make for the reasons I have given you, but based on assumptions that have been audited in some cases by the National Audit Office and where there has been a transparent debate over the years about how we judge the end of the cycle.

Q314 Mr Heathcoat-Amory: Can I just return to this very steep increase in tax as a percentage of gross domestic product which goes up, we are advised, to an all-time high. You are saying you can do this without tax rate increases, but are you worried about the effect on competitiveness? You have made much of your concern for the competitiveness of the British economy in world markets, and I share those concerns, but we are increasing our tax burden very steeply at a time when most of our competitor countries are reducing theirs. We have a table given to us from the OECD of revenue statistics. It does not project forward as far as yours, but it does show that our main competitor countries are either holding their tax receipts as a percentage of gross domestic product or indeed cutting them, so how can you reconcile your concern for British competitiveness with the fact that you are imposing additional tax burdens on British industry and the British workforce?

Mr Brown: I think if you read out the figures for the tax burden in other countries, you would be reading out figures of over 36% in Germany and nearly 45% in France, and I think the EU average at the moment is 41%. The figure in Britain at the moment has been 35.8%.

Q315 Mr Heathcoat-Amory: Well, in the trend here both Germany and France, according to these figures, have cut their tax burden—

Mr Brown: And what is their tax burden now?

Q316 Mr Heathcoat-Amory:—from a higher base, but the United States, from a lower tax base, has cut theirs still further, so you are defying the world trend as regards taxation at a time when you are expressing concern about competitiveness.

Mr Brown: No, I do not accept that at all. I think if you look at the figures, and I have got the table here now, the EU 15 average is 40.6% for 2002, the latest figures where we have everyone’s actual figures available to us, and at that point the UK was 35.8. The OECD average, even with countries that are lower tax, like Canada and the United States, is 36.3, so we were below the OECD average at the time. You said that we had an all-time high in tax rates; that is completely wrong, completely wrong. Under the last Government, the tax burden went up to 39%. I have repeated to you that when we came into government, the projections, and I will send them to you, that your previous Chancellor brought in projected a tax revenue above 38% of GDP during the period for which he was making a forecast in his Budget Report. The reason why our tax rates are competitive is corporation tax has been reduced from 33 pence to 30 pence and small business tax has been reduced from 23 pence to 19 pence. Under our Government, capital gains tax, which was at 40% for all assets, has been reduced to 10% for long-term assets. Income tax has been reduced from 23 pence to 22 pence and the basic starting rate of income tax is now 10 pence where it used to be 20 pence, and of course VAT on fuel was reduced. All these taxes, corporate tax, small business tax, income tax, capital gains tax and a lower rate of income tax, which you would say were important either to people’s incentives or to companies’ incentives, the rates have actually been lowered under this Government.
Q317 Mr Heathcoat-Amory: It is the overall burden of taxation that is important and under your own figures there is a steep increase from 35 to 38%. Now, your official conceded on Tuesday that this was a relevant consideration as regards competitiveness. Are you saying that this trend of the increased tax burden against the trend of most of our competitors is irrelevant or relevant, but not important?

Mr Brown: The figures for the early 1980s of the public sector current receipts were 45.8%, 45%, 44%, 44%, so that is a very different picture from the one you are giving. That was the all-time high under the previous Government. As far as we are concerned, the difference between ourselves and America, which is the country which you wish to draw attention to, is essentially this: that our healthcare is paid for in the public sector by taxation and in America it is essentially paid for in the private sector. Once you take that difference into account, the general level of taxation and public expenditure in both countries is not too dissimilar. Of course we have 8% rising to 9% of GDP paid for in the public sector for healthcare, which is the choice of the British people under your Government as well as under our Government, but in America the money that they spend on healthcare is principally spent in the private sector and does not require them to raise tax to do so. We raised tax for the Health Service, and there was the national insurance tax that we put in specifically for money for healthcare, that, I believe, is a decision which is supported by all sections of the British public. Other than that, as I have just shown you, for tax rates, corporate tax, income tax and for small business taxation, our rates are both competitive and have come down under this Government.

Q318 Mr Mudie: I think I have to ask you, Chancellor, because I gave your officials a rough time which I think was perhaps unfair, but from the Treasury Committee’s side of the situation, our integrity is as important as yours and our reputation. For the last four years we have argued with your officials that your revenue figures, your income figures are overstated and every year we have been proved right. Now, it is not that you would expect to be accurate every year, but with the level of inaccuracy, £10 billion, £10 billion, £10 billion, it is not that you do not take into account a change in the world economy or the British economy, but when it is factored in, when 4 years ago your income went down by 10, but there is no reflection of that in the following 3 or 4 years’ income figures, and then when the second year the income goes down again by 10, you start thinking, “Well, if you were doing the Budget, you would start adjusting your figures”. Now, I see this End of Year fiscal report, and you do not even admit to making a mistake. A mistake is down as “fiscal forecasting differences”. Now, the National Audit Office spell out the parts that are outwith your forecasting abilities, but then there are clear signs in this report that a large majority is just where you were wrong. I will save you from answering because I will just ask you to do one thing. In the Pre-Budget Report 2003, your income for this year was 456 and in the Budget it was down to 454. Today, in the Pre-Budget Report, it is down to 451. Do you stand by the 451? We will remember this when you come before us at Budget time. Do you stand by the 451, and, if I could ask a supplementary, do you stand by the 487 for next year?

Mr Brown: I stand by our commitment to meet our fiscal rules and that is the basis on which any Chancellor is going to come before this Committee. Now, if you take your 456 to 451 figure, oil prices changed dramatically over the course of the last year. I do not think anybody predicted the changes that have actually taken place. The oil price during the period I have been Chancellor has been $10 and it has been $50, and the movements have been speedy when they have actually happened and they affect the revenue position. Equally, if you have a world downturn, the effect on that will be rapid on your fiscal projections.

Q319 Mr Mudie: But your oil should be in favour of your income.

Mr Brown: But the reason that I say to you that you can have faith in what the Treasury is doing is that our commitment to you is that we will take the steps necessary to meet our fiscal rules and that is what we have been doing over the last few years. It would not be very sensible to say that I could predict today what the oil price is going to be definitively in 6 months’ time, but it is sensible for me to say to you that the level of discipline and the caution built into our projections are such that we will meet our fiscal rules.

Q320 Mr Cousins: Chancellor, you have been challenged by my colleagues on the Committee for being £3–£5–£10 billion out on tax receipts, but this Committee had evidence only last week from Mr Whiting of PricewaterhouseCoopers that in a mere handful of cases brought by big business in the European courts against the British Government, there was £10–20 billion of corporation tax revenues at stake. Now, I do not ask you to comment on those specific figures, that would be quite unwise, but does it not trouble you that we are one, two, three stops behind in the Underground away from one of the great world centres of tax receipts reduction?

Mr Brown: What I would say about the European Court of Justice is exactly what you said, that we will defend our corporate tax system against legal challenges under EU law, but at the same time you would not expect me to comment on any individual cases. The question I think you have to ask about corporate tax is whether the assumptions that we are making are reasonable assumptions and I think the assumptions are reasonable, that once you come out of a world downturn, then it is reasonable to expect that the bounce back will be quite high. In North Sea oil there is a lag, but you can see from the price change that the profitability of these companies is going to be such that we will get both petroleum revenue taxes and corporation tax. I have explained what has actually happened in the financial sector, so I think you have got to ask yourself whether the
assumptions that we are making both about the growth of the economy and about the profitability of our financial and other sectors are reasonable ones, and I think they are.

**Q321 Mr Cousins:** But 45% of the contribution to our growth rate in 2003, which is one of your great successes and one that, in my view, you are fully entitled to gloat about, should you wish to, was made by government expenditure. Do you not think that a series of legal cases, a great industry devoted to undermining the tax base of the country, is something that ought to cause concern?

**Mr Brown:** I think we have written to you about the ECJ and the corporate tax cases. You have a Treasury Sub-committee that has looked at these issues and we have written to you. As far as the contribution to the public sector is concerned, I do not think I would accept the figure that you give me, but it is right to say that at a time when the world economy was in a downturn, the contribution that fiscal policy could make to monetary policy was something to be welcomed, but you will see that the rate of growth of public expenditure in future years is less than it was in these years and you have been given the assumptions, looking forward to 2010, which show that having had a period of very substantial additional investment in our infrastructure, we have got a period where the growth rate of public expenditure will be substantial, but not as high as it has been in the past.

**Q322 Chairman:** Chancellor, on the tax avoidance elements, the new Tax Avoidance Disclosure Scheme, in an exchange with Mr Whiting, I suggested that creativity is still alive and well in the industry, and he thought that it was still alive, but whether it was as well was another matter. Have the Treasury become as clever as the tax avoidance lawyers and accountants regarding the level of disclosure and are the Treasury policies having a disincentive effect on the tax industry’s efforts to devise new schemes?

**Mr Brown:** Well, I think the new rules that we set out in the Budget about disclosure are working as intended. We have been receiving a number of disclosures, as we expected. We have now of course in the Pre-Budget Report cut back with a number of anti-avoidance measures, some of the schemes that we have discovered, and I think the whole Committee would wish to welcome the fact that we are dealing with some of these issues of tax avoidance.

**Q323 Chairman:** Yes, but is it having a disincentive effect?

**Mr Brown:** Well, I hope that the requirement to disclose means that people will not advise their clients to take schemes which clearly, once they are discovered, people will immediately close the loophole on, so I think the accountancy industry were in some cases giving people advice that they should go into a scheme which they had devised or someone else had devised, but they knew perfectly well that that person who went into that scheme would find it was closed off very, very quickly indeed, and I am not sure that that was good accountancy advice that was being given to these clients.

**Q324 Chairman:** What is the relationship between the new announcement about a general commitment to stop all future tax avoidance schemes on employment rewards and the Tax Avoidance Disclosure Scheme included in the 2004 Finance Act? Why is the disclosure scheme not adequate to achieve what the new announcement is trying to achieve?

**Mr Brown:** What we are doing is closing down a loophole in remuneration schemes of mechanisms that avoid the payment of national insurance and we have indicated that these would be closed from the date of the Pre-Budget Report, so to have the disclosure is one thing, but to actually close down the loophole is another.

**Q325 Chairman:** The announcement emphasised that any future legislation to close avoidance schemes down would be, “where necessary from today”, ie 2 December, but Mr Whiting, in evidence before us, saw a distinction between making such an announcement in respect of a specific avoidance scheme, quite normal and acceptable, and making such a generalised commitment in respect of schemes not yet devised. Is this not retrospective legislation and do you think you can act in this way and stay within the Human Rights Act?

**Mr Brown:** Well, I think that is, in my view, not an acceptable way of proceeding. If it is accepted that there is a loophole which has got to be closed, whether it is of a specific nature or in a number of different areas, then it should be closed immediately. If people are not going to act in a way that allows it to be closed through the Finance Act legislation, we just said that we would insist that it would be from the date of the Pre-Budget Report, and I think that is perfectly reasonable. Once you accept that a scheme is wrong, that as a form of avoidance it is unacceptable, then I think it is reasonable to close it on the day you have announced that you want it to stop. We are confident, I may say, that this does not conflict with the ECHR.

**Q326 Chairman:** And you do not think that you will be breaching the Human Rights Act?

**Mr Brown:** Well, I think the basis of the European Convention on Human Rights is that it gives a government the power on behalf of the tax-paying public to raise taxes in a fair and proportionate way.

**Q327 Norman Lamb:** On to expenditure and overall spending to start with, the PBR suggests that there will be a flatter profile to public spending through 2004–05 than we have traditionally seen. Are you confident that this can be achieved without squeezing departmental activities in the final quarter of the financial year?
Mr Brown: We will be publishing the departmental estimates, as is normal, over the next few months and you will see the exact figures. I think that departmental expenditure continues to rise in a sustained way that has not happened for many decades and I think people should be satisfied that we have maintained our commitments to health, education and all the other key priority public services.

Q328 Norman Lamb: But are you confident that you will avoid a squeeze on departmental activities?
Mr Brown: I think you will find that departments are spending at a rate that is consistent with the promises we have made in our election manifesto. I think you will see the figures in detail when they are published. I do not actually have them at the moment, but you will see them in detail when they are published.

Q329 Norman Lamb: On investment spending, in recent years you have identified a consistent pattern of government departments and local authorities not being able to deliver the amount of public sector net investment forecasts in the Budget. In the PBR 2003 you expected public sector net investment to grow by 30% in 2004. That was revised down to 17% in the Budget 2004 and by PBR 2004 the forecast growth was just 5.75%, so 30% down to 17% down to 5.75%. What threats to the delivery of modern public services does this sort of slippage pose and how are you actually tackling the problem?
Mr Brown: Well, the figures I have got are the cash public sector net investment rising from £9.9 billion in 2001–02 to 11.3 to 13.7 to 21.7, so whichever way you look at this, this is a very substantial increase in public sector investment.

Q330 Norman Lamb: But do you accept that there is slippage?
Mr Brown: We have always said that the departmental investment plans should be met on time and have accepted that one of the reasons was that in the past departments were so used to a stop-go on investment plans that we have had to get mechanisms in place so that people are assured that if we make a decision to invest, that decision will continue.

Q331 Norman Lamb: But that is not working fully yet, is it? There is still a problem there, is there not?
Mr Brown: It depends what you mean by a problem because the PSNI, which is the net investment, last year, 2003–04, was a 21% rise. Now, that is a very substantial rise whichever way you look at it and I do not think there has been a period in British history, to be honest, outside wartime when the scale of investment on a consistent and sustained basis has been rising so much. I can tell you that for the year 2004–05 to date there is a 13% rise, so these are not insubstantial figures.

Q332 Norman Lamb: No, but still slippage. Can I move on to—

Q333 Norman Lamb: Can I move on to the £1 billion announced to help keep the increases in council tax down. The Financial Times reported a “Whitehall fury at Brown demands for budget cuts”. What the £1 billion seems to consist of is actually £150 million of new money and £512 million of government departments reallocating expenditure from central programmes to local authorities. Now, which are those programmes where cuts will occur?
Mr Brown: I think that is based on a misunderstanding. You are talking about services that are run by both central government and local government, so the overall level of spending on that service will be maintained, if not higher, but what has happened is that more money has gone in to support the local social services, more money has gone in to support the local education service—

Q334 Norman Lamb: Yes, but can I just quote to you from the Pre-Budget Report. You say, “To fund this, departments have reallocated £512 million of existing funding from central programmes to local authorities”. Now, can you specify what those are?
Mr Brown: Well, I think we said on the day that the measure that we have taken in relation to the schools we have made public and I will send you detail on it.¹

Q335 Norman Lamb: Yes, but we are losing the money for child protection and child abuse, are we not?
Mr Brown: No, I do not think that is correct.

Q336 Norman Lamb: The Times reported that Mr Clarke would scrap the grant now given to councils to safeguard children.
Mr Brown: I am quite surprised you are reading it as if it is gospel.

Q337 Norman Lamb: No, I am asking you the question.
Mr Brown: What I am explaining to you is that what actually happens in practice is that the overall level of spending on education or social services or the police service or on the fire service remains as was expected, but this is spending which is now being done by the local authority rather than by the central government department. We announced on the day of the PBR, so we are absolutely clear about that, a reduction in the schools’ FSS, and that is the bit of local authority money which is allocated specifically

¹ Ev 93
for the schools, by £75 million and that allowed us of course to give local government more money, another £75 million.

Q338 Norman Lamb: You are saying it is the spending, but it seems to be smoke and mirrors. Is this real money?

Mr Brown: The overall level of spending remains and in fact the Treasury gave additional money, so the overall level of spending is higher, but of course the spending is being done by the local authority in this instance.

Q339 Norman Lamb: But can you specify now where the £512 million comes from, what programmes it is that central government departments are reducing because that is what your Pre-Budget Report says?

Mr Brown: We announced on the day a reduction in the schools’ FSS. We also said that there were measures—

Q340 Norman Lamb: Yes, of how much?

Mr Brown: Hold on. We also said that all these figures, once the final work is done, will be in the departmental estimates.

Q341 Norman Lamb: It refers to the past tense, “have reallocated £512 million”. It has already been done, so why can you not tell us which programmes?

Mr Brown: Because you are asking about what the final departmental expenditures are going to be and I think you will find that far from there being cuts, as you are implying—

Q342 Norman Lamb: No, but you made a specific pledge to find this £1 billion. You referred to £512 million in the Pre-Budget Report, so tell us which programmes are being reduced to fund this?

Mr Brown: I am just explaining to you that social services expenditure is probably higher, not lower, but more of it is being done by local authorities and not central government.

Q343 Norman Lamb: But this is a fairly simple question. In your Pre-Budget Report, you have referred to £512 million distinct funding from central programmes. Which are they?

Mr Brown: I have just explained: the reduction in the schools’ FSS.

Q344 Norman Lamb: How much?

Mr Brown: I have then explained that these figures will be available when we publish the departmental estimates and you will find that—

Q345 Norman Lamb: Why can they not be available now? You have already done the work.

Mr Brown: Because you are implying that there is a cut taking place when actually—

Q346 Norman Lamb: No, I just want the figures.

Mr Brown: But what would the figures suggest?

Q347 Norman Lamb: What the Financial Times suggests is that the work is still ongoing, there is still wrangling going on because the central departments are so furious. There is not a single department, it says, where there has not been fury created over these decisions.

Mr Brown: That is completely wrong and it was an exercise which involved the Cabinet as a whole and was supported by the Cabinet as a whole. There was a reduction in the schools’ FSS, then there was the question of the waster targets, then there was the question which has been announced already about the levying of fees and charges for licensing and planning—

Q348 Norman Lamb: Yes, but you are now moving on to the other end of it which is the reduced ring-fencing. I am asking you about the £512 million.

Mr Brown: I am explaining to you that the overall level of public expenditure is as high, if not higher, because of the Treasury contribution that was already announced. What has happened is that some local authority expenditure is higher as a result of the reallocation from central government, but the service as a whole, social services and education as a whole are getting more money.

Q349 Norman Lamb: It seems to be that this £1 billion has no substance at all. Can you provide us with a list of the reduced ring-fencing that you refer to? This is a third of a billion that we are talking about. Where is this and if what we are talking about is allowing councils not to spend this money, we are talking about local cuts, are we not?

Mr Brown: Yes, Defra have announced that whilst the Government is committed to a 25% recycling target overall, we will not be setting even higher targets for local authorities already exceeding the total. DfES have put money that was inside the schools’ FSS and instead allocated it to general spending, and DCMS—

Q350 Norman Lamb: So it is money not going to schools.

Mr Brown: I have adjusted licensing fee levels to allow local authorities to raise more from licensing fees.

Q351 Norman Lamb: So the fees will go up instead of the council tax?

Mr Brown: It is possible that the fee for a planning application may go up as a result of this, but I do not think anybody around this table would think that that was unacceptable.

Q352 Norman Lamb: Can you send us a note specifying these amounts so that we can see the breakdown?

Mr Brown: What the Department will be send is the departmental allocations when they are published.
Q353 Mr Fallon: What I do not understand about this reallocation of £1 billion is that we had the Comprehensive Spending Round back in July, so how is it that just 5 months later you have discovered all these immediate pressures that you did not spot in July, which is supposed to be the long-term framework for the next 3 years? How did you get into this mess?

Mr Brown: Well, actually I think this is based on a complete misunderstanding because basically the framework for public expenditure for the year 2005–06 was not really the issue that was in the Spending Round, but it was 2006–08, so, roughly speaking, the figures for 2005–06 remain the same and the Spending Round was announcing figures for 2006–08. What we have been dealing with on council tax is the pressures that exist in 2004–05 and 2005–06 which were really outside the scope of the major work of the Spending Review. Now, I think it is reasonable to say that when you identify pressures that you perhaps had not anticipated some years before, you take action to deal with them. I would have thought, from the reaction of local council leaders, that they do understand that we have understood that they have a difficulty and we have helped them to keep the council taxes substantially below the 5.9% average it was last year. Again, and I am surprised about this, I would have thought there would be all-Party support for us helping local authorities make sure that the council tax could rise at a lower level than in previous years. Now, as I said, the departmental spending will be announced in the departmental allocations which will be published very soon and I think you will see that, far from there being cuts in spending, the departments are spending on course, and of course they have their end-of-year flexibility carried over from previous years which they able to use.

Q354 Norman Lamb: What about the £100 payment to pensioners?

Mr Brown: The payment to pensioners, because we expect council tax rises to be lower this year than last year, indeed substantially lower than last year—

Q355 Norman Lamb: They are still higher though.

Mr Brown: Well, if you will allow me to finish, we have allocated £50 for each pensioner household—

Q356 Norman Lamb: Instead of £100?

Mr Brown:—for each pensioner household, and that is for the over-70s and for the over-80s.

Q357 Norman Lamb: So it is all the discount on the larger bills.

Mr Brown: Again I would have thought that Mr Lamb would have welcomed that, given that we will have two things achieved by this. One is that we will have lower rises than last year and, secondly, where pensioners have had to pay more, they will get what is a commensurate amount on average and that is £50 extra.

Q358 Mr Cousins: One of my colleagues has brought to your attention something from a newspaper called The Times. Could I bring you a bit of good news from a very important newspaper, The Newcastle Evening Chronicle, which tells us that the controlling Liberal Democrat group on the Council consider your settlement to be so good that the council tax increase they are projecting next year will only be 2%, so there is a Christmas present from Newcastle.

Mr Brown: I am grateful. Perhaps you could aid the process of the flow of information by sending it also to Mr Lamb!

Q359 Norman Lamb: It is not the case in Norfolk, I can tell you!

Mr Brown: It is quite clear that Liberal councils around the country have got no common policies!

Q360 Mr Cousins: I wonder if I could ask you whether the excellent innovation you have made of making lump-sum payments in the winter to pensioners that are free of all considerations of tax and benefit withdrawal, whether the £100 extra this year that has just now been paid could be continued at that rate next year bearing in mind the increases in water rates which of course are now in the pipeline and the increases in gas and electricity prices? It has been a wonderful innovation that brings many millions of pensioners a good Christmas and it seems important to continue to build it up.

Mr Brown: I think our decision to give the £50 next year is something that people will generally welcome in recognition that whilst the council tax will not rise in the same way it did in previous years, we are helping to meet some of the costs of the council tax for pensioner households who have generally fixed incomes and, therefore, a higher proportion of their income is paid in the council tax. I think we should bear in mind also that we have the winter allowance, we have the free television licence and for the group who are affected by the gas, water and electricity bills that you are talking about, the pension credit is something that I think has over time been able to increase the income of the poorest group of pensioners, those most affected by £40 a week.

Q361 Mr Walter: This reallocation, Chancellor, can you confirm that part of that has been the cancellation of capital spending programmes by church schools and that money has been reallocated by the Department for Education into the general pot as part of your £1 billion?

Mr Brown: No, I do not think so.

Q362 Mr Walter: Can you check that and write to me?

Mr Brown: I am very happy to write to you, but I think the capital budgets in schools have been rising quite steadily.

\[2\text{ Ev 93}\]
Q363 Mr Walter: This is church schools.

Mr Brown: It is capital investment you are talking about?

Q364 Mr Walter: I am talking about capital spending in church schools. There is one group of primary schools in my constituency which are losing £3.8 million next year as part of this reallocation.

Mr Brown: I shall bring this to the attention, I was going to say, of the Education Secretary, the new Education Secretary and see whether she would be able to write to you about this matter.

Q365 Chairman: On the council tax aspect, Chancellor, you mentioned the reaction of council leaders, acknowledging that they have a difficulty and you are helping them. I note that the figure for Scotland in terms of the Barnett allocation is £12.675 million they will be receiving, but the First Minister is on record as saying that none of this will go for council tax relief. I come from a very poor authority, like your own, and in fact I was talking to your council leader only last week, and we have pressures in my area. I have got one of the poorest communities in Scotland with 33% of people in poverty and high levels of council tax, just as high as any in Scotland. For example, the average bill for Band D is £904 in 1996 and it has risen to £1,089 in 2004. That is an increase of 28%, Chancellor. The councils in Scotland are under as much pressure as the councils in England, so should there not be a bit of equity here in the money that you have given to the poor councils like my own or your own?

Mr Brown: The Devolution Settlement makes it clear that the funding body at a governmental level for local authorities in Scotland is the Scottish Executive and it is for them to make the decisions. In fact, under the Barnett Formula, they were allocated not just £121 million as a result of the measures that we had in the Pre-Budget Report, but very considerably more because they got their share of the childcare allocations and they got their share of other allocations, and I can give you the exact figure, but it is their discretion—

Q366 Chairman: I understand, Chancellor, but in the Pre-Budget Report you focused on council tax relief and, as a consequence of that, Scotland getting £121 million, do you not think it is fair and people will not understand if it is not used to help council taxpayers?

Mr Brown: Scotland is getting substantially more than that as a result of the Barnett allocation of all the expenditures that happen as a result of the Pre-Budget Report. It is for them then to decide what to do, but at a UK level and including Scotland, the £50 is being paid to Scottish pensioner households as well as the rest of the UK.

Q367 Chairman: What would you say to your council leader then who comes to see you, as my council leaders come to see me, and says, “Wait a minute! You stood up in the House of Commons and announced this and there’s nothing coming to the local level”? Do you not think there is an unfairness there?

Mr Brown: I made it clear that I was announcing this for England, but I was announcing the pensioner allocation of an additional £50 for the whole of the United Kingdom and I said that there would be separate allocations made for Scotland and Wales.

Q368 Chairman: I think to many of us, particularly council taxpayers, that will strike as extremely unfair.

Mr Brown: The Scottish Parliament has a very large budget as a result of the rise in public expenditure generally and it is for them to allocate that to local authorities.

Q369 Angela Eagle: I am not sure I want to talk about equity and the Barnett Formula as I think that is probably something for another time, Chancellor, there are some who would argue that given the current state of the economy now, there is room for very large cuts in public expenditure and tax cuts on top. Do you agree with them?

Mr Brown: I think it would be a terrible mistake to make cuts in public expenditure at this stage. For the first time we are seeing sustained increases that are building up the capacity of our education and health systems in particular, but also tackling the problems of transport and policing, and to move from a situation where we are seeing these sustained improvements in capacity and to return to the old stop-go where you cut and cut at the wrong time would be a terrible mistake for the delivery of public services in this country.

Q370 Angela Eagle: So no room for tax cuts?

Mr Brown: The decision about tax cuts is one that I make at every Budget time according to our election manifesto commitments. I have just explained that we have cut the basic rate of income tax and we have cut the rate of corporate tax and we have introduced the 10p lower rate of income tax. If I look at the spending plans, moving forward, and if you are committed, as I gather some people are, to a balanced budget and, therefore, to £35 billion of cuts in public expenditure to get there, if you also have £15 billion additional public spending commitments that you have announced for a series of different measures, then you would have to find £50 billion in public spending cuts to get to your balanced budget, and £50 billion of public spending cuts, given that the whole of the Civil Service only costs £15 billion, means that you could sack every civil servant and you would still have to find £35 billion of public spending cuts, so it is very savage and severe indeed.

Q371 Angela Eagle: I remember when I first went into the Department of the Environment, Transport and the Regions, as it was then, and we were starting to look at issues of sustainability and I was shocked to be told by the civil servants there that they did not think that poverty existed in the UK. You have made poverty and the alleviation of poverty one of
your main themes both abroad and at home and you
gave us some insight into your agenda for poverty
abroad earlier in reply to some questions from the
Chairman, but could you say a little bit about your
approach to poverty at home, particularly child
poverty and pensioner poverty, and how you see us
meeting targets to end that? Also can you say
whether you think that this is about economic
efficiency and productivity or is it just greater
social justice?

Mr Brown: I do not think the economy is going to be
successful in the long term if it does not deal with the
problems of child poverty and does not ensure that
every child has the best possible start in life, so it is
for reasons of economic success and social justice
that you tackle child poverty. We will meet our first
target, which is to cut child poverty by 25%, and
then our second target, which is certainly very
challenging, is to cut child poverty by 50% by 2010
on the road to tackling it and eradicating it in a
generation, so we have set down already some of the
measures that we are going to take from 2004 so that
we meet our target by 2010. Part of the work of the
Childcare Review was to show how more money
could go to early-years’ learning, for nursery schools
and for SureStart and for the various programmes
that support the care and educational development
of children at an early age. As far as pensioner
poverty is concerned, we have taken the first million
pensioners out of poverty and I think that some
pensioners with the pension credit are better off than
they have ever been as a result of these measures, but
clearly we have got to continue to look at how we
can help pensioners who have got low incomes
partly as a result of small occupational pensions in
the past, partly because of widowhood and partly
because of low savings, and it is quite important for
this generation of pensioners that we take the action
through the pension credit that is necessary to get
them out of poverty.

Q372 Angela Eagle: I remember when I first came
into the House and listened to Budgets from the
Opposition benches and childcare was never
mentioned. Again you have made childcare one of
the features of the PBR statements that you have
made, but also Budgets and this particular statement
contains a big 10-year strategy for childcare. Can
you tell us whether again this is a social justice
economic opportunity issue or is it to make the
labour market more effective?

Mr Brown: Well, I think it is 2 things. Firstly, it is so
that every child can realise their potential and that
has got economic as well as social benefits and,
secondly, it is the flexibility of the labour market you
are talking about so that mothers and fathers have
got more effective choices available to them if they
have to work or if they want to for some period of
time, particularly mothers outside the labour force
while the child is very young. The purpose of the 10-
year strategy was to make sure that every child had
the best start in life and that is why the measures I
have mentioned are important, but also to help
parents make choices so that they can balance work
and family life. I think people will be interested in the
extension of maternity pay and maternity time off,
equally, the transferability between fathers and
mothers of some of that time off and then the greater
flexibility that companies may look at so that people
might be able to spend in the early years of their
children’s lives more time with the family by having
more flexible working hours. Then the second part
of that is, where childcare is required, to introduce
children centres, to make the childcare tax credit
work to help mothers and fathers have effective
choices so that they can actually draw on childcare,
and of course we have had a number of other
measures about the regulation of the childcare
market as well so that we open up opportunities that
perhaps were not there before in different areas of
the country.

Q373 Angela Eagle: There are many, many
expansions going on in childcare, but there were
some problems with the supply and quality of
childcare, particularly often occurring in those areas
where there are lots of lone parents and it is harder
for them to access reasonable and affordable
childcare. Are you happy that we are doing enough
on the supply side with the extension of these
services much more nationally to ensure that women
can happily leave their children and know they are
getting a high-quality early education?

Mr Brown: That is the issue now, that people want
both the supply of childcare places, which has not
been available, and the quality to give them the
assurance that when they are working or away from
their children that their children are properly taken
care of. One issue is extending nursery education
hours, which is what we have offered to do, to raise it
to 15 hours, and the second is the out-of-school care
both before and after school hours with the extended
schools so that people have got the satisfaction, and
less anxiety, knowing that their children are within
the school precincts. Then there is the question of
childrens centres which would be safe, reliable, high-
quality centres where particularly the people that
you have been mentioning, lone parents, could feel
that their children were being introduced to other
children and they were getting all the support that
they as lone parents needed from the SureStart
centres. So in each of these areas we are trying to
move forward with an expansion of the supply of
childcare.

Q374 Angela Eagle: I am quite interested to note the
beginning of something which I think is the creation
of wealth benefit rather than an income benefit,
which is the child trust funds which will be receiving
their first payments early next year, but also some
initial work that the Treasury did in piloting Savings
Gateways which assist people who have not been
able to save because of their very low incomes in the
past. Do you see this kind of approach to what I call
“wealth benefits” rather than income benefits as a
useful thing and do you see it being extended in the
future perhaps to other areas?
Mr Brown: I think that poverty is not simply the absence of income; it is the absence of having security through having no wealth, no savings, no assets. A wealth-owning democracy is to the benefit of everyone and, therefore, the child trust fund is helping every child get into savings at an early age and building up a trust fund, so no matter what your background is, you have at 18 some money that you can build from. That is why we have announced the 250 and 500 from this year and then we have got a consultative document on another payment made to 7-year-olds. With the Savings Gateway, it has been very interesting to look at the research on that as that is matching the savings of low-income people with the Government being prepared to make a contribution, essentially a tax credit, to encourage people to save. That has been working very well and in the areas it has been piloted it has been successful and that is why we are trying to extend it now and we were able to announce in the Pre-Budget Report that these Savings Gateways, as they are called, are going to be extended, and extended both to new income groups as well as into new areas, so I think the seeds of something quite big in a savings culture in this country for people who are on low incomes are very important for our future.

Q375 Mr Beard: Chancellor, as you note in the Pre-Budget Report there has been good progress by departments since the Spending Review in delivering efficiency savings. Given the need to achieve these savings, if the departments’ PSA targets are to be met, what role do you envisage the Treasury playing in ensuring that the efficiency savings are actually delivered?

Mr Brown: Well, it is the departments who are now accountable for the efficiency gains. They are setting out their plans of course and they are making some progress already. Gershon and his successor at the OGC continue to monitor these things. I did say in the Pre-Budget Report that we had achieved £2 billion of savings in procurement and then there was £1 billion saved in NHS drugs procurement and, on target, we had the reduction of the first 9,000 Civil Service posts. The figures are available obviously for individual departments on this, but it is for departments themselves now to show that they are making these efficiency savings. They will of course be monitored, and we are working with them, but it is a matter for them to show what they are doing.

Q376 Mr Beard: When we took evidence from you on the Spending Review in July, 6 months ago, you told us that the efficiency technical notes setting out how the efficiency savings were going to be achieved and measured had not been published because they were to be scrutinised by the National Audit Office and the Audit Commission first. You also noted that this Committee, quite rightly, would support you in seeking that independent advice.

Mr Brown: Yes, what are called the “ETNs”, the efficiency technical notes, are now published.

Q377 Mr Beard: Yes, I have got them here.

Mr Brown: Good. They were published at the end of October and I think that is progress. Now, some departments have lengthy notes and some have shorter notes. Sometimes that is a measure of how far they have previously got on their efficiency programme and in some areas it is because it is complex and they are now working with the National Audit Office in many cases to look at the system that they are using.

Q378 Mr Beard: Chancellor, could you say what the role is of the National Audit Office because, as I say, the last time they were going to be submitted to the National Audit Office and that was why they were not available, and the Financial Secretary in a written answer recently said that although these had been looked at by the National Audit Office, they had not been signed off. Mr Stephens after Tuesday’s session kindly sent a note which says, “We are discussing with the National Audit Office and the Audit Commission how they can be involved in the future process for new efficiency technical notes in a way that will add greatest value”, so what is envisaged as the National Audit Office’s and the Audit Commission’s role in all of this?

Mr Brown: Well, this is an evolving process, as obviously has become clear from your discussion on Tuesday. The National Audit Office and indeed the Audit Commission, they examined the draft efficiency technical notes against agreed criteria, the clarity of the savings, the measurement methods, the data quality, the service continuity and the readability of the documents, and they provided advice to departments in September. The departments then published their ETNs at the end of October and, as departments refine these because this is an evolving process, as I have said, the NAO and the Audit Commission will be asked to provide further advice. Now, many of the measures used in these notes are already subject to quality assurance processes, such as internal and financial audit, so the National Audit Office will be involved in this evolving process as it moves forward.

Q379 Mr Beard: You have mentioned already that the quality and the detail of these documents varies quite considerably and it does. The one from the Home Office is 3 pages and more or less a transcript of the Gershon Report, and the one from the DfES is 55 pages and covers as much detail as white boards. Who is trying to bring about some comparability between these and stimulate the departments to move rather further in being more explicit about what is going on?

Mr Brown: I think now that they are drawing on the advice of the National Audit Office and the Audit Commission, this is going to help the process, but it is in the end, and this is why I stressed this at the beginning, for departments to decide how best to set out their ETNs. In some cases, differences are justified because the measurement of certain efficiency measures is complicated, in some areas it requires a lot more explanation and in other areas it
is more simple. The ETNs were designed to set out the information and data which will underpin how progress can be measured. Now, I think we agree on this, that the ETNs published in October cannot be the last word and they are in a sense the first word in this, and we are working with the NAO to see how to return to some of the difficult measurement issues in the future, which some ETNs actually refer to explicitly, like the data sources of social care and children’s services which are being developed at the moment, so I think, as I said, it is an evolving process. We hear what you say as well as what has been said by the National Audit Office and this will develop with the co-operation of the National Audit Office, but it is primarily the departments that decide how best to move this forward because they have got to take responsibility for this.

Q380 Mr Beard: There have been comments on the Gershon savings to the effect that they are sort of fairy gold, they are heard about, but no one sees them. Would it not help if there was a statement in either of the Pre-Budget Reports or the Budget saying what the progress was towards achieving the £20 billion?

Mr Brown: Well, I thought that I had included some information even after a few months about how progress is being made in jobs, in procurement and in some other areas. I am told that £2 billion has been saved in procurement and then the use of e-options has made quite a difference. I also know that the MoD is on track to deliver £400 million in savings through improved defence logistics, the Department for Transport £140 million on the Highway Agency measures that they have announced, and a better use of IT in the Home Office. The workforce numbers lead us to announce that nearly 10,000 jobs by the end of the year have already been reduced since the Gershon Report was announced in April, so we are on track to get the numbers between now and 2008 that we talked about, but I am very happy to say that we will provide more updated information in the Budget.

Q381 Mr Beard: The Gershon criteria are very clear and they were set out in the Gershon Report, but there are 3 particular cases: the MoD, for instance, reducing 2 submarines as part of the Gershon exercise; the Department for Transport including fines for infringements covering driving hours for HGVs and PSVs; and then the Department for Education and Skills is bringing in raising the retirement age for teachers. None of those things appears to be within the criteria of the Gershon Report which were to do with inputs and getting similar things out for lesser inputs. These seem to be more policy matters.

Mr Brown: I think I can answer specifically some of these points. The plan to reduce the submarines is part of a wider package of measures to achieve the genuine efficiencies that you are talking about. As far as the fees by the Department for Transport are concerned, it is responsible for collecting vehicle excise duty, as you know, but it is now known that 4.5% of VED was not being collected and, therefore, it is an efficiency saving to get that money collected. I will write to you separately on the Department for Education and Skills, but I do say to you, and this is why the departments are now responsible, that the savings have been built into the Spending Round allocations so that if these savings are not achieved, then the departments will have to find another way of maintaining the services or not be able to maintain all the services that they agreed to in the 2006 Spending Round. We have built the savings into the figures for the Spending Round, so we believe that even with a lower rate of spending growth as a result of the decisions made in the Spending Round, with the efficiency savings the actual rate of growth of expenditure on front-line services would be as high as in the previous round, so departments are not only responsible and accountable, but if they can get these efficiency savings, they will be held to account because it will affect the delivery of other services.

Q382 Mr Beard: I appreciate that. It would answer the question if those savings were made more explicit, as you have suggested, in the Pre-Budget Report.

Mr Brown: Well, we will keep, in the Budget process, people in touch with what is happening, but of course individual departments are available to answer questions on what they are actually doing if you were to put them down.

Q383 Mr Cousins: I have a question about this teachers’ pension scheme. It is not just a point of detail; it is a point of principle. One of the component features of the changes in the teachers’ pension scheme is to raise the build-up rate of entitlement to pension from 80ths to 60ths. Now, the effect of that of course is to make people who are in teaching for shorter periods build up a bigger entitlement to pension. Regardless of its merits or demerits, do you think that is a legitimate thing to include in efficiency savings?

Mr Brown: I do not know the detail of this. This is not a matter essentially for me or the Treasury.

Q384 Mr Cousins: But you will have to take a view about whether it is properly an efficiency saving.

Mr Brown: No, that is not for me to take a view on it. That is for the Department to work out how it is going to move forward to achieve its efficiency savings, but, as you know, there is a wider debate about pensions taking place and if people are working in one job for less years, but working at a high standard of achievement, can you make sure that the retirement provision is adequate. These are issues that the Turner Commission is looking at.

Q385 Mr Mudie: I have three quick questions really. I was delighted to hear your remarks about the Savings Gateway which I think is an excellent scheme, but the result of the pilots is supposed to
report in February this coming year. That was applicable to the poorest households. Now, you have made a suggestion which is included in the Report that you are going to start another pilot to wider groups. Now, I am looking with anxious eyes to see if this first pilot is successful, and you have indicated that you think it will be, and you used the words “going well” and “very successful”. I was looking forward to my poorest constituents taking part in a national scheme after February at an appropriate time Budget-wise, but you are now suggesting another pilot for a wider group. Is there room for taking a decision, where this will help the lowest-income households, say, for taking a decision to run with that nationally?

Mr Brown: Our experience of a number of pilots we have done is that we extend them from one area to another before we make a final decision to go nationwide. The participants either receiving out of work qualifying benefits or individual earnings below £11,000 were in the first pilot. It was piloted in Tower Hamlets, Cambridgeshire, Cumbria, Gordon and Hull.

Q386 Mr Mudie: It has been very successful.

Mr Brown: The interim evaluation says mostly it has been new saving and sustainable saving, in other words it continues. The full evaluation comes in February 2005.

Q387 Mr Mudie: Chancellor, the question is will you give some thought if the final report in two months' time confirms your view it was very successful not to run with another pilot, a wider pilot that keeps it to a minority but to consider extending it?

Mr Brown: I am saying, if I may put it this way, there is a middle way to this, like the national employer training pilots which started in a number of local areas, then were extended to a third of the country and have now been extended nationwide. It is possible to widen the pilots before you make a final decision that you can afford to go nationwide or it is right to go nationwide.

Q388 Mr Mudie: I would be happy if you widen this pilot but you are suggesting a different pilot scheme starting.

Mr Brown: What we are testing are alternative match rates not just 50:50, we are looking at it as how it would affect a wider range of income groups and, therefore, there will be a larger set of pilots.

Q389 Mr Mudie: Now on affordable credit, one proposal you have got in your document that has caused distress to all the bodies dealing with constituents with problems getting affordable credit, is a proposal to allow lenders to apply for a deduction from benefit. I just really want to say can there be some fresh thinking on this because you are poor in your own benefit and to be put on a list as a condition for extending affordable credit is not acceptable out in the country.

Mr Brown: There are two views on this but I do say what we are doing on financial inclusion is wider than what you are referring to.

Q390 Mr Mudie: I know.

Mr Brown: There is £120 million over three years. It is to help citizen advice bureaux, it is to help other possible lenders from the charity and community sector, it is perhaps to extend the community investment tax relief which helps these agencies like credit unions.

Q391 Mr Mudie: All wonderful things. You are a wonderful Chancellor but are you willing to listen because there is quite an upset over this proposal?

Mr Brown: We are willing to listen, obviously.

Q392 Mr Mudie: Well done! For claimants it suits them that this work should happen because it gives a continuity to the commitments they have to make.

Q393 Mr Mudie: I am sorry because I know you have got questions so I am racing with these. I am not trying to cut you off because they are all very good measures. Two measures which are wonderful: social fund reforms, when somebody borrows it is 15% repayment, you are suggesting cutting it to 12% which is a very good first step, and then the capital limit for benefit which you are raising from £3,000 to £6,000 which will affect a tremendous number of people throughout the country. The trouble is both reforms you are suggesting from the year 2006. If they are as good as they are, why are you not suggesting doing them sooner?

Mr Brown: Because of the changes we are making in a whole series of areas affecting that department it is right that we do it with the proper procedures so that it is implemented in a way that the resources are there to do so. I think it is to give the department time to adjust to this change and make provision for it.

Q394 Mr Mudie: Chancellor, to adjust to repayment from 15 to 12 takes 5 minutes on a computer.

Mr Brown: No, as you said yourself, there will be a wider group of prospective claimants for these benefits.

Q395 Mr Mudie: That is the second one, not the first one.

Mr Brown: You have to have the resources for that second one. You have to have the resources to enable you to do it.

Q396 Mr Mudie: I am delighted with the fact that you have appointed, as Mr Holgate told me on Tuesday, the Chairman of the task force on basic bank accounts. I am surprised where he comes from. He has not been one of the people who has been regularly at this Committee on financial inclusion et cetera, but that is your choice. When is he going to be joined? When are you going to set this up? It does
not seem a major thing to set up, it is important. Can you make sure he is joined by people from areas that have expressed an interest in less well off people? 

Mr Brown: Yes. The membership of the group will be drawn from the financial services sector. It will include the voluntary sector and the community sector and people who have an expertise in academic university and colleges on these issues as well. It will be a widely drawn task force. This will be published shortly. I know Mr Pomeroy has been highly recommended to us.

Q397 Mr Mudie: By whom? 
Mr Brown: He is the former Chairman of the National Lottery Commission.
Mr Mudie: There you are, it might make sense to somebody.

Q398 Chairman: Chancellor, lastly, you mentioned with the Treasury that those excluded from mainstream credit could be faced with “... a lack of low cost options, a lack of transparency, pressure to take on more debt ... ” et cetera.

Mr Brown: Yes.

Q399 Chairman: You said, also, you would be encouraging the third sector. What discussions have taken place with potential providers of increased “third sector” areas on affordable credit, for example credit unions? Does the potential capacity exist to support the kind of expansion you have in mind? What targets do you have in mind? 

Mr Brown: That is right. We want to extend the institutions which are offering affordable credit. I think the best thing to say to you is I will write to you about the specifics of that but there is £120 million provided for this financial inclusion credit.

Q400 Chairman: Thank you for your appearance this morning, Chancellor, and particularly your officials. I think it is a record that none of them has opened their mouth this morning. Thank you for coming. 

Mr Brown: Thank you very much. Happy Christmas!

4 Ev 93
Written evidence

Memorandum submitted by the British Bankers’ Association

THE PRE-BUDGET REPORT 2004

1. The BBA: with over 240 member banks from over 60 countries, the BBA is the authoritative voice of the banking industry in the UK, and represents members’ interests in both wholesale and retail markets.

2. Financial Inclusion: the banks and Government are fully committed to work together to reduce by half the 2.8 million adults in households without accounts. Both the Government and the banks have worked constructively in the development and launch of the Universal Bank, and the on-going opening of basic bank accounts—1 million since April 2003. The announcement signifies an extension of this common cause and signals a further phase in jointly helping people into the financial mainstream. The new version of the Banking Code which will come into effect on 1 March 2005 will include a commitment that banks will offer a basic bank account to anyone who wants one (with some sensible caveats). This is the UK equivalent to the French statutory right to a bank account, but delivered by self regulation, and we are confident it will contribute towards banks meeting the Government’s and industry’s shared goal.

3. Dormant Accounts: the industry is currently working with HM Treasury to explore various technical aspects around their proposal that unclaimed assets should be donated to charity—such as tax, legal and accounting issues.

4. Child Trust Funds: BBA is supportive of the Child Trust Fund initiative believing it will bring an important early focus to saving. From a systems perspective, we have been working closely with HM Treasury and with the Inland Revenue to ensure that when the CTF is formally launched in April 2005, the CTF initiative will be smooth and successful.

5. ISAs: the introduction of ISAs has been one of the Government’s more successful savings initiatives, remaining popular with consumers and providers alike. We welcome HM Treasury’s announcement to consult on the continuation of higher ISA limits until 2009. The ISA initiative remains popular with both consumers and providers alike. The current changes taking place in the area of pensions combined with the long term savings debate, creates an air of uncertainty for savers. Continuation of higher ISA limits will help to ameliorate some of this uncertainty as well as keep people saving.

6. Non-commercial organisations and investment advice: the BBA considers that measures to enable non-profit making organisations, employers or CABs et al to provide investment advice is broadly positive given that consumers will be able to access alternative sources of investment advice and ultimately be better placed to make informed decisions. Those who provide investment advice should be competent to do so. We are closely involved with the work which the FSA is undertaking on financial capability, and are following with interest their work on generic advice.

7. Complaints to FOS that have a wider industry impact: the BBA is fully committed to the Financial Ombudsman Service (FOS), which we believe provides cheap and effective redress for consumers, but agrees that current working arrangements both between the FSA and the FOS (as well as between firms and the FOS) should be improved if customer complaints that have wider industry impact are to be dealt with in an expedient and systematic manner. We therefore fully support the FOS proposal to draw upon more external expertise and consult across industry and consumer groups where complaints may have wider implications, which is an eminently sensible approach.

For its part, the BBA has been looking at ways of ensuring that the industry takes a more pro-active role in identifying complaints with wider implications at an early stage and of communicating these to the FOS and to the FSA. This is why we have set up a complaints handling group, recognising that the industry itself needed to be better organised and better able to escalate these whilst bearing in mind commercial sensitivities. This combined with the role of the FOS banking industry liaison group (the Banking and Loans Liaison group) will ensure that industry lines of communication as well as process are clear for all.

8. European Legislation: we would like more detail on the pre-budget announcement on preventing additions to the requirements of European legislation. We would welcome HMT confirming the FSA’s approach to copy out FSAP directives, as we urged in the FSMA review to reduce compliance burdens. It is extremely important to the UK financial services industry, and to the City of London as an international financial centre, that EU legislation is implemented in the UK in a practical and flexible manner—avoiding “gold plating” and “superequivalence” as far as possible. There are times when UK implementation is incompatible with the purposes of the directive and breaches the uniformity principle of EU legislation. During work on the current Markets in Financial Instruments Directive (MFID)—formerly known as ISD 2—it became apparent that the UK had implemented the existing ISD in much more detail than many other EU member states.

9. Shari’a financial products: we will be discussing with the Inland Revenue and Customs and Excise how the banks can assist with this project. A number of our members now offer Shari’a products, which is particularly valuable to Asian communities, and assistance has already been provided by individual banks with expertise in this area.
10. **Corporation Tax**—transitional impact of switch to international accounting standards: although it creates uncertainty we recognise the reasons underlying the Government’s deferral of a decision on how to tax/relieve transitional movements arising from the switch to IAS on 1 January 2005. The amount of the adjustments is uncertain and likely to be substantial. Government will make a decision when they know the amounts involved and this seems a sensible decision. We will work with the Inland Revenue to obtain the necessary information at the earliest possible time. We have been lobbying to have the tax impact of all opening IAS 39 adjustments (positive and negative) spread over a period of years and we therefore would welcome the Government introducing regulations on spreading the impact over a number of years when they see what the figures are.

11. **Corporation Tax**: we will be reviewing the Technical Notes issued by the Inland Revenue as part of the continuing discussion on Corporation Tax reform. We will be looking closely at the proposals affecting leasing to ensure that they do not reduce the financing opportunities available to business customers.

9 December 2004

Memorandum submitted by The British Retail Consortium

1. **The Economic Context**

**Retail sales growth**

Retail sales growth is slowing to a level well below that of two years ago. In Q4 of 2002, the BRC’s Retail Sales Monitor was showing total sales growth of 7–8% and like-for-like growth of around 4%. Our latest (October) RSM, by contrast, indicates that total sales growth is now down to around 3%, while like-for-like sales are down to a three-month moving average of 1.1%. While October is traditionally a relatively quiet month for retailers, all the indications are that the Christmas trading period will be tougher and less profitable than for several years.

**Price competition**

Price competition in all sectors of the retail market is intense and will remain so. This is reflected in the BRC’s Shop Price Index, which has been falling more or less steadily since April and by October was 1.4% below the level of October 2003. In some sectors (food, electrical products, clothing and footwear, furniture and home entertainment) prices have fallen by between 0.4% and 5.3%. Much of the modest like-for-like sales growth recorded by the BRC’s RSM is being driven by promotional investment, funded not only by suppliers but by retailers themselves. Consumers have become attuned to special offers such as “buy-one-get-one-free” and retailers have no choice but to engage in this activity.

**Cost inflation**

The downward pressure on prices means that it is virtually impossible for retailers to pass on any cost inflation to their customers. The pressure on margins is already apparent in the well-publicised difficulties currently experienced by some leading high street retailers. Even the most successful performers, however, are having to absorb substantial increases in labour costs (National Minimum Wage, pensions and other regulatory burdens), rates (where revaluation kicks in next April), rents (where upward only reviews remain the norm), fuel and energy.

2. **Actions to Reduce Upward Cost Pressure and Inflation**

**National Minimum Wage**

Labour is the retail industry’s biggest single cost. The recent 7% increase in NMW to £4.85 has already cost the industry £1.7 billion a year, on top of the 7.8% increase in October 2003. If the LPC recommends, and the Government accepts, a similar percentage increase effective from October 2005, this will add a further £1 billion a year to retailers’ wage bills. Much of these increases are the consequence of larger retailers’ need to maintain internal and external differentials in order to maintain their competitiveness in a tight labour market. A significant number of retailers, large and small alike, are now taking steps to offset some of these cost increases by reducing staff hours, cutting head office jobs and trimming back staff benefits. We need the lowest possible increase in NMW for October 2005 and, if possible, no increase at all.
Property Costs

These represent retailers’ second largest cost. From next April, retailers will begin to absorb the impact of the rating revaluation, which will add around £500 million to their existing rates bill of £5 billion by 2009.

Retail Rents

Retail Rents continue to increase, thanks to the shortage of good sites, the effect of restrictive planning and the prevalence of upward only rent reviews. Although a few multiples maintain predominantly freehold store portfolios, most either depend on leasehold property or are doing sale and leaseback deals on their freeholds. Given that the ODPM’s current review of commercial leases is due for completion by Christmas, we urge Ministers to act quickly thereafter to put an end to upward only clauses in leasehold agreements.

Stamp Duty

The 2003 Finance Act introduced significant changes to the payment of Stamp Duty on commercial leases which resulted in an eightfold increase in duty for many retailers. The heaviest increases have been imposed on retailers in prime high street and out of town sites and, perversely, regeneration areas. The argument that landlords will accept lower rents for the first five years of a lease than they would otherwise have done in order to mitigate tenants’ Stamp Duty liability reflects a lack of understanding of how the commercial property market works in the context of landlord dominance.

3. Comparative Performance Issues

Any assessment of productivity in UK retail has to take account of the high cost of operating a retail business here, specifically:

- **property costs**, including site acquisition, design and fitting-out, rents and rates;
- **employment costs**, including NMW, national insurance, pensions and other benefits;
- **restrictive planning**, which constrains retailers from investing in optimum locations, ie large, low cost sites on out of town retail parks;
- and obliges them to focus more resources on extending existing stores in urban and suburban areas;
- **transport**, in the context of high operating costs, overworked infrastructure, virtually permanent urban/suburban traffic congestion and store delivery restrictions.

In these conditions, the relevant test of UK retailers’ efficiency is the productivity of their most valuable asset, ie their selling space. While comparative data is limited, it is now well-established that the average sales per square foot of the big four UK food retailers is in the £19–22 range (IGD data, 2003–04) and, as such, is well ahead of comparable American retailers’ performance. Smaller retailers in the UK achieve lower sales productivity but this reflects the smaller average size of their stores. Sales productivity is broadly correlated with store size, so on this criterion large US retailers should have a big advantage. The fact that they do not is explicable in terms of the saturation coverage which US retailers have achieved. This in turn reflects the combined impact of cheap land, low property overheads and a permissive planning regime.

While profit-based productivity measures suggest that UK retail has performed relatively well in the past, the cost inflationary pressures summarised in this report, set in the context of market maturity, slowing sales growth and intense price competition, represent a serious threat. The average food retailing operating margin across the major UK multiples (2003–04) was 4.9%, compared with 6% in the mid 1990s. The trend is gradually downwards and compares unfavourably with the average operating margins returned by the top half dozen food manufacturers in the UK, which are more than double those of the leading retailers. If retailers’ margins continue to edge downwards, the industry’s capacity to generate new employment, already reducing, will be seriously weakened.

We ask the Chancellor to take action to ease the pressure of cost inflation on the UK retail industry. Unchecked, the current and projected level of cost inflation will weaken the financial productivity of the industry and, therefore, its capacity to create jobs.

9 December 2004
Memorandum submitted by the Confederation of British Industry

CBI ANALYSIS OF THE AUTUMN 2004 PRE-BUDGET REPORT

1. Some of the broad themes of this year’s Pre-Budget Report announcement were welcomed by the CBI, with the UK’s longer-term competitiveness set to benefit if the Chancellor’s stated intentions come to fruition in the areas of:
   — enhanced skills and even greater labour market participation;
   — an improved environment for science, research and development; and
   — a reduction in the regulatory burden facing business.

2. However, the CBI’s member businesses also have some major reservations:
   — Some of the ideas raised in the area of parental leave could result in significant employer costs in future.
   — In terms of the net revenue flows associated with specific policy decisions, individuals stand to benefit in various capacities, but not very much—if at all—in their capacity as direct or indirect investors in UK business.
   — The Treasury’s projections for the public finances appear to be based on optimistic projections for growth and revenues. We concur with the widely-held view of independent economists that, unless the government of the day were prepared to rein in spending relative to the existing plans, tax rises of a noticeable size are likely to be needed early in the next parliament. CBI members are further concerned that in this event, a disproportionate share of the increased burden would once again fall on businesses and investors.

3. CBI members believe it important to judge this Pre-Budget Report in the context of Budget policies over the past few years, rather than in isolation. In total, these policies have disadvantaged UK businesses and investors, compared with the status quo ante. CBI members are also concerned at the direction of UK tax policy more broadly, particularly in the context of an increasingly competitive international environment.

4. The remainder of this analysis is set out as follows:
   — The Pre-Budget Report measures in isolation:
     — The broad policy themes
     — The specific policy decisions
     — Ongoing policy initiatives
     — Issues left unaddressed
   — The Pre-Budget Report measures in context:
     — The increase in business taxation since 1997
     — Wider pressures on UK business profitability
     — Economy-wide taxation: historical and international comparisons
     — Projections for the economy and the public finances

THE PRE-BUDGET REPORT MEASURES IN ISOLATION

The broad policy themes

5. This year’s Pre-Budget Report can be thought of as focusing on four major themes, each with an impact on UK business competitiveness. Of these, the CBI was able to welcome three: enhanced skills and employability, an improved environment for science and R&D, and a reduction in regulatory burdens on business. However, we are concerned that the potential benefits of these ideas could be offset, or more than offset, if action is not taken to limit the indirect costs to employers of new laws concerning parental leave.

Skills and employability

6. The government announced the national roll-out of the employer training pilots, to be known as the national employer training programme. The CBI believes that a skills strategy along these lines is crucial for the success of the wider UK economy. Employers want staff to be well-trained and take the issue extremely seriously, spending £23.5 billion a year. Yet without even more investment in skills, the UK could all too easily be left behind by economies with much lower costs. The threat from China and India to the UK’s low-skilled jobs is only going to increase.

7. This particular scheme will be welcomed by business, as the key success factors from the pilots—fully subsidised basic and “level 2” training, delivered flexibly with access to high quality brokers—will remain central to the national programme. Business is also pleased that the government has no intention of
compelling companies to participate through legislation: any statutory right to time-off would undermine the scheme’s success to date. The pilots were a success because employer participation was voluntary and the training provision tailored to firms’ needs.

8. In taking the scheme forward, the CBI would urge the government to be aware of three issues:

— The requirement to release staff for training must be applied flexibly to ensure that firms can meet both their training and their business needs. In the pilots, employees used the allocated periods for certain workplace-based activities, minimising disruption and increasing the relevance of training for both employer and employee.

— Wage compensation looks unlikely to be included in the national programme. But this is an important factor for some firms, particularly SMEs releasing staff for basic skills training.

— A sufficient supply of high quality brokers will be vital, to provide the service needed to employers, and especially SMEs.

9. In addition, the CBI welcomes the aim to increase labour market participation still further, through the “new deal for skills”.

Science, research and development

10. The CBI was able to welcome two decisions in the area of science, research and development: a technical tax change affecting university spin-offs, and the further consultation on the R&D tax credit. However, we were disappointed that no concrete changes in the operation of the credit have been made at this stage. Further detail on these matters is set out below, in the sections dealing with specific tax issues.

Reducing regulatory burdens

11. We welcome the shift in emphasis towards more-targeted, light-touch regulation, as suggested by the interim Hampton Review. This should help to ease the growing burden on employers.

12. Business, and smaller firms in particular, stand to benefit from specific proposals to:

— Simplify the calendar for the introduction of new legislation, so that the common commencement dates of 6 April and 1 October will now apply to health and safety, work and pensions, company and consumer legislation. This will minimise the time small business managers spend scanning the horizon for legislative change.

— Simplify smaller firms’ tax submissions. We welcome the announcement of the creation of the new small business unit in HM Revenue & Customs, and look forward to participating in consultation on small business taxation and related compliance issues.

— Ask the Better Regulation Task Force to examine the feasibility of a “one in, one out” regulatory model.

“Family-Friendly” Policies

13. The government announced long-anticipated steps to extend “family-friendly” rights, including the extension of paid maternity leave to nine months by 2007 and to a full year by the end of the next parliament. This leave will be transferable between the mother and the father.

14. The CBI is concerned about the potential implications for business of this policy:

— The government currently reimburses most maternity pay, but extended leave will lead to increased staff, training and administration costs. It is wrong in principle for business to be expected to bear these costs. The CBI has urged the government to offer more support to employers, particularly SMEs, to meet the costs associated with these rights. Other changes, such as to notice periods, could also ease the burden in terms of both cost and uncertainty.

— Allowing a portion of maternity leave to be transferable to the father could prove a significant administrative burden, if employers were responsible for policing the transfer of entitlement. Whilst a possible solution would be for the government to take responsibility for administering statutory payments, this would not necessarily be welcomed by all companies, particularly larger companies with complex and well-developed payment systems. Alternative, business-friendly, mechanisms should be explored.

15. There is a clear danger that the constructive relationship between government and business on this issue could come under serious strain, if ministers move too far too quickly.
THE SPECIFIC POLICY DECISIONS

16. Table 1 sets out the revenue impact of new policy announcements, based on the PBR costings. Business benefits from the roll-out of employer training pilots. But the only tax “benefit” comes from the freeze in petrol and diesel duty, and the decision to raise rebated oil duties by less than previously intended. These decisions do not, of course, improve firms’ cashflow position compared with before the PBR—they simply mean that the position is not quite as bad as it would have been, had the earlier decision to raise the duties gone through by default.

Table 1

PRE-BUDGET REPORT POLICY DECISIONS WITH A REVENUE IMPACT

<table>
<thead>
<tr>
<th>£bn yield (+) or cost (−) to the exchequer</th>
<th>2004–05</th>
<th>2005–06</th>
<th>2006–07</th>
<th>2007–08</th>
</tr>
</thead>
<tbody>
<tr>
<td>National employer training program</td>
<td>−0.08</td>
<td>−0.16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Petrol and diesel duty (half share)¹</td>
<td>−0.18</td>
<td>−0.33</td>
<td>−0.34</td>
<td>−0.35</td>
</tr>
<tr>
<td>Rebated oil duties²</td>
<td>−0.08</td>
<td>−0.10</td>
<td>−0.11</td>
<td>−0.11</td>
</tr>
<tr>
<td>Measures of benefit to business</td>
<td>−0.26</td>
<td>−0.43</td>
<td>−0.53</td>
<td>−0.62</td>
</tr>
<tr>
<td>Incapacity benefit</td>
<td>−0.06</td>
<td>−0.06</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Working tax credit</td>
<td>−0.17</td>
<td>−0.30</td>
<td>−0.30</td>
<td></td>
</tr>
<tr>
<td>Extension of paid maternity leave</td>
<td></td>
<td></td>
<td>−0.28</td>
<td></td>
</tr>
<tr>
<td>£50 payment for over 70s</td>
<td>−0.26</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Improving childcare quality and sustainability</td>
<td>−0.24</td>
<td>−0.24</td>
<td>−0.15</td>
<td></td>
</tr>
<tr>
<td>New deal for skills</td>
<td>−0.01</td>
<td>−0.01</td>
<td>−0.02</td>
<td></td>
</tr>
<tr>
<td>Petrol and diesel duty (half share)¹</td>
<td>−0.18</td>
<td>−0.33</td>
<td>−0.34</td>
<td>−0.35</td>
</tr>
<tr>
<td>Tax consequences: civil partnership act</td>
<td>−0.01</td>
<td>−0.02</td>
<td>−0.02</td>
<td></td>
</tr>
<tr>
<td>Measures of direct benefit to households</td>
<td>−0.18</td>
<td>−0.78</td>
<td>−0.97</td>
<td>−1.19</td>
</tr>
<tr>
<td>Addition to local authorities</td>
<td>−0.15</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Addition to special reserve</td>
<td>−0.52</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other expenditure measures</td>
<td>−0.52</td>
<td>−0.15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Remuneration based avoidance</td>
<td>0.20</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td>Capital gains options avoidance</td>
<td>0.01</td>
<td>0.05</td>
<td>0.08</td>
<td>0.08</td>
</tr>
<tr>
<td>Reform of film tax reliefs</td>
<td>0.02</td>
<td>0.09</td>
<td>0.11</td>
<td>0.12</td>
</tr>
<tr>
<td>Life insurance companies avoidance</td>
<td>0.03</td>
<td>0.05</td>
<td>0.05</td>
<td></td>
</tr>
<tr>
<td>Abuse of controlled foreign companies regime</td>
<td>0.03</td>
<td>0.05</td>
<td>0.05</td>
<td></td>
</tr>
<tr>
<td>Abuse of double tax relief</td>
<td>0.14</td>
<td>0.20</td>
<td>0.20</td>
<td></td>
</tr>
<tr>
<td>VAT: abuse of input tax rules</td>
<td>0.01</td>
<td>0.04</td>
<td>0.04</td>
<td>0.05</td>
</tr>
<tr>
<td>Loans and financial instruments avoidance</td>
<td>0.01</td>
<td>0.11</td>
<td>0.15</td>
<td>0.15</td>
</tr>
<tr>
<td>Modernising the taxation of leasing</td>
<td>0.06</td>
<td>0.17</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company car tax</td>
<td>0.04</td>
<td>0.10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue-raising measures ³</td>
<td>+0.25</td>
<td>+1.01</td>
<td>+1.29</td>
<td>+1.50</td>
</tr>
<tr>
<td>Total ¹</td>
<td>−0.71</td>
<td>−0.36</td>
<td>−0.22</td>
<td>−0.34</td>
</tr>
</tbody>
</table>

¹ Notional cost to Treasury of not implementing previously-announced rise.
² Notional cost to Treasury of smaller increase than initially announced.
³ The first eight measure shown here are described as “protecting tax revenues”. Remuneration-based avoidance and company car tax relate to employee taxation, but the remainder relate to businesses and investors.

17. In total, the measures shown as benefiting business build to £0.6 billion in 2007–08, while those of direct benefit to households build to £1.2 billion. This is to be paid for by revenue-raising measures building to £1.5 billion, together with a small further relaxation in the public finances worth £0.3 billion.

18. Of the measures shown in the table, two were welcomed by the CBI:
— There will be a modest cost to the Treasury as a result of the welcome decision to roll out employer training pilots across the UK. However, the ultimate benefit to the business sector, and to the UK economy at large, could be much greater than this revenue effect—as set out earlier in this paper.
— The decision to abandon any rise in petrol and diesel duty is also clearly of benefit to business, compared with the “default” situation of uprating in line with inflation. However, the decision is fully justified in view of the high price of oil, as well as the fact that the UK has the highest tax rates on road fuel in the EU.

19. In addition, business can welcome some specific policy decisions with a negligible exchequer impact—or none at all—which do not appear in the table:
— A tax problem which has stifled university spin-outs has been solved from PBR day. Recent legislative changes had inadvertently stifled spin-out activity and reduced the ability of academics and businesses to work together. It was vital that the government acted speedily to remove this obstacle to technology transfer, so news of this change is warmly welcomed.

— In an effort to improve access to finance for growth firms, the government has accepted in full the recommendations of the Graham Review of the small firms’ loan guarantee and will implement them by the end of 2005. Many of these proposals were originally put forward by the CBI, and will streamline the administration of the scheme.

— To make it easier for small firms to raise finance from business angel investors, the government will introduce self-certification for sophisticated or high net worth investors from January 2005.

— As part of the Financial Service and Market Act two-year review, employers who contribute to employee pensions, and who receive no direct commercial benefit from promoting their pension scheme, will be exempt from the Financial Promotions Order from Spring 2005. The CBI sees this as a small but essential step in raising awareness and understanding of pensions in the workplace—a key element in any strategy to improve employer-sponsored provision. (In July, the CBI’s Pensions Strategy Group called for the government to amend this Order, to allow employers who so wished to promote stakeholder schemes to their employees.)

20. However, some specific decisions have raised concerns:

— While the main road fuel duties were frozen, the duty on marked gas oil, diesel and kerosene for off-road use have been increased. Although the increase of 1p per litre is less than the initial intention announced at the time of the Budget, it still amounts to a rise of nearly 24%, and will have a direct impact on costs in such sectors as rail, quarrying, construction and agriculture.

— For duty on heavy fuel oil, the 1p per litre increase amounts to a rise of over 26%. The cost impact will fall disproportionately on Northern Ireland, which is eight times more dependent on this oil than the rest of the UK.

— On company car taxation, we are concerned about the proposed abrupt end to the relatively favourable tax treatment of diesel company cars that meet EU emissions standards. Phasing in such a change would have avoided potentially excessive volatility in the demand for such cars that the motor industry may now face.

— While some of the measures to “protect tax revenues” clearly aim at curbing practices that might be fairly termed “abuse”, in other cases we are concerned that the effect could be to raise genuinely new revenue flows, with potentially adverse consequences. We are, for example, aware of the life insurance industry’s concerns about the effects of a change targeting that sector.

Ongoing Policy Initiatives

21. The CBI welcomes publication of the technical note containing proposals for further reform of corporation tax, and emphasises the importance of simplifying the system with a minimum of disruption and without adding to the tax burden. We also look forward to the new public consultation on the wider issues raised by the ECJ’s current interpretation of EU law, which will be crucial to maintaining a competitive UK tax regime capable of meeting global challenges.

22. The CBI can also welcome:

— The forthcoming consultation on how to further improve the effectiveness of the R&D tax credit, and in particular its application for mid-size businesses. This should help the most enterprising growth companies.

— The review of the climate change levy, as part of the wider climate change programme review. The CBI will be fully engaged in this.

— The scheme whereby landfill tax revenues are to be recycled to business, through initiatives to improve resource efficiency. However, robust systems will be needed to ensure that the money benefits business directly.

— The ongoing commitment to garner international support for emissions trading in the aviation sector. However, if in the event emissions trading does ultimately get the go-ahead, this would reinforce the case for eliminating air passenger duty, the environmental rationale for which is extremely weak.

23. The CBI was disappointed that the government has not moved faster to implement UK real estate investment trusts (REITs). These are designed to stimulate investment and liquidity in property by lowering transaction costs and reducing double taxation. Given the clear benefits of REITs and the virtually unanimous support from business, it was hoped that these would have been a top priority. Further delays will put the UK property industry at a disadvantage as competitors press ahead with similar vehicles.
Issues left unaddressed

24. It was disappointing that some minor tax changes suggested by the CBI, which would have had a near-negligible cost for the Treasury, were not taken up (though it remains possible that they will be in the March Budget). In particular, we had put forward a limited set of measures aimed at removing tax anomalies and distortions that discourage enterprise. These include:

- some disallowed company expenses (“tax nothings”) including the incidental costs of raising equity finance;
- the corporation tax treatment of small “associated” companies;
- the limited availability of tax-efficient schemes (such as the EIS and VCTs) for investors in smaller quoted companies; and
- the exclusion of leased assets from the SME capital allowance regime.

25. Although further consultation on some aspects of the R&D tax credit is welcome, we were disappointed that there were no concrete changes at all at this stage. While the credit has been successful in stimulating innovation, for smaller firms especially there have been teething problems with both administration and coverage. The CBI had suggested that the definition of R&D recently adopted by the DTI should be the one used for the purposes of the credit. We also urged that better training be introduced for tax inspectors dealing with the credit, and/or that the Inland Revenue should use R&D specialists for this work.

26. We believe that the above measures could quite reasonably be introduced in April 2005, due to their near-negligible exchequer cost. But in addition, there are a number of much broader, longer-term aims which the CBI believes to be fully justified, but which would involve more significant sums. These include: a rolling back in the overall business tax burden to reverse the rise imposed in recent years; a narrowing of the gap between road user taxation and transport spending; and steps to tackle the pensions “crisis”. We note that there was no reference to any of these objectives in the Chancellor’s announcement.

The Pre-Budget Report Measures in Context

The increase in business taxation since 1997

27. Although the net financial impact for business of this year’s Pre-Budget Report is very limited, the Report must be seen in the wider context of tax policy in recent years, the impact of which has been to push up the tax burden faced by UK businesses and investors in them.

Dividend tax credits

28. A first major blow came in 1997, with the announcement of restrictions on dividend tax credits for investors in UK companies, including complete and immediate abolition for pension funds. The CBI opposed this idea when it was mooted in the mid-1990s. In our response to the 1994 “Industrial Finance Initiative” we stated that: “The CBI would strongly oppose any move to phase out or restrict the imputation system. Such a change to the tax system would seem bound to discourage rather than encourage investment.” And in our submission to the Chancellor ahead of the 1997 Budget we stated: “It is widely thought that the Government might restrict, or even abolish, the tax credits attached to dividends. The CBI would oppose this measure . . .”.

29. When the change was introduced, the CBI’s then Director General Adair Turner responded as follows in his subsequent letter to the Chancellor: “It is difficult to estimate the precise effect on pension funds . . . However, it is likely that many firms will find that they have to pay higher employer contributions . . . and this will increase their costs. It is also likely that employers will be discouraged from introducing, or even continuing with, the occupational schemes which at present are the backbone of the UK’s pension provision.” Seven years on, we are saddened that this prediction has been borne out in such a dramatic way.

Why corporations have not benefited from “offsetting” tax rate cuts

30. It is sometimes claimed that the abolition of the dividend tax credits was offset by the associated reduction in corporation tax rates. However:

- The full-year impact of the dividend tax credit change is shown in the 1997 “Red Book” to be £5.4 billion per annum. The full-year impact of the two-percentage-point cuts in corporation tax rates announced at the time was just £2.2 billion, with the subsequent one-point cuts announced in 1998 eventually worth a further £1.2 billion. As Adair Turner stated in his 1997 letter: “This change would have been more acceptable, though still not welcome, if it had been made in a revenue-neutral fashion. However, it has clearly not been . . .”.

- In any case, business sector cash flow has not benefited from these tax rate cuts, as they have been offset by other changes. Most notably, large companies were forced shortly thereafter to pay five years’ worth of corporation tax in the space of four years, during the transition to the new payment
The cashflow squeeze as a result averaged £2.1 billion per year during that period (1999–2000 to 2002–03). And just as this impact came to an end, employer NICs were pushed up by £4 billion per annum.

The overall revenue impact

31. The net impact of all of the major tax policy decisions made between spring 1997 and spring 2004, and affecting UK businesses and investors, is summarised in Table 2. There have of course been some very welcome measures, including helpful changes for SMEs and entrepreneurs, the introduction of the R&D tax credit and intellectual property relief, and elimination of the problem of surplus advance corporation tax. But as the table suggests, the revenue impact of these measures has been more than offset by other changes. In total, a net cumulative £44 billion of revenue has been gained by the Treasury from UK businesses and its investors over eight years, as a result of these decisions.

32. CBI members have been particularly concerned by the recent trend, towards increases in taxes that are unrelated to profitability and push up the cost base. The rise in employer NICs has hit businesses of all sizes and in all sectors, regardless of their financial health. The increase in rates and coverage of stamp duty land tax has specifically penalised businesses planning to move from one property to another, and as such is totally at odds with the government’s stated goal of raising UK productivity. And increased reliance on “green” taxation has raised various concerns relating to international sectoral competitiveness, targeting and compliance costs.

Table 2

APPROXIMATE REVENUE IMPACT OF BUSINESS TAX POLICY CHANGES, SPRING 1997–SPRING 2004

<table>
<thead>
<tr>
<th>£bn yield (+) or cost (−) to the exchequer</th>
<th>Annual average: 1997–98 to 2003–04</th>
<th>This year: 2004–05</th>
<th>Cumulative: 1997–98 to 2004–05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employers’ national insurance</td>
<td>+0.2</td>
<td>+2.9</td>
<td>+4.4</td>
</tr>
<tr>
<td>Climate, landfill &amp; aggregates taxes</td>
<td>+0.6</td>
<td>+1.7</td>
<td>+6.0</td>
</tr>
<tr>
<td>Fuel duties (share of) and lorry VED</td>
<td>+0.3</td>
<td>−0.7</td>
<td>+1.3</td>
</tr>
<tr>
<td>Stamp duty land tax (share of)</td>
<td>+0.6</td>
<td>+1.1</td>
<td>+5.3</td>
</tr>
<tr>
<td>Oil royalties</td>
<td>−0.0</td>
<td>−0.2</td>
<td>−0.4</td>
</tr>
<tr>
<td><em>Taxes adding to business costs</em></td>
<td>+1.7</td>
<td>+4.8</td>
<td>+16.7</td>
</tr>
<tr>
<td>Main corporation tax rates</td>
<td>−2.2</td>
<td>−3.1</td>
<td>−18.2</td>
</tr>
<tr>
<td>Move from ACT regime to in-year payments</td>
<td>+1.2</td>
<td>−0.5</td>
<td>+7.6</td>
</tr>
<tr>
<td>SME corporation tax measures</td>
<td>−0.7</td>
<td>−1.6</td>
<td>−6.8</td>
</tr>
<tr>
<td>Other allowances &amp; reliefs, etc</td>
<td>+0.0</td>
<td>+0.8</td>
<td>+1.0</td>
</tr>
<tr>
<td>North Sea profits taxation</td>
<td>+0.1</td>
<td>+0.6</td>
<td>+1.1</td>
</tr>
<tr>
<td>Windfall tax on utilities</td>
<td>+0.7</td>
<td>−</td>
<td>+5.2</td>
</tr>
<tr>
<td><em>Taxes on profits at the corporate level</em></td>
<td>−0.9</td>
<td>−3.8</td>
<td>−10.0</td>
</tr>
<tr>
<td>Dividend tax credit restrictions</td>
<td>+4.8</td>
<td>+5.4</td>
<td>+38.7</td>
</tr>
<tr>
<td>Entrepreneurs’ capital gains tax</td>
<td>−0.1</td>
<td>−0.3</td>
<td>−1.1</td>
</tr>
<tr>
<td><em>Taxes on profits at the investor level</em></td>
<td>+4.6</td>
<td>+5.1</td>
<td>+37.6</td>
</tr>
<tr>
<td>All taxes on UK business and its investors</td>
<td>+5.5</td>
<td>+6.1</td>
<td>+44.3</td>
</tr>
</tbody>
</table>

1 CBI estimates based on successive Treasury Budget and Pre-Budget Reports.
2 Excluding impact of original duty “escalator” set in train before 1997.
3 Gains from the R&D tax credit, intellectual property relief, “green” capital allowances and withholding tax on interest, offset by changes to double tax relief, foreign company UK branches, loan relationship rules and film tax relief.

Wider pressures on UK business profitability

33. The increase in business taxation in turn needs to be seen in the context of wider pressures on profitability. Increased taxes have added to the pressures on business, at a time when a number of other factors have also constrained profits growth. This matters because profits, after all taxes and other costs, provide:

— In the case of future profits, the incentive for business investment in tangible and intangible assets, the incentive for enterprise, and the incentive for globally mobile capital to locate in the UK rather than elsewhere.

— In the case of past profits, often the funding for new business investment, whether directly in the case of retained profits, or indirectly in the case of reinvested dividends.
— Returns for pension funds, endowment policies and other savings vehicles, on which the living standards of millions of UK residents depend.

34. Chart 1 illustrates the share of total UK corporate sector profits in GDP since 1977. Given the stage of the current economic cycle (i.e. very close to the peak), it would be highly unusual for this share to climb further from here. The best that might be expected (in the absence of an unanticipated policy change) is for profits to grow broadly in line with GDP in the year or two ahead. It therefore appears that profits peaked in the latest cycle at just over 22% of GDP—markedly lower than the peak of just above 25% reached in the 1980s and again in the 1990s, and lower even than the peaks achieved in the 1970s.

![Chart 1: UK corporate sector profits as % of GDP](image)

35. This structural decline in the profits share since the mid-1990s can be explained by five factors:
— More intense international competition, associated with the rise of China as a major trade player and continuous sterling strength. The average sterling price of both imports into and exports from the UK (for goods other than oil) is some 15% lower now than in 1996.
— The increased cost of employer pension funding, to contain the notional deficits caused by increased longevity, global stock market declines, the under-performance of the UK stock market relative to other major world markets, and the direct impact of the abolition of dividend tax credits.
— The Budget decisions pushing up taxes adding to the business cost base (employer NICs, stamp duty and “green” taxes), and regulatory changes also adding to costs directly or indirectly (e.g. the working time directive amongst many others).
— The role of government sector expansion in pushing the labour market towards its current, relatively tight position. The corporate sector’s share of national economic activity has been squeezed as a result, and businesses forced to compete more fiercely than otherwise for labour, capital and other resources.
— Most recently, the sharp rise in the cost of oil, and of other raw materials such as metals.

**Economy-wide taxation: historical and international comparisons**

36. The CBI notes with some disquiet the government’s intention to push up the economy-wide tax burden, from 36.2% in this financial year to 38.4% in 2009–10— with the burden increasing in each and every year between now and then. If achieved, the burden would at that point be the highest since 1984–85. It would be a substantial 6.2 percentage points of GDP higher than in 1993–94, and a notable 1.9 points higher even than in 1998–99—when the economy was considered to be close to “trend” and the public finances recorded a slight overall surplus.

37. We doubt that this 38.4%–of-GDP aim can be achieved without further discretionary tax increases. But the tax burden would need to be pushed very close to this level one way or another, unless the government were prepared either to bring down the share of its spending in GDP compared with the latest projections, or to allow the “spirit” of the fiscal rules to be broken or discarded.
38. Turning to international comparisons, it is much fairer to describe the UK as a “medium-tax” than a “moderate tax” economy. The UK is only a “moderate tax” economy if the comparison is confined to the (generally high unemployment) economies of the EU. In fact by the standards of the industrialised world outside of the EU, the UK could be fairly described as a “high-tax” economy.

39. Specifically, the latest OECD Revenue Statistics report shows that:
   - In 2002, the latest year of complete data, the UK had the 16th highest tax-to-GDP ratio out of the 30 OECD members, at 35.8%. This was just 0.5 percentage points below the OECD average (table 3).
   - Amongst the 11 non-EU OECD members, the average burden was just 30.7%. The burden was lower than in the UK in nine of these countries, and higher only in two.
   - The UK tax burden had increased by 0.8 percentage points between 1995 and 2002, above the OECD average of a 0.4 point rise. Of the other 29 OECD countries, 14 enjoyed a decline in the tax-to-GDP ratio, including other G7 economies the US, Japan, Germany and Canada, and major UK trading partners Ireland and the Netherlands. A further two countries, including G7 member France, saw the burden increase by less than the UK. A minority of 13 suffered a greater increase than here.

40. Looking ahead, if the government is “successful” in pushing UK tax revenues to 38.4% of GDP, while all of the other OECD countries’ tax burdens remained at the latest levels shown in the OECD report (mostly 2003 but some 2002), that would be enough to overtake Germany and push the UK burden to the 13th highest out of 30.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>44.0</td>
<td>6</td>
<td>+0.1</td>
<td>16</td>
<td>44.2</td>
</tr>
<tr>
<td>Italy</td>
<td>46.6</td>
<td>8</td>
<td>+1.4</td>
<td>13</td>
<td>43.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>39.2</td>
<td>11</td>
<td>−2.7</td>
<td>27</td>
<td>38.8</td>
</tr>
<tr>
<td>Germany</td>
<td>36.0</td>
<td>14</td>
<td>−2.2</td>
<td>25</td>
<td>36.2</td>
</tr>
<tr>
<td>UK</td>
<td>35.8</td>
<td>16</td>
<td>+0.8</td>
<td>14</td>
<td>35.3</td>
</tr>
<tr>
<td>Canada</td>
<td>33.9</td>
<td>20</td>
<td>−1.7</td>
<td>22</td>
<td>33.9</td>
</tr>
<tr>
<td>Ireland</td>
<td>28.4</td>
<td>26</td>
<td>−4.4</td>
<td>29</td>
<td>30.0</td>
</tr>
<tr>
<td>US</td>
<td>26.4</td>
<td>27</td>
<td>−1.5</td>
<td>21</td>
<td>25.4</td>
</tr>
<tr>
<td>Japan</td>
<td>25.8</td>
<td>28</td>
<td>−2.0</td>
<td>23</td>
<td>n/a</td>
</tr>
<tr>
<td>CD average</td>
<td>36.3</td>
<td></td>
<td>+0.4</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td>EU average</td>
<td>40.6</td>
<td></td>
<td>+0.3</td>
<td>n/a</td>
<td></td>
</tr>
</tbody>
</table>

1 The countries shown comprise the UK’s top five trading partners as well as remaining G7 members.
2 Assuming other countries hold their tax burdens constant at the latest (2002 or 2003) levels shown in the OECD report.


PROJECTIONS FOR THE ECONOMY AND THE PUBLIC FINANCES

41. The Treasury’s forecast for overall economic growth of 3–3.5% in 2005 is somewhat more optimistic than our own forecast of 2.5%. As a result, the revisions made to the Treasury’s public finance projections (summarised in table 4), are relatively small.

42. Based on these forecasts, the Chancellor is able to claim that the “golden rule” will be met in the present cycle (albeit only in terms of the average of each year’s current balance as a percentage of GDP, rather than in terms of the actual accumulated balance over the cycle). However, the CBI remains less sanguine about the government finances. In our view:
   - The government is on course to miss the “golden rule” in the present cycle, even on the definition used by the Treasury.
   - Because the rule will be missed by only the narrowest of margins (we put the average annual current budget balance over 1999–2000—2005–06 at −0.1% of GDP), that fact in itself would be of no great consequence from an economic perspective.
However, the public finances would start the next cycle (from 2006–07) on a poor footing, making it more likely than not that fiscal tightening of some kind will be necessary in the early stages of the next parliament. The CBI forecast puts the current budget deficit at £7 billion (0.6% of GDP) in 2006–07. And we see little reason for significant improvement beyond that, in the absence of policy action.

### Table 4

**THE PRE-BUDGET REPORT AND THE PUBLIC FINANCES**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>HMT forecast of PSNB</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>— March 2004</td>
<td>32.9</td>
<td>30.6</td>
<td>27</td>
<td>27</td>
</tr>
<tr>
<td>— November 2004</td>
<td>34.2</td>
<td>33.4</td>
<td>29</td>
<td>28</td>
</tr>
<tr>
<td>— Change</td>
<td>+1.3</td>
<td>+2.8</td>
<td>+2</td>
<td>+1</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in planned spending</td>
<td>−2.4</td>
<td>+0.1</td>
<td>+1</td>
<td>0</td>
</tr>
<tr>
<td>Change in projected revenues</td>
<td>(−3.7)</td>
<td>(−2.8)</td>
<td>(−2)</td>
<td>(−1)</td>
</tr>
<tr>
<td>Due to Spending Review (DELs only)</td>
<td>0.0</td>
<td>+0.8</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Due to economy, etc</td>
<td>+0.6</td>
<td>+1.6</td>
<td>+2</td>
<td>+1</td>
</tr>
<tr>
<td>Due to PBR policy decisions</td>
<td>+0.7</td>
<td>+0.4</td>
<td>+0.2</td>
<td>+0.3</td>
</tr>
</tbody>
</table>

1 For 2006–07 and 2007–08, Treasury projections are given only to the nearest £1 billion.
2 Departmental expenditure limits.
3 See table 1 for breakdown.

43. This in turn heightens our concern about the prospects for business taxation:

— Although taxes on business are ultimately borne by individuals, and can have significant detrimental effects on the economy and living standards, they are less visible. Raising business tax is therefore a very attractive option to policy makers who know that higher taxes are unpopular, but who nevertheless wish to push them up regardless. If taxes were to be raised in the 2006 Budget, then it would be a welcome surprise if businesses and investors did not bear a disproportionate share of the increased burden, as they did in the post-election tax-raising budgets of 1997 and 2002.

— The superficial case for increasing business tax would be bolstered in the eyes of some, if corporation tax receipts in particular fell short of their target—as seems likely. It would be open to the authorities to suggest that this “tax gap” was due to “concerted tax avoidance” on the part of business, when in fact the real cause would lie elsewhere. The current Treasury projections of corporation tax revenues appear to be based on a significant bounceback in profits—a bounceback which we believe to be extremely unlikely in today’s economic circumstances.

44. If in the event business taxes are raised, then this could only serve to depress the business investment required to drive long-term economic growth, and to limit still further the returns to investors in UK business—including pension funds amongst others.

*December 2004*

Memorandum submitted by Professor David Heald, Sheffield University Management School

PRE-BUDGET REPORT 2004: TESTING THE FISCAL RULES

**INTRODUCTION**

1. There could not presently be a Pre-Budget Report or Budget Report without the customary barrage of pre-announcements and diversions and of Treasury-sponsored reports on a plethora of topics nominally within the jurisdiction of other departments. Similarly, at this stage in the electoral cycle, the search for black holes and election bribes is in full swing. Cutting through this cacophony indicates relatively little substantive change. The one safe bet was that the Treasury would not announce that the fiscal rules were about to be breached.

2. This memorandum concentrates on three issues:

— Testing the fiscal rules.
— The independent audit of macroeconomic assumptions.
— The End-of-Year Fiscal Report.
TESTING THE FISCAL RULES

3. The Treasury (2004b, p 193, Box B1) explicitly rejects the claim that it has moved the goal-posts, by redefining how the golden rule is measured. The projected future surpluses in Table B1 (Treasury, 2004b, p 192) are just large enough to keep the average surplus since 1999–2000 positive. Observers may feel that this is too convenient, but the Treasury’s recent forecasting track record means that it would be unwise to bet against it. The chosen measure is more difficult to explain to a non-technical audience than that of the cumulative surplus over the economic cycle being non-negative, but that is not a decisive consideration. My personal view is that:

— From a public finance viewpoint, it would have been preferable not to have such high fiscal deficits when the economy continues to perform strongly; the breach of the Treaty deficit in 2003–04 is indicative of the lack of fiscal room for manoeuvre should there be serious economic difficulties ahead.

— From a macroeconomic viewpoint, the fact that there have been 49 successive quarters of GDP growth, notwithstanding the weaker performance of major trading partners, is impressive and the Treasury might argue that macro-fiscal management took precedence over this period.

4. Uncertainty about the world economy, and the margins of error attached to forecasting, means that it is a matter of judgement whether the golden rule will be met over the current or next cycle, when safety margins are so small. A curious paradox comes into play. With one caveat, it is immaterial from a macroeconomic perspective whether the golden rule is precisely met ex post; its usefulness is as a guide to fiscal planning. However, the present Chancellor of the Exchequer has placed such great store on the golden rule that its breach would be widely portrayed as a devastating blow to his credibility. This leads on to the caveat; a loss of credibility by the fiscal rules might erode their beneficial effects in terms of promoting economic stability. Such a charged political context emphasises the importance of Parliamentary monitoring of the fiscal numbers and alertness to any rechanneling of policy commitments into forms that evade the scoring mechanisms.

INDEPENDENT AUDIT OF MACROECONOMIC ASSUMPTIONS

5. The Treasury always makes extensive reference to the fact that certain Budget assumptions are audited by the National Audit Office under the provisions of the 1998 Finance Act. The level of assurance provided is much less than what is portrayed in Budget documents. Unlike in its financial audit and VFM 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. Box B2 (page 199 of the Pre-Budget Report 2004) lists the “Key assumptions audited by the NAO”. However, with reference to Box B2, paragraph B27 states:

All these assumptions are subject to review by the NAO under the three-year rolling review process, but none were due for review in this Pre-Budget Report.

This is consistent with there being no NAO Report on newly audited assumptions either on the Treasury’s Pre-Budget 2004 website or on the NAO’s website.

6. Although experience-to-date of the 1998 macro-fiscal framework allows reflected credit to be claimed, I have always had reservations about this unusual role—the “client” determines what can be looked at—for the National Audit Office:

The Treasury relied quite heavily on the assumptions having been independently audited by the National Audit Office (NAO), following the practice first established in 1997. The NAO does not audit the forecasts, its role being to ensure that these forecasts of the public finances are based on assumptions that are transparent and widely regarded as reasonable. However, the NAO can only audit the assumptions that the Treasury puts to it, though since the March 2000 Budget there has been a rolling review of previously audited assumptions. Thus far, the assumptions embodied in earlier macro forecasts have not been seriously tested by events. In such an eventuality, the NAO could be seen to be implicated in forecasts that later came under challenge, thus deflecting some blame from the Treasury and potentially creating difficulties in its relationship to Parliament and its committees. Although the NAO only audits certain forecasting assumptions, and not forecasting systems or methodology, this distinction might be lost in practice (Heald and McLeod, 2002, para 505).

Although the three-year cycle means that assumptions, once referred, will in due course be reassessed, the notion that the NAO’s sanction can be claimed for three years, without it having the opportunity to decide for itself what assumptions now need to be revisited, is strange at best and manipulative at worst.
7. The Committee’s requests for clarification about the NAO’s role have generated only the following non-answer in the Government’s Reply to the Committee’s Report on the 2004 Budget, HC 654, Session 2003–04, page 7:

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)

The audited assumptions are referred to the Comptroller and Auditor General as part of the three-year rolling review process. In addition, the assumptions are submitted for audit when they are changed or modified, as set out in the Code for Fiscal Stability. In addition, the Government asks the Comptroller and Auditor General to audit significant “spend to save” compliance packages where these principally affect operational activity rather than requiring legislative change.

8. The NAO’s role in auditing “cautious assumptions” is credited a remarkable number of times in Pre-Budget Report 2004, as in previous Budgetary documents. Moreover, the calls by policy critics for greater audit involvement seriously underestimate the limitations of audit in the area of macro-forecasting, where policy expertise and experienced judgement are paramount. The auditor needs to establish that the audit involvement seriously underestimate the limitations of audit in the area of macro-forecasting, where

Budget Report

E

2 The composition of the total amount of £11,394,246,000 is as follows: Administration costs (£1,233,398,000); EC Structural funds Resources (£93,384,000); Other resources (£7,466,368,000); EC Structural funds Capital (£12,231,000); and Other Capital (£2,588,365,000). These amounts are analysed by departmental group in Table 6 (Treasury, 2004a, p 14).

END-OF-YEAR FISCAL REPORT 2004

9. The Treasury should be commended on the End-of-Year Fiscal Report (EYFR) (Treasury, 2004c), now in its third edition. This brings together valuable fiscal data for the previous two years, this year being 2002–03 and 2003–04. The provision of reliable and prompt outturn data was for many years a serious deficiency; the End-of-Year Fiscal Report can be seen as a reporting counterpart to the invaluable Public Expenditure: Statistical Analyses. Encouragingly, the EYFR exhibits the measured tone of PESA, not the breathless tone into which Pre-Budget and Budget Reports often lapse.

10. The usefulness of PESA is, in part, a consequence of the Committee’s systematic pressure over the years for more comprehensive coverage. There is now an opportunity to press for extensions to the coverage of the EYFR. Some examples of what might be sought are listed below:

(a) An unexpected characteristic of the post-1998 expenditure planning system has been the build-up for various reasons of a stock of End-Year Flexibility (EYF) claims. These are reported, annually in July, in the Public Expenditure Provisional Outturn White Paper. Table 6 (Treasury, 2004a, p 14) shows Total DEL carried over to 2004–05 as £11,394 million.2 One of the present uncertainties regarding compliance with the golden rule in circumstances when the margins are small concerns the speed with which departments holding EYF entitlements will run these down, thus adding to current year expenditure, as planned spending growth decelerates and especially if their freezing is anticipated. Data tracking the evolution of EYF would be a valuable addition to the EYFR.

(b) The Private Finance Initiative has become an important form of public procurement, with many PFI assets falling off the public sector balance sheet and, indeed, often appearing on the balance sheet of no organisation. The EYFR is the ideal place for systematic reporting of PFI capital expenditure and of the stock of future commitments. Without this information, it is difficult to place in context reported underspending of direct public sector capital expenditure.

(c) The accounting numbers for UK central government are now on a Resource Accounting & Budgeting (RAB) basis, and the fiscal numbers are on an ESA95 (ie national accounts) basis.

1 The Public Accounts Commission put the following question to the National Audit Office after its evidence session on 24 February 2004: Question: How much advance notice does the Treasury give the National Audit Office of the assumptions that it wishes to be audited before a particular budget or pre-budget?

Answer: For the 2003 Pre-Budget Report, the National Audit Office staff first met Treasury staff on 5 November 2003 to consider the remit for that audit, and the report was published on 10 December 2003. In the most recent analyses, for Budget 2004, the first discussions of the remit took place on 12 February 2004 and the report was published on 17 March 2004. The agenda for these meetings was circulated in advance, and the Treasury also sometimes forewarn the Office of the likely extent of the audit some time before the first meeting. For example an informal meeting was arranged in the summer to discuss some of the background issues that would be relevant to the 2003 Pre-Budget Report audit. The budget assumptions work also includes a rolling review of assumptions last audited three years ago; as this element of the audit is carried out on a cyclical basis it is known about well in advance (National Audit Office, 2004, p 6).

2 The composition of the total amount of £11,394,246,000 is as follows: Administration costs (£1,233,398,000); EC Structural funds Resources (£93,384,000); Other resources (£7,466,368,000); EC Structural funds Capital (£12,231,000); and Other Capital (£2,588,365,000). These amounts are analysed by departmental group in Table 6 (Treasury, 2004a, p 14).
Accordingly, changes to accounting do not necessarily affect the fiscal numbers. The EYFR is the ideal place for systematic reporting of important issues such as the outstanding debt of quasi-public organisations, such as Network Rail, and of liabilities arising from public sector (employee) pension schemes.

7 December 2004

References


Supplementary memorandum submitted by HM Treasury following evidence on 14 December 2004

Q235 Financial Inclusion Fund—allocations to the Devolved Administrations

The Financial Inclusion Fund is £120 million over three years from 2005–06.

Different elements of the Fund have different geographical coverage reflecting differing devolved responsibilities. Where appropriate the Devolved Administrations will receive Barnett consequentials relating to the Financial Inclusion Fund. Wales is covered by the £120 million fund so does not receive any consequentials from this.

The consequentials from the £120 million break down as follows:

Scotland—£4,887 million
Northern Ireland—£3.316 million

Otherwise, bids to the Fund from organisations in the Scotland, Wales and Northern Ireland will be assessed along the same lines as those from England.

Further details on the allocations within the Financial Inclusion Fund will be announced in due course.

Q236 Council Tax and Local Authority expenditure

The Committee asked for a breakdown of the increase for the devolved administrations announced in the PBR as a consequence of the £125 million addition for England. The unrounded figures are: Scotland £12.675 million; Wales £7.363 million; Northern Ireland £4.168 million. It is for the devolved administrations to decide how to allocate these sums.

Q227 Efficiency Technical Notes (ETNs)—The NAO and Audit Commission’s Role

THE PURPOSE OF ETNs


SR2004 also committed departments to publishing Efficiency Technical Notes (ETNs) by the end of October 2004. All the main departments met this deadline.
The purpose of ETNs is to set out how departments will measure progress against their agreed efficiency targets. The documents are designed to provide the public and Parliament with greater clarity on efficiency measurement, thereby increasing the Efficiency Programme’s transparency and accountability. It is not the purpose of ETNs to describe every detail of a department’s efficiency plans or the detailed processes involved in achieving efficiencies.

Ideally, ETNs should describe efficiency measures in a simple way that is easily understood, covering issues such as baselines and the data that will be used. Balancing the need for clarity and simplicity with the need to provide an appropriate amount of detail on data and measurement is challenging. The role of the NAO and the Audit Commission in advising departments on ETNs was designed with this purpose in mind.

**The NAO and Audit Commission’s Involvement**

The NAO and Audit Commission were asked to examine drafts of departments’ ETNs against agreed criteria—clarity of savings, measurement methods, data quality, service continuity, and readability.

Departments submitted drafts of their ETNs to HM Treasury in September. The drafts were subsequently passed on to the NAO and Audit Commission. The NAO and Audit Commission co-ordinated their efforts and jointly produced advice on the draft ETNs to departments via a scrutiny panel comprising OGC and HM Treasury officials. The advice assessed the strengths and weaknesses of the drafts, highlighting areas where improvements were desirable. The risks to efficiency measurement, and ways to mitigate them, were subsequently discussed at meetings of the panel with the auditors. It was then for departments to take this advice into account before publishing their ETNs.

The scrutiny covered the main departments of government, namely Cabinet Office, Crown Prosecution Service, Department for Constitutional Affairs, Department for Culture, Media and Sport, Department for Environment, Food and Rural Affairs, Department for Education and Skills, Department for International Development, Department for Transport, Department for Health, Department of Trade and Industry, Department for Work and Pensions, Foreign and Commonwealth Office, Home Office, HM Revenue and Customs, HM Treasury, Ministry of Defence, Northern Ireland Office and Office of the Deputy Prime Minister (for both main programmes and local government). Departments subsequently published their ETNs at the end of October 2004.

**The Future Process**

The measurement of efficiency is complex and, in many areas, this Government is breaking new ground. Further work will be needed, building on lessons from the measurement of PSAs and the work of the Atkinson Review. The ETNs published in October are the first step towards demonstrating the achievement of efficiency gains. Government took the view that it would be better to publish documents early and to build on these public documents as the Efficiency Programme moves forward.

As stated in the 2004 Spending Review White Paper, additions and amendments to ETNs will be allowed. As departments identify further efficiencies and develop their plans further, we expect ETNs to change, develop and improve. We are discussing with the NAO and Audit Commission how they can be involved in the future process for renewing ETNs in a way that will add the greatest value.

Departments will also be required to report on efficiency in their Departmental Reports, as efficiencies are achieved. This should add further clarity and transparency on how gains are being measured.

Q232 Comment on specific examples in department efficiency plans

The Treasury Select Committee asked for the Treasury view on specific examples within departments efficiency plans, including the Ministry of Defence example of cutting submarines, the issue of fines in Department for Transport, and DfES’s plans to raise teachers’ retirement age.

Each department agreed their efficiency proposals as part of Sir Peter Gershon’s review process, with the review team. It is, therefore, the responsibility of departments to explain how their individual proposals will release efficiency gains and how the proposals fit with the departmental sections set out in the Sir Peter Gershon’s report.
Central Government Current Spending: background to and impact of ONS decision to reclassify NHS Trusts from the PC to the Central Government sector of the economy

SUMMARY

No impact on the Government’s overall fiscal position by moving NHS Trusts from PC to CG sector. This is because the fiscal rules measure the transactions and liabilities of the entire public sector, not just the government sub-set of the public sector.

There is no change in DH DEL caused by this switch. This is because the relationship DH has with NHS Trusts in order to control their expenditure has not changed. As noted above there is no impact on the fiscal position and as such no need to change control arrangements.

There is however a drop in Public Sector Current Expenditure as transactions between DH and NHS Trusts now consolidate out as transfer payments inside the central government sector. This reduction in spending is matched by a reduction in Public Sector Current Receipts, which no longer benefit from an amount equal to the gross operating surplus of NHS Trusts.

BACKGROUND

ONS announced on the 2 July 2003 that NHS trusts in all four countries of the UK were to be reclassified from the Public Corporation (PC), to the Central Government (CG) Sector. The switch was affected in Public Finances First Release on 30 July 2004 and is reflected in the annual ONS publication the Blue Book.

SECTOR CLASSIFICATION

A body is considered part of the public sector if government or another part of the public sector controls it. Control is defined as the ability to dictate corporate policy. The public sector divides into the General Government sector and the Public Corporations sector. This split is based on whether a body is market, ie selling goods and services and so a PC, or non-market, ie financed by general taxation, and as such part of General Government. The distinction for public sector bodies can be difficult. After looking at the way NHS Trusts are financed ONS decided that a non-market classification was appropriate.

It is expected that once the new trading/tariff arrangements come into force—c2008, that NHS Trusts will once again be considered market bodies and accordingly score as Public Corporations.

IMPACT

The Government’s two fiscal rules cover the public sector in their entirety. As such switching a body between the sub-sectors of the national accounts due to a reclassification has no impact on either the Golden Rule or the Sustainable Investment Rule. Indeed the fiscal rules were designed to ensure that total levels of public sector expenditure and debt are measured and controlled, and that liabilities of publicly owned enterprises are properly recorded.

IMPACT—CONTINUED

Whilst no impact on the two fiscal rules there is a small impact on the government’s preferred measure of expenditure, called TME, or Total Managed Expenditure. TME is a consolidated measure of public sector current and capital spending. This consolidation means that intra public sector transfers of interest and dividends are consolidated out, ie TME only scores interest and dividends paid to the private sector. The same is true of other transfer payments such as current and capital grants.

However this is not true for transactions in goods and services between general government and public corporations, or any subsidies paid to public corporations. These all score in TME. Public Corporations’ receipts of these payments form part of their Gross Operating Surplus, which is a revenue item on the same side of the accounts as other current receipts.

This means that when NHS Trusts were in the PC sector the amount paid by DH to NHS trusts to make a profit/pay dividends scored in TME. This was balanced in the overall public sector accounts by the gross operating surplus of NHS Trusts, which had benefited from these payments.

Now that NHS Trusts are part of CG these payments are considered transfer payments between institutions in the CG sector and are consolidated out accordingly. This results in a drop in TME equal to the gross operating surplus of the Trust, net of NHS trust depreciation that now also scores in TME with other non-trading capital consumption.

FromD = 30&FromM = 06&FromY = 2004&ToD = 30&ToM = 06&ToY = 2004&B1 = Begin + Search.
IMPACT ON DH BUDGETS

Under Resource Accounting and Budgeting the DH DEL budget measures a combination of the transactions between DH and NHS Trusts and NHS profits/losses. Because the relationship between DH and NHS trusts has not changed the budgeting framework has remained the same. As noted above the change in sector classification has no impact on the fiscal rules and as such there is no weakening of control over the public finances.

HM Treasury
15 December 2004

Memorandum submitted by Ms Anne Redston, Ernst & Young

PAYMASTER GENERAL’S STATEMENT ON FINANCE BILL MATTERS

The PBR contained a number of proposals to deal with various types of tax avoidance, including those set out in HM Treasury Note PN3 “Protecting Tax Revenues” and in the Inland Revenue Technical Note “Avoidance and employment related securities.” These are all specific in nature, and many are a response to the new tax disclosure regime introduced in the last Finance Act.

However, contained with the Paymaster General’s “Statement on Finance Bill on Finance Bill Matters”, published as an attachment to the Technical Note referred to above, the PMG says:

“I am therefore giving notice of our intention to deal with any arrangements that emerge in future designed to frustrate our intention that employers and employees should pay the proper amount of tax and NICs on the rewards of employment. Where we become aware of arrangements which attempt to frustrate this intention we will introduce legislation to close them down, where necessary from today.”

This statement raises a number of concerns.

1. Retrospective taxation

The PMG is announcing the introduction of retrospective taxation. This is a radical new departure for the UK, which has for centuries accepted that tax cannot be levied unless parliament has passed specific legislation authorising its collection. This principle was set out by Lord Simonds Scott v Russell (1945) 30 TC 375 at 424:

“My Lords, there is a maxim of Income Tax law which, though it may sometimes be over-stressed, yet ought not to be forgotten. It is that the subject is not to be taxed unless the words of the taxing statute unambiguously impose the tax upon him.”

It is a principle with deep roots, deriving essentially from the Magna Carta. As Simon Sharma puts it in his History of Britain:

“The Magna Carta . . . spelled out for the first time, and unequivocally . . . that the law was not simply the will or whim of the king but was an independent power in its own right.”

The history of democratic government in Britain has, as one of its fundamental themes, the establishing of the right of citizens not to be taxed by government fiat, but by the clear words of statute, following the introduction of specific legislation agreed by parliament. The statement of the PMG suggests a departure from that fundamental principle.

2. The scope of the statement

The PMG’s words are set in the context of certain specific PAYE and NIC avoidance, described elsewhere in her statement as “contrived” and “complex.” But her “notice of intention” goes beyond an attack on artificial, structured avoidance. It talks about “any arrangements” which prevent “the proper amount of tax and NICs” being paid “on the rewards of employment.”

This statement echoes other recent government pronouncements. In the 2003 Pre-Budget Report, the Government announced that it was introducing measures “to ensure that the right amount of tax is paid by owner managers of small incorporated businesses on the profits extracted from their company.”

This was not a reference to some contrived and artificial avoidance scheme, but rather to the incorporation, by thousands of self-employed small businesses, following the Chancellor’s reduction of the rate of tax on the first £10,000 to zero in 2000.

This 0% rate was a relief granted by the government, and referred to by the PMG in the parliamentary debates following its introduction as a “gift horse” which small businesses surely would not refuse. However, the cost proved too high, and following the statement of intent set out above in the 2003 Pre-Budget report,
the government imposed a 19% tax on money withdrawn from small companies, effectively eliminating the effect of the 0% rate. This Select Committee has already commented, in previous sessions, on this policy reversal.

However, had the PMG’s new taxation principle been in force in 2000, it would appear that the 19% tax would have been backdated, since Ministers were clearly of the view that individuals had not paid “the right [or proper] amount of tax” on the rewards of employment.” This would have imposed considerable hardship on many thousands of taxpayers, who believed they were responding to a government incentive.

The broad scope of this new principle is very worrying. As drafted, it encompasses not only ordinary tax planning, but the usage of government approved tax reliefs. Enormous discretion is being proposed under which the executive (and presumably the Inland Revenue) can decide whether or not the “proper” amount of tax has been paid, and if it considers this is not the case, to exact it retrospectively.

3. Disclosure rules

In FA 2004 the government introduced new rules for the disclosure of tax avoidance arrangements. These were described in the 2004 Budget “Red Book” as “aimed at those marketing and using certain tax avoidance schemes and arrangements [and] will allow early detection of such schemes and enable more effective targeting of avoiders.”

The professional bodies, and many firms of tax advisers, have worked with the Revenue over recent months to help ensure that the new disclosure rules are effective. Under the rules, new schemes have to be disclosed to the Revenue within five days of being made available in the marketplace.

As a result of these disclosures, the PBR also introduced specific legislation to target schemes. Comment in the Financial Times, on the day following the PBR, suggests that the rules are achieving their objective. Mr Frank Hollmeyer, of Armstrong International, is quoted as saying:

“This move will have an impact particularly as it has happened quickly and bonuses will be paid at some banks in three weeks time.”

It would thus appear that the new disclosure rules are proving effective in preventing contrived and artificial tax avoidance because they allow the Revenue to react quickly. Anecdotal evidence suggests that they are also having a widespread preventative effect—there is little point in designing and implementing a complex arrangement if it will be stopped soon after disclosure.

It is thus surprising that the government felt the need to introduce new, radical provisions to allow retrospective taxation when the evidence suggests that its latest weapon against complex tax avoidance has succeeded.

If retrospective taxation is to become the order of the day, then the disclosure regime—which aims to nip schemes in the bud—has in effect been superseded within months of its commencement. There is no need for disclosure if the government can collect the tax at any point in the future when it discovers the tax planning. Indeed, there will soon be no need for anti-avoidance tax legislation at all; it appears to be enough that the arrangements fall foul of what the government considers to be the payment of the “proper” amount of tax.

4. Human rights

Article 1 of Protocol No 1 to the Human Rights Convention provides that:

“Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.”

Contracting states thus have a wide margin when collecting taxes (Svenska Management Gruppen AB v Sweden, Application 11036/84, 45 DR211 [1985]), but this is subject to an interference that they must achieve a “fair balance” between the demands of the general interest of the community and the requirements of the protection of the individual’s fundamental rights and that there must be a reasonable relationship of proportionality between the means used and the aim pursued, see AGOSI v the United Kingdom, 1986, Series A no 108, p 17, para 48.

In the Sunday Times v UK [1979–80] 2 EHRR 245 at 271, para 49, the European Court of Human Rights gave its opinion that:

“A norm cannot be regarded as a ‘law’ unless it is formulated with sufficient precision to enable the citizen to regulate his conduct: he must be able—if need be with appropriate advice—to foresee, to a degree that is reasonable in the circumstances, the consequences which a given action may entail. Those consequences need not be foreseeable with absolute certainty: experience shows this to be unattainable. Again, whilst certainty is highly desirable, it may bring in its train excessive
rigidity and the law must be able to keep pace with changing circumstances. Accordingly, many laws are inevitably couched in terms which, to a greater or lesser extent, are vague and whose interpretation and application are questions of practice.”

If the principle of retrospection set out in the PMG’s statement is enacted, it is likely that it will be tested in the European Court of Human Rights, in order to ascertain whether the citizen can “foresee, to a degree that is reasonable in the circumstances, the consequences which a given action may entail”. It seems, on the bare words of the PMG’s statement, that the new principle would fail this test.

CONCLUSION

In summary, the proposed new powers are a fundamental departure from the tax principles established over many centuries in Britain; they are unnecessary, as the disclosure rules are proving successful, and they will place an intolerable burden of uncertainty on ordinary taxpayers who will not know if or when the government will decide that certain arrangements are unacceptable.

4 December 2004

Memorandum submitted by Professor Peter Spencer, University of York

THE FISCAL ARITHMETIC AND THE ECONOMY

The Chancellor has had everything going his way this year with the economy; asset markets and oil prices as strong as or stronger than he expected. However, there has still not been any improvement in the public sector finances—quite the opposite. The public sector current deficit of £17.2 billion for the first seven months is actually worse than it was last year (£15.6 billion). How does the Treasury expect to meet the golden rule, when despite all the good news, the current deficit is even higher than it was last year?

The answer is buried away in the appendices to the Report. In essence, it seems the recent data are misleading. Tax revenues have lagged the strong economy and the high oil price and have been held back by unforeseen problems like the accumulation of past losses in the financial sector, which provide a temporary tax shelter. The pattern of public spending across the year has shifted forward, so the figures for the last few months of this financial year will be more subdued. Going into next year, the economy will continue to grow at an above trend 3–3.5% rate, promising another surge in tax revenue.

Once again we are faced with a forecast in which the Chancellor meets his golden rule with a slim margin of error (0.1% of GDP). Once again, this forecast is just possible, but does not represent the most likely scenario. Indeed it shows exactly what has to happen for the public finances to come right in the end. Arithmetically, the growth in tax revenues necessary to meet the golden rule after the recent slippage is now very challenging. Economically, the PBR allows fully for the beneficial effects of factors like high oil prices while playing down the adverse effects. The odds are that tax revenue will continue to undershoot the forecast and that the golden rule will be broken in this economic cycle.

This note gives my assessment of the outlook for the remainder of this financial year and 2005–06 and takes a brief look at fiscal prospects over the next economic cycle.

GOVERNMENT REVENUES IN 2004–05

Table B11 of the PBR shows tax receipts in the first seven months of 2004–05 alongside the Treasury projection for the rest of the year. This table shows acceleration in Inland Revenue receipts from 8.6% to 10%. This is largely due to faster growth in Petroleum revenue tax (PRT) and Corporation tax (CT). The Treasury are expecting a windfall of £1.7 billions from the North Sea this year. While this seems reasonable, high oil prices reduce the profits of non-oil companies, especially when they find it difficult to pass higher fuel costs on to their customers. This is a reason for thinking that the strong growth rate in CT projected for the rest of the year will not be achieved.

The PBR argues that the high oil price reflects the strength of demand in the world economy, which is of clear benefit to UK companies. However, much of this demand has come from China, which takes just 1.2% of UK exports (with another 8% going to Japan and the Far East). Moreover, these benefits have been offset by the weakness of the dollar, which (along with the high oil price) is holding back our important European markets. Reflecting this, UK exports have failed to benefit from the upturn in the world economy this year (see below), helping to explain the weakness of manufacturing and the shortfall in corporation tax. Against this background, an increase of 21.5% in CT receipts (over last five months compared with a year earlier) is optimistic.

On these PBR projections, tax receipts and national insurance contributions will undershoot the Budget forecast by £3.9 billions this financial year. Table B12 shows how this figure is made up, with losses on onshore income and corporation tax and elsewhere partially offset by the North Sea windfall. This outcome would be very disappointing in view of the strength of the economy and the oil price, but our estimates at
ITEM point to a larger shortfall, of about £6 billions. Our forecast is summarised in Table 1 below. This table brings together ITEM’s revenue forecast and the government’s expenditure projections to give projection for the current deficit.

**Table 1**

<table>
<thead>
<tr>
<th>Current economic cycle</th>
<th>Next cycle</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. £ billion</strong></td>
<td></td>
</tr>
<tr>
<td>Current receipts</td>
<td>418.7</td>
</tr>
<tr>
<td>Current spending</td>
<td>425.5</td>
</tr>
<tr>
<td>Depreciation</td>
<td>14.3</td>
</tr>
<tr>
<td>Current balance</td>
<td>-21.1</td>
</tr>
<tr>
<td>Cycle cumulative</td>
<td>14.538</td>
</tr>
<tr>
<td>Net investment</td>
<td>13.7</td>
</tr>
<tr>
<td>Net borrowing</td>
<td>34.8</td>
</tr>
</tbody>
</table>

**B. As % of GDP**

| Current receipts | 37.52 | 38.18 | 38.65 | 39.08 | 39.46 | 39.85 | 40.22 |
| Current spending | 38.13 | 38.15 | 38.46 | 38.46 | 38.67 | 38.54 | 38.45 |
| Depreciation | 1.28 | 1.27 | 1.29 | 1.30 | 1.31 | 1.32 | 1.32 |
| Current balance | -1.89 | -1.23 | -1.09 | -0.67 | -0.52 | -0.01 | 0.44 |
| Cycle cumulative | 1.95 | 0.72 | -0.37 | -0.67 | -1.20 | -1.21 | -0.77 |
| Net investment | 1.23 | 1.85 | 2.17 | 2.22 | 2.26 | 2.22 | 2.25 |
| Net borrowing | 3.12 | 3.08 | 3.26 | 2.89 | 2.78 | 2.22 | 2.12 |

Source: Forecasts for current receipts from ITEM October Economic Outlook, rest from PBR 2004.

**PUBLIC EXPENDITURE**

Turning to the spending side, the PBR argues that the excessive increases seen so far this year are just a timing effect: 42% of departmental spending is coming in the last five months as against 43% last year. So these increases will tail off as the year-end approaches, from the current 6.8% pa to just 4%. On this forecast, public spending will be £1 billions below the Budget forecast.

**Chart 1**

The Price and Volume of Public Consumption
Despite the buoyancy of the recent figures, I am not expecting a large overshoot in expenditure this year. The pressure on budgets this year is much less than last year, when it was increased by the Iraq war and the aftermath of the big pay restructuring agreements seen in 2001 and 2002. This year public sector pay settlements have been relatively restrained, reflecting an emphasis on performance pay rather than reform or catch-up.

Reflecting this trend, the implicit deflator for government consumption (which mainly reflects wages and salaries) increased by just 3.1% in the year to the second quarter. The increase for the financial year is likely to be close to 3.8%, compared with 5% in 2003–04 and 6.9% in 2002–03. As my first chart shows, this has the effect of increasing the resources available for public services represented by a given money budget. So the volume of consumption is 3.8% this year, up from 2.8% in 2002–03 two years earlier, despite a reduction in money spent from 9.7% to 7.6%.

This has helped to maintain the level of demand in the economy, which is measured in real terms. Adding in capital expenditure, PBR Table A4 shows government spending adding 1% to demand this year, broadly in line with last year’s contribution. However, the rising cost of procurement in the second half of 2004–05 and in 2005–06 will now bring down the growth of real consumption. This squeeze is clearly shown by the chart which shows that next year’s money spend is less resource rich than this year.

**The Economy and the Public Finances in 2005–06**

The problem is that if the Treasury succeeds in slowing spending in the second half of the year when prices are rising more quickly, this will amount to a significant retrenchment in the public sector. This will tend to slow the economy, making it harder for the Treasury to hit the growth forecast. The massive infusion from the public sector, which has kept the economy growing over the last few years, will be reduced to a mere drip feed.

This is clear from the Treasury economic forecast, set out in Annex A. Table A10 at the end shows the volume of the main components of demand on a half (calendar) year basis. My table 2 shows the implied half-year growth rates for the four main components of final expenditure. Comparing the first half of next year with the second half of this year, the table shows the volume of public sector current expenditure growing at an annualised rate of just 2.4%, after 3.6% and 4.3% respectively over the two previous half year periods. There is also a deceleration in household consumption.

The Treasury assumes that the pace of output growth is maintained by a rapid acceleration in investment and export growth. Investment is boosted by a 30% increase in public sector investment next year, shown separately in PBR Table A6. Adding this to current expenditure, government spending adds 3% to output next year, compared with a contribution of 1% for this year (Table A4 again). However, there is clearly scope for public sector investment to fall short of this figure, reducing the support for the economy. The Treasury forecast a similar 30% increase for this year at the time of the Budget, but their latest estimate is for a rise of just 5%. Public sector investment managers have consistently undershot their targets in recent years.

**Table 2**

<table>
<thead>
<tr>
<th></th>
<th>Household consumption</th>
<th>Government consumption</th>
<th>Fixed Investment</th>
<th>Exports</th>
<th>Imports</th>
<th>GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 H1</td>
<td>3.5</td>
<td>4.3</td>
<td>7.7</td>
<td>1.2</td>
<td>4.9</td>
<td>3.3</td>
</tr>
<tr>
<td>2004 H2</td>
<td>2.3</td>
<td>3.6</td>
<td>5.7</td>
<td>7.0</td>
<td>5.9</td>
<td>2.8</td>
</tr>
<tr>
<td>2005 H1</td>
<td>2.6</td>
<td>2.4</td>
<td>9.5</td>
<td>6.6</td>
<td>6.2</td>
<td>3.6</td>
</tr>
<tr>
<td>2005 H2</td>
<td>2.4</td>
<td>3.1</td>
<td>2.8</td>
<td>6.4</td>
<td>5.8</td>
<td>3.2</td>
</tr>
<tr>
<td>2006 H1</td>
<td>2.2</td>
<td>3.1</td>
<td>3.1</td>
<td>5.2</td>
<td>5.4</td>
<td>2.7</td>
</tr>
<tr>
<td>2006 H2</td>
<td>2.3</td>
<td>2.9</td>
<td>4.5</td>
<td>7.2</td>
<td>5.3</td>
<td>2.7</td>
</tr>
</tbody>
</table>

*Source: PBR 2004 Table A10.*

Similarly, the Treasury forecast shows the volume of exports growing at an annualised 7% in the second half of this year and 6.6% in the first half of next year, following rates of about 1% over the two previous half years. This is again ambitious, particularly in view of the effects of the high oil price and euro exchange rate on our European markets. Although I am relatively optimistic about the prospects for the business investment and export sectors it seems risky to assume that they will be able to pick up the baton quite so deftly. Reflecting the risks inherent in the prospective rebalancing of the economy, the ITEM October forecast shown in table 3 is significantly below the Treasury, although above consensus.
The optimistic Treasury economic forecast for 2005 is accompanied by a revenue forecast for 2005–06 which is even more optimistic, showing revenues growing much faster (8.0%) than money GDP (5.7%). Table B13 shows the detail. Inland revenue receipts are very buoyant, rising by 10.1%, with income tax up another 8.1%. Again, corporation tax is the most striking—sporting another 25.5% gain. This is very ambitious given the rising cost base; the lack of pricing power in many business sectors and the need to increase (tax deductible) contributions to pension funds. While it is possible that the economy could just pick up again and give the Chancellor the extra output he is expecting, it is unlikely that he will get this kind of revenue growth.

**Prospects for the Public Finances in the Next Business Cycle**

The PBR takes the fiscal arithmetic up to 2009–10, showing a small margin of comfort on the golden rule and the debt to output ratio on the central case. This long run projection is based on a stylised assumption of a move back to trend as the output gap is eliminated in 2006–07 followed by trend growth of 2.5% from 2007–08 (Table B3). However, as chart 2.7 shows, the current budget remains in cyclical deficit until 2009–10 on the cautious case in which the trend level of output is 1% lower. This has to be of concern given the uncertainty about the current level of the output gap, which the Bank of England and the OECD believe is close to zero at present. If the output gap is zero rather than the 1% estimate of the PBR, then it is arguably more realistic to look at the cautious case rather than the central one.

More of a concern in my view is the Treasury’s continued optimism about the tax multipliers, shown in Table B14. This shows the share of tax in GDP increasing from 35.6% in 2003–04 to 38.4% in 2009–10. This would be the highest ratio since 1984–85 when North Sea revenues were at their peak, worth 3.6% of GDP. The Treasury projection suggests that Non-North Sea taxation will take up 38.0% of GDP in 2009–10, without any apparent increase in tax rates. This compares with 35.3% in 1984–85, when the maximum rate of income tax was 60%. Indeed, it would represent an all time high in the Non-North Sea share. While the effect of fiscal drag is likely to bring some rise in the share of personal taxes in GDP, it is hard to see what could possibly justify such a large rise in the tax ratio other than a rise in tax rates.

![Chart 2](net_taxes_and_nics_as_share_of_gdp.png)

Sources: PBR Tables B14 and B26
Inland Revenue Statistics.

The ITEM projections shown in my table 1 are based on tax-by-tax- forecasts. These suggest that total receipts will grow about 1% faster than money GDP between 2006–07 and the end of the forecast. This projection suggests that the current balance will enter the next economic cycle in the red. The cumulative balance will remain in deficit until the end of the period despite the rising share of GDP paid over in taxes.
CONCLUSION

The PBR provides a good illustration of what has to happen if the Chancellor is to avoid breaking the golden rule next year. The high oil price has to boost oil revenues without depressing our overseas markets or the taxes paid by non-North Sea companies. Exports (and business investment) have to revive despite the weakness of the European market and the rise in the pound against the dollar. Serious weakness in the housing market and the high street has to be avoided. Public procurement managers have to slow current budgets at a time of rising cost inflation, while simultaneously boosting capital spending. This could all come to pass, but it seems an unlikely combination of events.

Table 3

FORECAST COMPARISONS

<table>
<thead>
<tr>
<th>ITEM</th>
<th>% change on previous year</th>
<th>Consensus</th>
<th>HMT</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>3.3</td>
<td>3.2</td>
<td>3½</td>
</tr>
<tr>
<td>2005</td>
<td>2.8</td>
<td>2.5</td>
<td>3–3½</td>
</tr>
<tr>
<td>2006</td>
<td>2.5</td>
<td>—</td>
<td>2½–3</td>
</tr>
<tr>
<td>Household Spending</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>3.2</td>
<td>3.1</td>
<td>3½</td>
</tr>
<tr>
<td>2005</td>
<td>2.6</td>
<td>2.2</td>
<td>2½–2³</td>
</tr>
<tr>
<td>2006</td>
<td>2.6</td>
<td>—</td>
<td>2–2½</td>
</tr>
<tr>
<td>Gov’t consumption</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>4.4</td>
<td>4.3</td>
<td>4½</td>
</tr>
<tr>
<td>2005</td>
<td>3.0</td>
<td>2.9</td>
<td>3</td>
</tr>
<tr>
<td>2006</td>
<td>2.6</td>
<td>—</td>
<td>3</td>
</tr>
<tr>
<td>Investment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>6.8</td>
<td>6.3</td>
<td>6½</td>
</tr>
<tr>
<td>2005</td>
<td>4.5</td>
<td>4½</td>
<td>6½–7½</td>
</tr>
<tr>
<td>2006</td>
<td>4.0</td>
<td>—</td>
<td>3½–3½</td>
</tr>
<tr>
<td>Exports</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>2.2</td>
<td>2.1</td>
<td>2½</td>
</tr>
<tr>
<td>2005</td>
<td>4.8</td>
<td>4.7</td>
<td>6½–7</td>
</tr>
<tr>
<td>2006</td>
<td>5.7</td>
<td>—</td>
<td>6½–6¾</td>
</tr>
<tr>
<td>Imports</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>4.9</td>
<td>4.4</td>
<td>4½</td>
</tr>
<tr>
<td>2005</td>
<td>6.3</td>
<td>4.8</td>
<td>6–6½</td>
</tr>
<tr>
<td>2006</td>
<td>6.8</td>
<td>—</td>
<td>5½–5¾</td>
</tr>
</tbody>
</table>


Memorandum submitted by Mr David Walton, Chief European Economist, Goldman Sachs

From a macroeconomic perspective, the Pre-Budget Report (PBR) raises several issues, most of which relate to whether the Government’s fiscal rules will be met.

1. ARE THE TREASURY’S ECONOMIC GROWTH PROJECTIONS TOO OPTIMISTIC?

The Treasury’s main economic projections are unchanged from Budget 2004. GDP is forecast to grow by 3–3½% in 2005 and 2½–3% in 2006. These forecasts are based on a consideration of trend growth in the economy and the size of the output gap.

Trend GDP Growth: Table A2 of the PBR (p 169) gives the Treasury’s estimate of trend GDP growth. Between 2001 Q4 and 2006 Q4, it is put at 2½% a year—down from just over 3% a year between 1997 H1 and 2001 Q3. Thereafter the economy is projected to grow by 2½% a year due to slower growth in the working age population.

These estimates are very similar to those made by Kevin Daly of Goldman Sachs. Trend growth appears to have risen in recent years from 2½% to around 2¾% (see Chart 1). This is due partly to faster growth in the labour force but also to a better productivity performance. The level of productivity in the UK remains comfortably below that in the US and Euroland but the gap has been closing over the past decade (see Chart 2).

Given the likely trends in employment and productivity from now on, trend GDP growth is likely to be maintained at around 2¾% over the next few years. Unfavourable demographics will then reduce growth after 2008. Table 1 gives Goldman Sachs’ estimates of the contributions to GDP growth.
Table 1

<table>
<thead>
<tr>
<th>GDP GROWTH PROJECTION OVER THE NEXT 10 YEARS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Average Annual Growth Rates</strong>¹</td>
</tr>
<tr>
<td>GDP Growth equals changes in Population</td>
</tr>
<tr>
<td>plus Productivity (GDP/Hour)</td>
</tr>
<tr>
<td>plus Labour Utilisation</td>
</tr>
<tr>
<td>Of which Average Hours Worked</td>
</tr>
<tr>
<td>Employment Rate</td>
</tr>
<tr>
<td>Working Age Population</td>
</tr>
</tbody>
</table>

¹ Data are smoothed and may not sum to totals due to rounding.

**Output Gap:** The Treasury believes that GDP is currently below potential by around 1%. The Treasury bases its view on three judgements: (i) average hours worked “remain below their projected trend levels”; the employment rate has also "grown at a little less than its projected trend”; “the lack of apparent inflationary pressure in the economy lends strong support to the current assessment of a negative output gap”.

Each of these judgements can be questioned.

— Average hours, which have been declining since the Industrial Revolution, are only slightly below a simple trend estimate (see Chart 3). According to the Labour Force Survey, the number of people who say they are in part-time work only because they cannot find full-time work is at a record low of 71%. It is hard to argue, after two years of above-trend GDP growth, that the continuing decline in average hours is cyclical.

— On the employment rate, any difference with the “projected trend” can only be very small. In the year to 2004 Q3, employment rose by 0.16% of the workforce; the average rise over the previous five years was 0.21% a year.

— On inflation, a negative output gap would mean not just “a lack of apparent inflationary pressure” but its opposite—an increase in deflationary pressure. This is certainly not what is suggested by the sharp acceleration in core producer output prices and the gradual rise in non-bonus pay growth.

**Assessment:** The Treasury’s growth forecasts are reasonable if output is below trend. Given its view of the output gap, there would be a serious risk that inflation will continue to undershoot its target unless growth is as strong as the Treasury expects. We believe that the output gap is close to zero but the difference should not be exaggerated. On our view of the output gap and trend growth, GDP growth could average 2¼% a year over the next two years to be consistent with the inflation target—a cumulative increase in GDP of 5.5%. This is at the lower end of the Treasury’s expected growth rate of 5.5–6.5%.

2. ARE THE TREASURY’S PUBLIC BORROWING ESTIMATES TOO OPTIMISTIC?

For 2004–05, the Treasury revised its estimate of the current budget from −£10.5 billion to −£12.5 billion. Of this £2 billion revision, £0.7 billion is due to discretionary changes announced in the PBR (mainly the £520 million added to the special reserve for the Iraq war). Central government receipts are forecast to grow by 7.2%, compared with growth of 6.3% in the first seven months of the financial year. Some pick-up in the growth rate of receipts is likely reflecting stronger corporation tax and petroleum revenue tax receipts, though we expect an undershoot of around £1 billion. Central government current spending is forecast to grow by 5.4% vs 6.6% so far this year—most of the slowdown in spending expected by the Treasury is within DEL, and quite likely to be seen. Thus we expect the deficit on the current budget to be around £1 billion larger than the Treasury expects. As in previous years, there is a good chance that investment spending will undershoot, leaving public sector net borrowing close to the £34.2 billion PBR forecast.

For 2005–06, we are considerably more cautious about receipts. The Treasury is projecting a 0.9% rise in the share of tax receipts in GDP. Some rise is likely in response to the lagged effects of above trend growth and higher oil prices but the Treasury seems to be placing a lot of faith in the effectiveness of measures announced in the Budget to tackle tax avoidance. We expect an £8 billion shortfall in receipts and a similar shortfall in the current budget relative to the Treasury’s expectations.

Thereafter, we project a gradual clawing back in this receipts gap, mainly because the Treasury adopts a more cautious estimate of GDP growth in its public finance projections than Goldman Sachs.
3. Will the Fiscal Rules be Met?

On the Treasury’s definition of the economic cycle from 1999–2000 to 2005–06, we expect the golden rule to be missed by 0.05% of GDP a year on average. In the period from 2005–06 to 2009–10, we expect the golden rule to be missed by 0.12% of GDP a year on average. In both periods, the sustainable investment rule is met comfortably—net public sector debt peaks at 37.4% of GDP in 2007–08 and then begins to decline, below the 40% ceiling set by the Government (see Chart 4).

4. Does it Matter if the Golden Rule is Breached?

If the golden rule is missed by a small margin in the current cycle, it would be of little economic consequence. Importantly, the UK would still have the soundest fiscal position of any country in the G7. As required by the Code for Fiscal Stability, the Chancellor would be required to explain the reason for the deviation. He could do this easily. He might, for instance, decide to treat the £5 billion or so of expenditure on the Iraq war as of a one-off nature, best dealt with outside the fiscal rules.

Looking forward, there is a great deal of uncertainty about the path of tax receipts. One approach would be to raise taxes in Budget 2005, or reduce the growth of public spending, to be absolutely certain of hitting the golden rule over the next cycle. Another approach would be to see how things develop: fiscal drag could be sufficient to push the tax share up over the next cycle to hit the golden rule as the Treasury expects. A third approach would be to change the fiscal rules.

There are strong arguments in favour of the wait-and-see approach. Net debt remains below 40% of GDP. The deficit on the current budget is narrowing. It peaked last year at 1.9% of GDP and is set to fall to 1.1% of GDP this year. A move back to balance is likely in coming years without government intervention. An analogy can be made with the actions of the Monetary Policy Committee. When inflation undershoots the target, the MPC does not cut interest rates aggressively to get inflation back to target as soon as possible. This would be too disruptive for the real economy. Instead it aims to get inflation back to target on a two year view. There are merits to a similar gradualist approach to eliminating current budget imbalances.

5. Are the Fiscal Rules Sacred?

The Code for Fiscal Stability is a lot more relaxed about the fiscal rules than many analysts are. It merely requires fiscal policy to be conducted in accordance with five principles:

(i) transparency (setting of objectives, implementation of policy, publication of accounts);
(ii) stability (process, impact on economy);
(iii) responsibility (management of public finances);
(iv) fairness (including between generations); and
(v) efficiency (policy design, managing public sector balance sheet).

The Code allows the Government to change its fiscal objectives and operating rules provided that they abide with these five principles and the Government states the reasons for departing from the previous objectives and operating rules. This means that no new Government or new Chancellor is tied to the previous fiscal framework.

In this regard, it is somewhat surprising—with a general election in sight—that all of the debate about the public finances, by Government and opposition alike, is conducted within the framework of the current fiscal rules. As the Treasury notes (on p 140 of its book “Reforming Britain’s Economic and Financial Policy”), “it is for the elected Government of the day to choose and announce its fiscal policy objectives and rules, provided these are consistent with the fiscal principles set out in the Code.”

Once the election is out of the way, one of the first tasks for the Chancellor will be to set the fiscal framework for the new Parliament. This will involve a consideration of the appropriate levels of spending, taxation and borrowing in the next Parliament. There is nothing in the Code that requires the fiscal framework to be the same as in the last two Parliaments.

7 December 2004
Memorandum submitted by Mr Martin Weale, National Institute of Economic and Social Research

A. Government Borrowing and the Fiscal Rules

1. The *Pre-budget Report* shows the Golden Rule, that over the cycle the government should borrow only to invest, and run a balance or surplus on the current account, being met by £3 billion if the cycle ends in March 2005 and broken by £4 billion if the cycle ends in March 2006.

2. The Treasury calculations, showing that the rule will be met even if the cycle ends in 2006, are incorrect because they involve aggregating surpluses and deficits as proportions of GDP rather than simply adding up money borrowed or saved. This has the effect of uprating surpluses early in the cycle. Such uprating is wrong because the interest accruing on the surpluses is separately counted as income in subsequent years.

3. The *Pre-Budget Report* (Box A3) recognises the difficulties in measuring the economic cycle until well after the event but does not explain the implications of these for the fiscal rules.
4. Given the Treasury’s past forecasting record it is obvious that there is a significant risk of even their calculations showing the rule being broken. Precise estimates of the probability depend on the assumptions one makes about whether forecast errors are likely to persist from one year to the next or not. Nevertheless it is perfectly possible for the Treasury to estimate the probability of failure; two years ago this Committee asked it to produce a fan-chart which would answer the question. The fundamental issue over the budget projections remains not whether they are right or not; indeed such a question about a forecast is pointless. Rather it is that there should be a coherent and transparent statement of the chance of the Golden Rule being broken and an analysis of the policy changes which would be adopted if this probability rose over some threshold.

5. More generally, the debate about the Golden Rule suggests that it is not a sensible way of targeting fiscal policy. There are a number of problems

(a) It is not symmetrical. A better arrangement would be to have a target with a zone on each side of it regarded as a perfectly satisfactory outcome. We already have this arrangement with the inflation target.

(b) Estimates of the state of the cycle are uncertain and subject to substantial revision for several years after the apparent end of the cycle. Thus the rule cannot be used satisfactorily in real time.

(c) As noted above, forecasts of public current account borrowing are inherently uncertain and the fiscal framework needs to reflect this uncertainty.

6. A more satisfactory arrangement would probably refer to balance over the medium term rather than the cycle. But because it is never possible to be absolutely certain that a deficit is cyclical rather than structural, the Chancellor would need to make some effort to correct a deficit whenever it appeared. He would also need to pay attention to the stock of public debt and monitor how this was changing over and above any borrowing needed to pay for investment.

7. There is the separate and rather important question what that medium target should be. A case can be made that it should be slacker than the Golden Rule target. Since inflation erodes the stock of national debt there seems to be little wrong with allowing a medium term level of public borrowing designed to maintain the stock of debt roughly constant in real terms. This would allow a steady state current account deficit of up to 0.8% of GDP.

8. However an opposite argument can also be made. The United Kingdom is a country with a structurally low level of saving; the pension crisis is largely the result of this. In such circumstances there are good arguments to say that in normal circumstances the Government should run a current budget surplus. In essence the public sector should save to provide the retirement benefits which people do not save up to provide for themselves.

B. Savings Adequacy

9. The main economic issue the country faces is the question of savings adequacy. This can be explored at both micro-economic and macro-economic issues. At a macro-economic level it is anomalous that, although both the Pre-Budget Report and the Budget Statement are wide-ranging documents they make no reference at all to the question whether the overall level of saving in the country is adequate. The United Kingdom has one of the lowest savings rates in the OECD, the fundamental cause of the pensions crisis. Turkey, Portugal and the United States save less.

10. Instead of discussing whether saving is adequate or not the Pre-Budget Report asserts that “Traditional measures of aggregate saving... often fail to reflect... the positive impact asset growth has had on households’ balance sheets in recent years (paragraph 5.32).” This equation of saving and capital gains is correct only in very unusual circumstances. Much more commonly increases in asset prices are ways of enhancing the position of current generations (or at least those who own the appreciating assets) at the expense of their descendents. Thus they function in much the same way as government borrowing.

11. For the country’s wealth to grow in line with its income, without relying on capital gains transferring resources from the future, the rate of national saving would need to be over £50 billion higher than it currently is.

12. Even if one takes the view that land and house prices should be expected to increase in line with wages, this a substantial savings gap remains. The gap is augmented because these figures do not take account of the fact that the population is ageing.

---

4 Over the last couple of years they have been slower than some independent forecasters to recognize the true state of the public finances. The National Institute publishes a budget fan-chart indicating the error margin round budget forecasts. The implications of the Treasury forecasting errors were discussed by me in The Guardian on 14 November 2003. There I argued that the chance of meeting the target with the cycle ending in 2005 was just over 50%, so it is no great surprise that the current projections show it not being met.

5 For example if the price of capital increases because existing capital becomes more productive.
13. The Pre-Budget Report discusses the implications of low investment on Britain’s productivity. An increase in investment without any increase in saving would lead to a larger and possibly problematic external deficit. Thus the questions of investment and savings adequacy need to be considered side by side.

December 2004

Memorandum submitted by Mr John Whiting, PricewaterhouseCoopers

This paper gives a brief overview and commentary on the taxation measures contained in the Chancellor’s 2 December Pre-Budget Report (PBR) statement and the associated press releases, parliamentary statements and technical notes. It does not attempt a full analysis.

Whilst the state of the economy naturally commanded much of the attention in the PBR, there were some significant tax changes announced. The moves on anti-avoidance, and in particular the threat of retrospective taxation (which flies in the face of the Rees rules and the way tax law operates in the UK) had the highest profile but they should not obscure other measures.

1. Corporation Tax Reform

The commitment to take forward corporate tax reform, as first mooted in August 2002, is welcome. Removing the archaic schedular system and the irritant of charges on income are both useful simplifications and overdue. Hopefully the (inevitable) anti-avoidance measures around loss offsets will not be unnecessarily complex.

The proposals for capital asset reforms are interesting and will merit considerable study and discussion over such matters as the way capital losses will interact with what seems to be a future income-based system. Eliminating the £12,000 “expensive car” limit would be a welcome administrative simplification.

The possibility of capital allowances on offices and shops is a major step forward. However, the quid pro quo seems to be income-based charges on gains on buildings, seemingly including the land element, without the benefit of indexation. It is also uncertain whether rollover relief would be available for reinvestment. Whilst the modernisation is sensible, the price may be too high, particularly as there is a proposal to move most fixtures to the 4% buildings allowance regime rather than the 25% plant and machinery regime.

It is pleasing that there is recognition of the need to give relief for abortive capital expenditure: there needs to be a wider commitment to eliminate such “tax nothings” as far as possible.

The plans for further changes to the leasing regime are disappointing as they seem to stem from the Inland Revenue’s continuing view of leasing as a tax avoidance device rather as the constructive financing arrangement it usually is. Start up businesses (usually loss making in the early years) will lose out from the proposals but at least changes are only going to affect new leases.

2. IFRS and Related Tax Changes

The changes to the tax rules in anticipation of the move to IFRS are generally welcome and constructive. The deferral of some transitional gains is welcome. There needs to be continuing dialogue with the Inland Revenue over issues arising from some financial instruments.

Changes to bad debt relief are in part welcome (removal of restrictions on sovereign debt losses) and part irritating (trade debts between connected companies).

3. Small Business Measures

It is good news that the Government has recognised that differing business forms—sole trader, partnership and company—give differing tax and NIC results. The discussion paper on small business taxation is constructive, in that it appears to open up all areas for debate. It is to be hoped that there is a real will to rationalise the tax system, and thus try and solve some of the anomalies within small business taxation (for example, the lack of a disincorporation relief to parallel the incorporation relief) and not just tackle perceived tax avoidance (such as incorporating a business to take advantage of lower corporate tax rates).

The setting up of a dedicated small business unit within the new HMRC is a good move. The vision of HMRC taking a “whole view” of their customers and not “assuming we know best” is admirable and the sort of benefit that should flow from the creation of the single tax authority. It is to be hoped that it really can make inroads into the tax-related administrative burdens small businesses shoulder.
4. **THE EMPLOYER’S PERSPECTIVE**

The major administrative burden that businesses, large and small, take on tend to be employee-related. That should be a focus for the new small business unit.

Employers will view the PBR with mixed feelings. The moves on training and support and skills development sound promising. However, as with the family-related measures that formed such a key part of the Chancellor’s package, the concern will be whether there will be an administrative burden to be carried by the employer. Whilst the maternity/paternity leave extensions sound admirable, will business be able to manage the increased absences of staff easily?

Returning to the training incentives, those with memories of problems over the Individual Learning Accounts may want reassurances as to how this new system will develop and its likely length of service. One wonders whether a simple move such as an increased tax deduction for employee training costs (paralleling the 125%–150% deduction for Research & Development spend) would be more efficient, particularly for small businesses.

5. **ANTI-AVOIDANCE MEASURES**

The PBR contained a significant number of changes of an anti-avoidance nature. That was as expected, now the Tax Avoidance Disclosure (TAD) regime is in full operation. Indeed it is in some ways reassuring that there were such changes—this presumably confirms that the TAD system is perceived as working and that the considerable efforts made by the tax advisory profession and its clients (and, in discussions, the tax authorities) have been worthwhile.

There can be no objection to the principles inherent in TAD (ie full disclosure to the tax authorities—which is the only way firms such as PricewaterhouseCoopers have ever operated) nor to the ability of the authorities to change the tax system. However, three points need to be made:

1. Changes announced by Press Release (as with the PBR) need to be followed by discussions and draft legislation as soon as possible so as to remove uncertainty.
2. It is unacceptable to make significant changes to the tax system as it impacts on a major sector of the economy under the guise of anti-avoidance. To do so with negligible consultation adds insult to injury. Within the package are proposals to change the taxation of free assets held by life assurers. These changes are being made by statutory instrument rather than primary legislation and the industry has been allowed all of three days for consultation. The impact on some companies is very significant (some could suffer tens of millions of additional tax annually as a result) and it is not clear why some of the companies have been targeted in this way. One has to question why such a major change has to be rushed through when the issue being tackled has been a feature of life assurance taxation for many years.
3. The possible use of retrospective taxation needs to be considered very carefully. Whilst one understands the Government’s wish to stamp out what it sees as unacceptable avoidance, it needs to be remembered that a cardinal principle of the UK tax system is that people are taxed on the basis of what the law says when the transaction is undertaken. If the law is defective, case law has said countless times that the taxpayer and authorities must abide by its effects. Cases such as the Ramsay/Furniss line of cases have put boundaries on how transactions can be structured tax-effectively; why is retrospection now needed?

Apart from the general principle, there are two big practical issues:

- If retrospection is acceptable in one area, is this just the start of a slippery slope? The possible use of retrospection has been mentioned—admittedly informally—in at least one other area.
- Businesses want as much certainty as possible and a Damocletian sword of retrospection hanging around gives the wrong message, particularly to potential overseas investors.

One has to wonder whether the threat of retrospection is a means of introducing a General Anti-Avoidance Rule (GAAR) by the back door. When a GAAR was rejected, after extensive consultation, the key reason was, apart from its inherent uncertainty, the difficulty for the tax authorities of staffing the necessary clearance system. If retrospective legislation is to be used, it could be a GAAR without the counterweight of clearances.

6. **OTHER AREAS**

To conclude, we would like to welcome a diverse range of measures including:

- common commencement dates for regulatory changes (whilst wondering how practical the commitment will prove in practice);
- the changes to the tax treatment of university spin-outs (whilst having to point out that better discussion of the FA2003 schedule 22 changes could have obviated the need for this change and prevented the apparent damage to some of our scientific business plans in the interim);
— looking at maintaining the £7,000 ISA allowance (whilst wondering why this could not just be a commitment now, so the consultations could look at the much bigger issue of what happens after 2009 when ISAs may end); and
— the setting of personal allowances, NIC limits etc for 2005–06, which helps employers and many others (whilst wondering why the tax bands could not also be set now).

We are, however, disappointed with the lack of announcements in the PBR on:
— Real Estate Investment Trusts (REITs)—much needed in the UK; it is a shame that they were not committed to in the PBR. The only mention was tucked away and it seems we will have to wait another year for them.
— Trusts—it would have been timely to give a progress report on plans following the consultation on the modernisation of trusts.
— The impact on the increasing number of European Court of Justice (ECJ) cases on the UK’s direct tax system—surely we should hear how the Inland Revenue plans to make changes?

As a final comment, given the impact of the ECJ cases, changing business patterns and generally lowering tax rates among our trading partners, we do have to wonder about the projected yields of corporation tax in the PBR figures.

December 2004

Supplementary letter to the Committee from Mr John Whiting, PricewaterhouseCoopers

TREASURY COMMITTEE HEARING ON THE 2004 PRE-BUDGET REPORT

At the end of the Hearing today, I was discussing with the Committee the changes to the taxation of life assurance companies. In the time available I hope I answered the Committee’s questions appropriately; as I said to you I would be happy to amplify the points further if appropriate.

However, the reason for writing now is that on my return to the office I saw a letter from the Inland Revenue, dated today, that withdrew the particular provision that had aroused so much concern. I thought I should therefore write to draw this development to the Committee’s attention. Just to clarify the sequence and this latest development:

1. A package of measures was announced on 2 December affecting the Life industry; mostly these were of an anti-avoidance nature and many of the changes were planned to be made by statutory instrument.
2. The timing of this was that the announcement on 2 December was to be followed by a consultation period of 3 full working days.
3. Within these proposals was found to be a measure that affected the taxation of “free assets” held by life assurers. That was a substantive change to the method of taxing such companies and affected a situation that had been in existence about for many years. Thus it was not an anti-avoidance device that required immediate blocking.
4. The basis for bringing in changes like this was the power under Section 431A ICTA 1988 which gives the Treasury power to make regulations affecting insurance company taxation. It was the wide-ranging nature of this power that Paul Boateng expressed concern about on its introduction in 1990. Mr Boateng was the Opposition spokesman, seeking reassurance from the then Minister, Peter Lilley, about how the power would be used. The exchange took place in 1990 in Standing Committee E, recorded in Hansard at Col 105/106, at the conclusion of the discussions on Clause 34 and Schedule 4.
5. It seemed totally inappropriate to make such a substantive change to tax law for such a major industry by way of statutory instrument and with such negligible consultation.
6. The Revenue’s announcement in the letter I have seen states that this change will now proceed by way of proper consultation with provisions being introduced in the Finance Bill. (The other, technical, changes will still be made in the statutory instrument and can be accepted.)
7. It is of course very welcome that the Government has listened to concerns expressed by the Industry and advisers and it is to be hoped that the promised consultations will be full and proper in nature. However, the changes to be made will still operate for period of account beginning on or after 1 January 2005 it seems.

The Committee will therefore no doubt wish to take note of this development in framing any questions it may have of Inland Revenue officials or Ministers. Had I been aware of this development, which took place literally when I was addressing the Committee, I might have posed some questions:
— Why was such a substantive change attempted to be put through in the way it was?
— If the changes are now to be subject to proper consultation and Parliamentary process through the Finance Bill, can we have assurance that the Inland Revenue is approaching those consultations with a properly open mind?
— Why are the changes still to be introduced from 1 January 2005 when the Revenue have implicitly conceded that they may not have fully understood the impact on the industry of the proposals—surely tax changes should only be introduced on the basis of a proper understanding of their impact?

I would be grateful if you would draw the contents of this letter to the attention of the Chairman and his colleagues.

10 December 2004

Supplementary memorandum submitted by Mr John Whiting PricewaterhouseCoopers

It’s a good question as to why this (preventing tax avoidance relating to International Accounting Standards) was announced today and not included in the (extensive) paper on IAS issues published at the time of the PBR. I will if I may just give a quick response.

To be fair, I think that the main reason is that discussions of this whole area—the transition from UK GAAP style accounts to IAS-style accounts—has produced a host of issues, many of which are really only emerging as the time for implementation draws close & companies focus on the points. There have been good discussions between industry/advisers and the Revenue as to how to solve the issues that arise. As you would imagine, much of the drive is to make sure there is a fair result on the transition. That may mean that the Revenue starts from the assumption that any differences that arise would be taxable (if they are a profit); meanwhile business wants to make sure that adjustments are allowable (if they are a loss). The Revenue and business may then want to spread adjustments over a period, if they are losses and profits respectively—you will appreciate the differing viewpoints of the two sides!

The package that came out with the PBR included measures to delay the effect of a lot of transitional changes to 2006, rather than 2005 when IFRS first takes effect. That was generally welcomed; however, a business that was about to recognise a loss with the transition might validly argue that they have incurred the loss and on general principles should get relief for it. (Tax law and practice does have as a long-standing and still-valid principle that one can anticipate losses to some degree (eg bad debt provisions) but one is not expected to anticipate profits—though all that is subject to GAAP these days.)

The Press Release suggests that some companies have tried to take actions to bring forward the losses that will be recognised for tax purposes. I’m afraid I don’t know the detail of what has been attempted but I assume that the Revenue’s attitude is that if gains are being deferred, so should losses be. Against that, one goes back to general principles—and that these are real losses, not artificially-created ones.

The Committee may consider whether issues arising from the move to IAS have been tackled sufficiently early and with sufficient resource. Whilst many of the issues arise over funding arrangements (hence, I guess why much of the work has been led by Richard Thomas who also leads the Insurance tax team at the Revenue), this move to IAS is something that affects all significant businesses in the UK and the tax implications of the move have been an issue to be addressed for some time.

15 December 2004

Letter from the Parliamentary Clerk, HM Treasury to the Clerk of the Sub-committee

EUROPEAN COURT OF JUSTICE: CORPORATE TAX CASES

You wrote to me on 4 November asking for a note on the impact on the UK tax system of corporate tax cases before the European Court of Justice (ECJ).

To date, there have been relatively few cases relating to corporate tax that have been referred to the ECJ from national courts as a result of domestic litigation. What the cases have in common is that they concern the application of general EU principles (the fundamental freedoms that underpin the Single Market) to legislation on direct taxes in the Member States.

As Member States’ direct tax systems are very different, it is cases directly relevant to each Member State that have most immediate impact on that Member State.

Decided Cases

So far as the United Kingdom is concerned there have been four references to the ECJ in corporate tax cases.

In one case, (Daily Mail—C-81/87) UK law was upheld by the ECJ. (This case upheld HM Treasury’s power under S 482 ICTA to refuse permission for a company to transfer its central management and control outside the United Kingdom.)

The other three cases were:

— C-330/91, Commerzbank, which concerned entitlement to repayment supplement;
— C-264/96, ICI v Colmer, which concerned the grant of consortium relief; and
— Joined cases C-397/98 and C-410/98, Hoechst/Metallgesellschaft concerning the operation of the UK Advance Corporation Tax (ACT) system.

In the light of Commensbank, repayment supplement to tax refunds was made available to EC resident companies.

Following ICI v Colmer, the Government introduced a substantial reform to the rules for group relief and consortium relief (Finance Act 2000). This reform represented a relatively wide-ranging modernisation of the rules, including the specific point that had been at issue before the ECJ.

In the last of these cases (Hoechst-Metallgesellschaft), the ACT system had already been abolished as part of the modernisation of the UK CT system by the time the judgment was given (March 2001), so no further change was required to the corporation tax system.6

Aside from these four cases, there have also been instances where it has been accepted that cases referred to the ECJ by courts in other Member States have raised questions about aspects of the UK corporation tax regime.

In 2000, the Government accepted that the decision in the case of Compagnie de Saint-Gobain v Finanzamt Aachen-Innenstadt (Case C-307/97) meant that the UK should extend the limited double taxation relief then available to branches/agencies of EEA residents—and allow back claims for earlier years, subject to the normal rules. I attach the Inland Revenue press release of March 2000 that explains this (Annex A).

The Government also recognised (in the consultation on CT Reform in August 2003) that some uncertainty had arisen concerning the UK rules on transfer pricing in the wake of the decision in C-324/00, Lankhorst-Hohorst. The Government therefore acted to remove this uncertainty, and the transfer pricing and thin capitalisation rules were reformed in the Finance Act, 2004.

Pending Cases

As to pending cases, there have been two recent references to the ECJ from courts in the United Kingdom concerning the compatibility of aspects of the UK corporate tax system with EU law. The cases, which the Inland Revenue are defending robustly, are

— C-446/03, Marks & Spencer, concerning the UK system of group loss relief which currently can only be claimed by companies resident in the United Kingdom; and
— C-196/04, Cadbury Schweppes, concerning the application of the UK’s controlled foreign company legislation. This is anti-avoidance legislation, which charges UK companies to tax in respect of the income of certain controlled companies outside the UK.

It plainly would not be sensible to speculate on what the outcome of these cases might be. In particular, in the event of an adverse judgment, any action we might have to take would depend very much on the terms of the particular judgment, so I cannot say what the impact on the UK corporate tax system might be in that event.

The Government is already committed as part of the ongoing work on CT Reform to keep the UK CT system under review to take account of, inter alia, developments in ECJ case law. We are therefore continuing to monitor all cases referred to the ECJ that might affect the UK taxation of corporate profits. The Inland Revenue will also continue to defend the UK corporation tax system strongly from challenge.

29 November 2004

Annex A

BUDGET—TAX RELIEF FOR BRANCHES OF EU/EEA RESIDENTS

REV14 21 March 2000

DOUBLE TAXATION RELIEF FOR BRANCHES OF EU/EEA RESIDENTS

Residents of other EU/EEA Member States may claim double taxation relief for past years in respect of the income and gains of their United Kingdom branches and agencies. United Kingdom law already allows branches or agencies of non-residents to have the benefit of double taxation relief in some circumstances. Following a decision by the European Court of Justice last September the relief will now be available more generally to branches or agencies of residents of other EU/EEA Member States, subject to the normal time limits for claiming the relief. Claims should be sent to the office which deals with the tax affairs of the branch or agency.

6 Litigation in the wake of Hoechst-Metallgesellschaft, in particular concerning the issues not decided by the ECJ in that case, is being pursued through the UK Courts and the ECJ and is not dealt with in this letter because the subject matter of the litigation is not concerned with mainstream corporation tax.
1. On 21 September 1999 the European Court of Justice decided in the case *Compagnie de Saint-Gobain v Finanzamt Aachen-Innenstadt* (Case C-307/97) that Germany could not deny the company, which was resident in France, double taxation relief in respect of the income of its permanent establishment in Germany if such relief would be allowed to a German resident.

2. United Kingdom law enables relief for foreign tax to be claimed by persons who are resident in the United Kingdom. The relief extends also to non-residents but is currently restricted to foreign tax on the interest income of the branch or agency of a non-resident bank and on the income and gains of the branch or agency of a non-resident life insurance company. For the future, as foreshadowed in a discussion paper on double taxation relief for companies published by the Inland Revenue in March 1999, the Government proposes that the relief should be extended to the income and gains of branches and agencies of non-residents generally. See today’s Budget Note entitled Double Taxation Relief for Companies. (REVBN2D)

3. As regards the past, residents of other EU/EEA Member States who have not been able to claim double taxation relief under existing United Kingdom law in respect of the income and gains of their United Kingdom branches and agencies are invited to make claims to relief, subject to the normal time limits, as if the restrictions mentioned in the previous paragraph did not apply. If the profits include dividends from other non-resident companies, relief will be available for underlying tax if all the conditions for relief that apply if a dividend is paid to a United Kingdom resident company are met as regards the dividend and the non-resident companies concerned.

4. The time limit for claiming credit relief is six years from the end of the year of assessment or accounting period concerned (except that if relief is claimed against income tax or capital gains tax for 1996–97 or later, it must be claimed on or before the 5th anniversary of the 31 January following the end of the year of assessment concerned).

**Notes for Editors**

1. The United Kingdom may tax the profits of a branch or agency which a non-resident person has in the United Kingdom. Double taxation may occur if the profits are taxed also in another country where they arise.

2. Underlying tax is the tax paid by subsidiary companies on the profits out of which they pay dividends.

**Supplementary memorandum submitted by HM Treasury following evidence 16 December**

**Pre-Budget Report 2004**

1. Notes were requested on the following issues:

   Returning substance users to work
   A note to bring together figures across Government about the success of initiatives such as progress to work in returning substance users to work.

   Schools and Council Tax
   (1) Information on the Council Tax package announced in PBR in relation to reduction in schools FSS on education.

   (2) A note to confirm that there has been no cancellation of capital spending programmes by church schools in the £1 billion for Council Tax, and showing the rise in capital budgets for schools.

   DfES efficiency savings—retirement age of teachers.
   A note on the DfES efficiency savings—particularly the raising of the retirement age for teachers.

   Financial Inclusion
   A note on the specifics of the discussions with potential providers of increased “third sector” areas on affordable credit.

2. The Education Minister will write separately on the question raised by Mr Walter about £3.8 million being reallocated from one group of (church) primary schools in his constituency.
**RETURNING SUBSTANCE USERS TO WORK**

*Progress to Work*

Progress to Work currently helps about one in four people into work (compared with New Deal for Young People which helps around one in two into work and New Deal 25 Plus which helps about two in five into work7). However, people who go on to Progress to Work are, or have been, long-term drug users (mainly heroin) and experience a wide range of disadvantages. For example:

- 80% have a criminal record;
- 22% are homeless or in temporary accommodation;
- 40% have no formal qualifications;
- 46% of have been out of employment for more than two years; and
- over 40% are on inactive benefits.

Given these characteristics, you would expect lower job outcome rates for Progress to Work clients than for people who go on to mainstream Welfare to Work programmes. Comparisons of job outcomes are also difficult because participants are still classified as being on the programme when they enter work and remain so for up to three months.

A longitudinal cohort analysis is perhaps the best way of measuring progress on job entry rates. For example, of the 284 starts in July 2003, 17% had a job within three months rising to 20% within six months. There are other encouraging signs of progress:

- 94% of clients on Progress to Work are currently engaged in either employment, training, education or mainstream provision; and
- 26% of starts will eventually leave to positive outcomes.

The fundamental Progress to Work approach of connecting drug treatment with extra personal support and employment help is the right one. But there is clear scope for further performance improvement. DWP aim to use the Building on New Deal (BoND) prototypes to do this. BoND will allow a more flexible, modularised, menu of jobs help which is likely to be more attractive to people on Progress to Work. In addition, local delivery plans agreed between Jobcentre Plus districts and the relevant local agencies will drive better joint working.

*General—Home Office and Department of Health interventions*

**Drug Treatment**

The Drugs strategy has set the challenging goal of doubling the numbers in treatment to 200,000 within 10 years (against a 1998 baseline). So far they are on target to deliver: at least 154,000 users were in treatment in 2003–04. This represents an increase of 54% since 1998.

The numbers retained in or successfully completing treatment are up from 52% in 2002–03 to 72% last year. Waiting times are now lower than ever and immediate treatment is available for the most serious cases.

**Young people**

Class A drugs use among young people stabilised after years of growth. The Positive Futures programme equips young people with healthy alternatives to drug misuse. More than 50,000 young people have participated in Positive Futures since the programme began in 2000.

Additionally, the FRANK information campaign has been successful with the website receiving more than 3.5 million hits and the helpline over 650,000 phone calls.

**Schools and Council Tax**

1. *Information on the Council Tax package we have made public in PBR in relation to reallocated resources on education*

The Pre Budget Report announced a package of measures to reduce pressures on council tax by £1 billion in 2005–06.

This included reallocation of £512 million of existing funding from central programmes to local authorities and £125 million of new funding for England. Alongside this funding a range of further measures were agreed to relieve pressures on local authorities. Relevant details are set out in the Pre Budget Report.

---

7 New Deal performance data is based on leavers into work as a proportion of all New Deal YP and 25 Plus leavers, averaged over the past 12 months.
DfES’ contribution remains consistent with meeting the Government’s per pupil minimum funding guarantee for 2005–06. In addition local authorities can, at their discretion, make additional funds available to schools if they wish.

2. A note to confirm that there has been no cancellation of capital spending programmes by church schools in the £1 billion for Council Tax figure, and showing the rise in capital budgets for schools.

There has been no cancellation of capital spending programmes by church schools as a result of the £1 billion support to reduce Council Tax pressures in 2005–06.

Government support for capital investment in schools has risen considerably since 1997, from under £700 million in 1996–97 to £4.9 billion this year.

As announced by the Department for Education and Skills in November 2004, capital investment in schools will rise to £5.5 billion next year, £5.8 billion in 2006–07 and will reach £6.3 billion by 2007–08. Through the Building Schools for the Future programme, the Government is committed to rebuilding and renewing schools buildings to ensure that secondary education in every part of England has facilities of 21st Century standard.

DfES efficiency savings—retirement age of teachers

Since the publication of the December 2002 Pensions Green Paper, “Simplicity, Security and Choice: Working and Saving for Retirement” (CM 5677), the Government has been making it clear that higher pension ages are needed in the public services to reflect improved longevity, modern working patterns, practice in the private sector and longer working lifetimes. Higher pension ages will also help ensure financial sustainability and give scope for the other reforms, including benefit improvements, that scheme members and employers want. This is being carried out through a programme of pension scheme reviews, such as that for teachers’ pensions.

Increasing the pension age of teachers from 60 to 65 is expected to generate a small saving over the Spending Review 2004 period (and further savings thereafter). Around half of the savings from this change will be ploughed back into improving the benefits of the scheme. The remainder will be passed on to employers (schools, further education colleges and higher education institutions), because the employer contribution rate will be lower than it would otherwise have been had this change not been made. These institutions should therefore have more resources available for other priorities than if the pensions review had not taken place.

The scheme will still provide a high level of benefit, forming part of a very competitive reward package for teachers, and we anticipate that the benefits of the scheme in teacher recruitment and retention will be maintained. If so, the cost reduction will not affect the level of service provision, meaning that this will amount to an efficiency saving under the Gershon criteria.

Financial Inclusion

Third sector provision of affordable credit

The Government recognises the valuable role already played by third sector lenders in providing low-cost lending services to financially excluded customers. However, coverage is at present limited and a number of barriers to further growth remain.

The Pre-Budget report supplementary document “Promoting financial inclusion” therefore sets out a range of measures to increase the capacity of not-for-profit or third sector lenders in providing affordable credit to those on the lowest incomes.

Subject to any necessary state aids clearance from the European Commission, the Government will set up a growth fund for third sector lenders, from within the Financial Inclusion Fund, to boost the coverage, capacity and sustainability of the sector. The Government will invite bids to the Fund from third sector lenders. Support for credit unions will be granted on the basis of credit unions’ business strategies for further growth and sustainability. Support for community development finance institutions (CDFIs) will be made up of a mixture of revenue and capital support.

Further guidance on this process and the allocations within the Financial Inclusion Fund for the provision of affordable credit will be issued in due course.

Some in the third sector think that the statutory interest rate limit of 1% a month to which credit unions are subject constrains their ability to make loans available to the most vulnerable; disadvantages credit unions in comparison with other not-for-profit lenders; and makes it harder for credit unions to become financially self-sufficient. The Government will consult on the costs and benefits of raising the cap on interest that credit unions can charge on loans, in particular to ascertain the likely impact on existing credit union members and the communities they serve.
CDFIs need to attract investment from external investors in order to ensure long-term sustainability. The Government will also consult stakeholders on the case for and practicalities of, extending the Community Investment Tax Relief (currently only available for investment in enterprise lending CDFIs) to investments in CDFIs' personal lending activities. Any action in this area would be subject to state aids clearance from the European Commission.

In developing all these proposals, the Government has undertaken extensive discussions with individual practitioners in both credit unions and CDFIs, along with the key representative bodies within the third sector. These continuing discussions will inform the final guidance on the growth fund and the planned consultations to ensure that Government action in this area is appropriately targeted and monitored. Further details will be published shortly.

January 2005
### List of Reports from the Treasury Committee since 2001

#### Session 2004–05

<table>
<thead>
<tr>
<th>Report</th>
<th>Govt Response*</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Report: The 2004 Pre-Budget Report</td>
<td>HC 138</td>
</tr>
</tbody>
</table>

#### Session 2003–04

<table>
<thead>
<tr>
<th>Report</th>
<th>Govt Response*</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Report: The Transparency of Credit Card Charges</td>
<td>HC 125</td>
</tr>
<tr>
<td>Second Report: Child Trust Funds</td>
<td>HC 86</td>
</tr>
<tr>
<td>Third Report: The 2003 Pre-Budget Report</td>
<td>HC 136</td>
</tr>
<tr>
<td>Fifth Report: Restoring confidence in long-term savings: Endowment mortgages</td>
<td>HC 394</td>
</tr>
<tr>
<td>Sixth Report: The 2004 Budget</td>
<td>HC 479</td>
</tr>
<tr>
<td>Seventh Report: The Administrative Costs of Tax Compliance</td>
<td>HC 269</td>
</tr>
<tr>
<td>Eighth Report: Restoring confidence in long-term savings</td>
<td>HC 71</td>
</tr>
<tr>
<td>Ninth Report: Merger of Customs &amp; Excise and the Inland Revenue</td>
<td>HC 556</td>
</tr>
</tbody>
</table>

#### Session 2002–03

<table>
<thead>
<tr>
<th>Report</th>
<th>Govt Response*</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Report: National Statistics: The Classification of Network Rail</td>
<td>HC 154</td>
</tr>
<tr>
<td>Second Report: The 2002 Pre-Budget Report</td>
<td>HC 159</td>
</tr>
<tr>
<td>Third Report: Split Capital Investment Trusts</td>
<td>HC 418</td>
</tr>
<tr>
<td>Fourth Report: The Handling of the Joint Inland Revenue/ Customs and Excise PFI Project</td>
<td>HC 184</td>
</tr>
<tr>
<td>Fifth Report: Annual Report for 2002</td>
<td>HC 491</td>
</tr>
<tr>
<td>Sixth Report: The UK and the Euro</td>
<td>HC 187</td>
</tr>
<tr>
<td>Seventh Report: The 2003 Budget</td>
<td>HC 652</td>
</tr>
<tr>
<td>Eighth Report: Appointment to the Monetary Policy Committee of the Bank of England of Mr Richard Lambert</td>
<td>HC 811</td>
</tr>
<tr>
<td>Ninth Report: Appointment of Ms Rachel Lomax as a Deputy Governor of the Bank of England and member of the Monetary Policy Committee</td>
<td>HC 1011</td>
</tr>
<tr>
<td>Tenth Report: Inland Revenue Matters</td>
<td>HC 834</td>
</tr>
<tr>
<td>Session 2001–02</td>
<td></td>
</tr>
<tr>
<td>------------------------------------------------------</td>
<td>--------------------------------------</td>
</tr>
<tr>
<td>First Report  The 2001 Census in England and Wales</td>
<td></td>
</tr>
<tr>
<td>Second Report  Budget 2002</td>
<td></td>
</tr>
<tr>
<td>Third Report  The Office of Government Commerce</td>
<td></td>
</tr>
<tr>
<td>Fourth Report  Appointment to the Monetary Policy Committee of the Bank of England of Mr Paul Tucker and Ms Marian Bell</td>
<td>HC 880</td>
</tr>
<tr>
<td>Fifth Report  Banking, the Consumer and Small Businesses</td>
<td></td>
</tr>
<tr>
<td>Sixth Report  The Financial Regulation of Public Limited Companies</td>
<td>HC 758</td>
</tr>
<tr>
<td>Seventh Report  Parliamentary Accountability of Departments</td>
<td>HC 340</td>
</tr>
<tr>
<td>Eighth Report  Inland Revenue: Self Assessment Systems</td>
<td>HC 681</td>
</tr>
<tr>
<td>Ninth Report  Appointment of Sir Andrew Large as a Deputy Governor of the Bank of England and member of the Monetary Policy Committee</td>
<td>HC 1189</td>
</tr>
</tbody>
</table>

* 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.