House of Commons

Treasury Committee

The 2006 Budget: Government Response to the Committee's Fourth Report of Session 2005–06

Fourth Special Report of Session 2005–06

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The Treasury Committee

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

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Powers

The Committee is one of the departmental select committees, the powers of which are set out in 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.

Committee staff

The current staff of the Committee are Colin Lee (Clerk), Fiona McLean (Second Clerk and Clerk of the Sub-Committee), Dominic Lindley, Andrew Staines and Adam Wales (Committee Specialists), Lis McCracken (Committee Assistant), Mandy Sullivan (Secretary) and James Clarke (Senior Office Clerk).

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Fourth Special Report

The Treasury Committee published its Fourth Report of Session 2005–06, *The 2006 Budget*, on 24 April 2006, as House of Commons Paper No. 994. The Government response to this Report was received on 3 July 2006, and is appended below.

Appendix: Government response

The Government notes the conclusions of the Treasury Committee's Report on the 2006 Budget.

Energy prices

1. The rise in energy prices appears, so far, to have had muted second-round effects. We note the Government's proposed actions to encourage an "independent investigation" into European gas markets (and energy markets in general) and we recommend that the Government provide an update on the outcome in the 2006 Pre-Budget Report. (Paragraph 7)

The Government is keenly aware of the impact of high energy prices and the pressures they can impose and believes that market liberalisation will help reduce upward pressure on energy prices. The Government strongly supports the independent investigation of the EU's energy markets, and will continue to encourage the European Commission to act against anti-competitive practices and fully support the recent steps taken as part of their investigation into European electricity and gas markets. The Government will also work with other Member States to support the proposals to improve competition contained within the Commission's recent Energy Green Paper. We note the request to provide an update on this area in the 2006 Pre-Budget Report.

The output gap

2. There are some differences between the Treasury's forecast for the size of the output gap going forward, and the forecasts of independent observers and some members of the Bank of England Monetary Policy Committee. We note that the concept of the output gap has significant, and possibly insuperable, measurement and definitional problems, particularly given the growing economic importance of migration and its potential influence on the output gap, but we recommend that the Treasury publish a technical note on its methodology for measuring the output gap. (Paragraph 10)

Budget 2006 acknowledged the uncertainty regarding the magnitude of the current output gap (paragraphs B.46–51 in Chapter B of the Financial Statement and Budget Report); and the 2005 Pre-Budget Report included a more detailed discussion of the uncertainties (paragraphs A.45–51). The Treasury's methodology for measuring the output gap has been set out in a number of publications, most recently in the Treasury Paper *Evidence on the UK economic cycle* (July 2005). This paper also explained and discussed alternative approaches. To ensure further transparency of the Treasury's approach, a Treasury paper *Technical Note on Cyclical Indicators* was published alongside the 2005 Pre-Budget Report.

Consumer spending

3. While the forecasts of the Budget do not suggest that consumer spending growth will reach the previously high levels seen in the recent past, several outside observers note significant downside risks to these forecasts. We recommend that the Treasury provide all necessary assistance to the ONS in its task of understanding and measuring consumer spending, such as on services rather than retail sales, to help improve the quality of consumer spending forecasts. (Paragraph 13)

The Treasury's view on the outlook for consumer spending in set out in paragraph B.86 of the FSBR 2006.

The latest independent forecasts for private consumption in 2006 and 2007 are within the Budget forecast range.

Average absolute errors on Treasury forecasts are presented in Table B9 of FSBR 2006 (page 247) and show the average error on household consumption forecast over the past ten years has been a little below that of all other main GDP expenditure components.

Improvements to early (quarterly) estimates of consumer spending will follow from the national accounts modernisation programme, when the various sources of data on the supply and use of goods and services will be reconciled at a detailed level, on a quarterly basis.

The labour market and migration

4. We note the recent slight weakening in the labour market, and recommend that the Treasury monitor the situation closely. We also note the recent publication of research by the Department for Work and Pensions into migration effects of people moving into the United Kingdom from the new European Union countries and the Home Secretary's statement on a points-based immigration system. However, we recommend that the Government now undertake a more wide-ranging study of the effects of all migration, both high- and low-skilled, looking at areas such as wages, productivity, business investment and the effect on aggregate labour supply overall. (Paragraph 16)

The Government continues to conduct research into the effects of migration. As part of its ongoing assessment of the UK economy, the Treasury closely analyses developments in the UK labour market and their wider economic implications. The Treasury is also looking at the trends of demographic and socio-economic change and their implication for the decade ahead, in the Comprehensive Spending Review.

5. We welcome the moves in the Budget to encourage a higher rate of female labour participation, but note that these only form part of the way in which the Government will be expected to respond to the recommendations in the report of the Women in Work Commission. (Paragraph 17)

The Government has welcomed the Women and Work Commission's report and is currently considering its response to the recommendations. The Government has committed to producing an action plan within six months.

Productivity

6. We note the closing of the productivity gap (on certain measures) with international competitors. However, we also note the debate on the productivity figures, and recommend that the Treasury monitor those figures closely to ascertain the effect of labour hoarding. We also note the work being done to improve the public sector productivity figures, and recommend that the Treasury and the ONS ensure that there is significant public consultation before the new official statistical standards are disseminated. (Paragraph 20)

The Government welcomes the Committee's comments on the relatively strong productivity performance of the UK economy.

As set out in Budget 2006 and in *Productivity in the UK 6: Progress and new evidence*, the cyclical slowing in productivity growth may in part reflect labour hoarding. The Treasury will continue to monitor productivity figures closely and will include an updated assessment in the 2006 Pre-Budget Report.

ONS are currently planning a series of public consultation seminars, starting in summer 2006, to debate proposed methodological improvements for measuring public service performance.

The consultations will be based on developments first proposed in the UK Centre for the Measurement of Government Activity's Public Service Productivity articles. The aim is to ensure that this work is made available for, and benefits from, as wide a consultation as is possible with experts in the field—analysts and practitioners.

The key areas for consultation include general methodological issues that impact across all of the public services and specific issues for individual public services, such as education and health. ONS has developed a principled framework for these consultations, which complement the Cabinet Office Guidelines. The consultation process will last at least three months in accordance with this best practice.

Business investment

7. The statistics on business investment are prone to revision, and may also under-report investment. We recommend that the Treasury, in conjunction with the Bank of England as a prime user of these statistics, work with the Office of National Statistics to refine both the methodology and definitions of the business investment statistics, especially given the greater proportion of service sector activity in the United Kingdom. We further recommend that the Treasury continue to monitor the performance of business investment (including any effects from under-reporting as a result of weaknesses in the official statistics), including by international comparisons. (Paragraph 25)

As set out in the current Framework for National Statistics, the National Statistician has responsibility for the methodology and definition of official statistics, including those on business investment. Paragraph 4.3.4 of the Framework document (http://www.hm-treasury.gov.uk./media/724/BD/78.pdf) defines this role.

Early estimates of business investment are provisional and subject to revision when fuller information is available. Revisions are constantly monitored and analysed to inform the compilation of the national accounts; and results are published to inform users of the historic reliability of the estimates. The ONS has a number of initiatives underway to improve the coherence and coverage of business investment estimates. Improvements to coherence will follow from the national accounts modernisation programme; estimates of business investment will be based on a wider range of sources with assessments of coherence at a detailed level built in to all routine processes. Improvements to coverage will follow from the ONS's investigation into the under-recording of software investment in the national accounts. The results of this work will be incorporated into the national accounts in 2007. In addition the feasibility of the measurement of 'intangibles' such as training and R&D is being investigated.

External demand and United Kingdom trade

8. Should the Treasury's forecast of the zero input to GDP growth from net trade be achieved, we recognise that this would be a positive break from the recent trend. (Paragraph 26)

As noted in Chapter B of the FSBR 2006, net trade is forecast to make a broadly neutral contribution to GDP growth over the forecast horizon. The latest average of independent forecasts also implies a neutral contribution from net trade to UK GDP growth in both 2006 and 2007.

Paragraphs B97 to B105 of the FSBR explain recent trends in UK trade. The drag exerted on UK GDP growth from net trade in recent years reflects a number of factors, not least strong UK demand growth relative to that in the UK's largest export market, the Euro area. Paragraph B104 and table B7 of the FSBR set out the Government's forecasts for export and import volume growth and net trade.

The golden rule

9. We note the Treasury's projections which show that the Government is on course to meet the golden rule after the end of this economic cycle. We remain concerned that fiscal policy towards the end of a cycle may be constrained unnecessarily by spending levels or data classifications from, say, 12 years earlier, at the start of the cycle. In particular, revisions to data might be held to require sudden and undesirable changes to tax or spending in the final years of the cycle for the sole purpose of meeting the mechanical calculation implicit in the golden rule. We remain of the view that it would be appropriate to review the fiscal rules now such that any improved formulation of the rule could be introduced at the start of the next cycle. (Paragraph 38)

As explained in the Government's response to the Committee's *Report on the 2005 Pre-Budget Report*, fiscal policy is set in a forward-looking manner. Budget 2006 included extensive projections for key fiscal aggregates. On the golden rule, Budget 2006 shows that the average surplus on the current budget will be 0.7% of GDP over the years from 2008–09 to 2010–11. So, at this early stage and on the basis of cautious assumptions, the Government is on course to meet the golden rule in the next economic cycle.

The golden rule ensures fairness for future taxpayers by requiring that current spending, including the consumption of fixed assets, be financed by current revenue over the economic cycle. Performance against the golden rule provides a clear yardstick by which fiscal policy can be monitored. The golden rule has worked to ensure sound public finances: the surplus on the current budget over the current economic cycle is projected to average 0.1% of GDP, as shown in Budget 2006. That compares with an average deficit of 1.9% of GDP over the last economic cycle from 1986–87 to 1997–98.

Sustainable investment, liabilities and Whole of Government Accounts

10. As we noted in our Report on the 2005 Pre-Budget Report, while criticisms of the arbitrary level of the limit imposed by the sustainable investment rule have some merit, these do not outweigh the essential role that the rule plays in ensuring that Government expenditure and investment today do not lead to an unfair or unsustainable burden on future generations. However, looking forward, the sustainable investment rule will need to be considered in the context of the Government's balance sheet to be prepared under the Whole of Government Accounts (WGA) programme, which is discussed further below. (Paragraph 45)

The Government agrees that the sustainable investment rule, alongside the golden rule, plays an essential role in ensuring sound public finances in the medium term, which is the primary objective of the Government's fiscal policy.

Performance against the sustainable investment rule is measured by the level of public sector net debt as a percentage of GDP, which will be maintained below 40% in each and every year of the current economic cycle.

As set out in *Delivering the benefits of accruals accounting for the whole public sector*, published alongside the 2005 Pre-Budget Report, the Whole of Government Accounts programme is providing an additional and valuable perspective on the public finances. The Government is continuing to work on the development of WGA.

11. Future public sector pensions can be paid from future tax revenues and therefore long-term forecasts of cash payments are directly relevant when considering fiscal sustainability. We recommend that the estimated present value of the Government's public sector pension liabilities today, which is useful for the purposes of comparing the pensions provision for public sector employees with that for employees in the private sector, be published regularly. (Paragraph 50)

Estimates of the present value of public sector pension liabilities provide a snapshot of the stock value of liabilities accrued at a particular point in time. They therefore give only a partial picture of the ongoing cost to government. That is why the Government publishes long-term projections of the flow of cash payments for public sector pensions, which include not only payments accrued to date by current public sector employees but also, crucially, future accruals to current and future public sector employees. The latest estimates were published in the 2005 *Long-term public finance report* and show that public sector pension commitments are fully consistent with sustainable public finances over the long term.

The Government also recognises that the total unfunded public service pension liability and the reasons for changes in it in the course of a year are issues in which there is an interest. This is why as well as publishing projections of payments by the unfunded schemes in its long-term public finance reports, the Treasury has regularly published the latest estimate of the total unfunded liability along with a detailed technical note on how it had changed during the preceding financial year.

12. The publication of WGA is likely broadly to coincide with the end of the current economic cycle, although estimates in WGA may be volatile over the first few sets of accounts as valuation issues are ironed out. However, once any valuation concerns have been resolved, it may be timely to revisit the sustainable investment rule to ensure that estimates of public sector liabilities included in the Government's accounts are borne in mind in any review of the sustainable investment rule. (Paragraph 51)

As set out in *Delivering the benefits of accruals accounting for the whole public sector*, published alongside the 2005 Pre-Budget Report, the Whole of Government Accounts programme is providing an additional and valuable perspective on the public finances. The Government is continuing to work on the development of WGA.

The Comprehensive Spending Review

13. A full understanding of the costs associated with policy options arising from the recent Report of the Parliamentary Ombudsman on final salary occupational pensions is essential to a proper public and parliamentary debate on that report in the context of the Comprehensive Spending Review. We recommend that the Government publish estimates of the cost of various options for compensating affected pensioners in net present value terms as part of the Department for Work and Pensions' further reply to the Report of the Parliamentary Ombudsman, including options for expanding the Financial Assistance Scheme. (Paragraph 60)

John Hutton, Secretary of State, Department for Work and Pensions has announced that he will publish a full response to the Ombudsman's report; this response will include an explanation of the estimated cost of meeting the Ombudsman's proposals.

14. It is important that the Government clarifies at an early stage whether the "modernisation fund" proposed as part of the spending settlements for the Department for Work and Pensions, HM Revenue and Customs, the Treasury and the Cabinet Office is included within the new totals for those departments or is to be accounted for separately and provides a breakdown of the proposed expenditure between the departments. (Paragraph 65)

Modernisation funding sits outside these departments' settlements and is available for departments to help meet transitional costs. Allocation of funding will depend on the approval by HM Treasury of departments' applications for access to the fund. The fund is designed to offer flexibility to departments in their planning. Because the modernisation fund will only be made available on application to HM Treasury, no presumption has been made about the years in which the fund will be drawn down, and the exact proportion of the fund that will eventually be spent by each department is not fixed. The fund is therefore not included in departments' Departmental Expenditure Limit (DEL) totals.

15. The early announcement of a decision on the overall spending levels of the Home Office provides an opportunity to focus on the distribution of expenditure within that total and the savings to be expected in specified areas of the Home Office budget, although it does also constrain the forthcoming national debate on spending priorities in relation to services funded through the Home Office. (Paragraph 66)

The Government agrees with the Committee that the early Comprehensive Spending Review settlement for the Home Office provides the long-term stability of funding that will enable the Home Office to focus on delivering maximum value for money, improving delivery, and ensuring they have the optimal distribution of expenditure between their priorities. The national debate will inform this process.

16. We welcome the Government's decision to initiate a national debate as part of the Comprehensive Spending Review. It is important that this debate is set in a context which enables it to amount to an opportunity for full consideration of options and priorities, rather then simply providing an opportunity for departments to canvass for public support for their bids for increased expenditure. In this context, it is vital that departmental select committees of the House of Commons ensure that they are fully engaged with the process. As a first step, we expect to hold an initial inquiry on spending matters following the publication of the report expected in mid-2006 on the spending challenges. To assist with timely parliamentary scrutiny of matters arising from that report, we urge the Government to ensure that this document is published no later than the end of June 2006. (Paragraph 68)

The Government agrees that it will be important that the national debate takes place in the context of realistic trade-offs and questions about priorities, rather than simply about increased expenditure. The Government will take full account of the need for parliament to have time to debate the issues when determining the timing of any report on spending challenges.

Efficiency savings and the public sector workforce

17. We welcome the contribution made by the recent National Audit Office study to understanding of the Efficiency Programme. We also welcome the Treasury's commitment to work closely with the National Audit Office on the issues identified in that study. We continue to believe that public and parliamentary confidence in the Programme, and in the effectiveness of the central coordinating role played by the Office of Government Commerce, would be enhanced by the provision of more information about measurement systems and data in a single source in Red Books and Pre-Budget Reports. We recommend that such documents contain further analysis of progress of the Efficiency Programme as a whole, including an indication of the proportions of the overall reported savings that are attributable to central and local government and that are cashable and non-cashable, as well as analysis of savings in relation to the themes identified in the Gershon review—back office functions, transactional services, procurement, policy, funding and regulation, and productive

time. We further recommend that such documents include an update on verification, in cooperation with the National Audit Office, of previously reported savings. (Paragraph 76)

The Government agrees that public and parliamentary confidence in the Programme, and in the effectiveness of the central coordination function of the OGC, is important. To this end, there already exists a substantial amount of publicly available information related to the efficiency programme.

Regarding measurement systems, departments already set out their approach to measuring their efficiencies in their Efficiency Technical Notes (ETNs), which were drawn up in consultation with the NAO and refreshed in December 2005. In February, the NAO noted that all ETNs had been improved.

Departments report on the progress of their efficiency programmes twice yearly in their Departmental Reports and Autumn Performance Reports. These provide the breakdowns of savings by department that the Committee has previously requested. HMT guidance to departments on reporting in their Departmental Reports states that departments should provide breakdowns of their gains by cashable and non-cashable efficiencies. The overall projection for cashable and non-cashable gains in the programme is contained in the original Gershon report.

Local authorities have already produced Annual Efficiency Statements that set out the sectors where efficiency gains are being achieved through locally delivered services, including the cashable amount of these gains. The Statements are available on the Department for Communities and Local Government website.

Regarding verification and NAO, the Budget announced £6.4bn of provisional annual efficiencies. We are currently working with departments, and with input from the NAO, to further develop the verification procedures for reported efficiency gains.

18. We welcome the Government's determination to embed the efficiency agenda as part of the process for spending allocations during the Comprehensive Spending Review. We recommend that the initial report as part of that Review to be published in mid-2006 contain initial proposals for consultation on how an Efficiency Programme for the period from April 2008 onwards can be monitored and reported on. As part of such proposals, we expect the Government to give consideration to ensuring that efficiency projects are designed and measured using net as well as gross savings in order that the investment necessary to secure efficiency savings can be properly measured and assessed. (Paragraph 77)

The current efficiency programme is continuing to have an impact, delivering significant efficiency savings across government. For the Comprehensive Spending Review, the Government will look to put in place an efficiency and value for money framework that builds on the success of the current programme while seeking to learn lessons and to make improvements where appropriate. There are no specific proposals to put before the committee at this stage, but we welcome the committee's views and will consider these recommendations carefully.

19. We recommend that, in seeking to embed a culture of efficiency in Government departments during the period covered by the Comprehensive Spending Review, the Government places greater emphasis on delivering and reporting on targets for continued reductions in departmental administration budgets rather than on workforce reductions attributed to efficiency projects. (Paragraph 79)

The Government will consider carefully the merits of all aspects of the current efficiency programme, including the case for continued headcount targets, as plans for the efficiency framework for the Comprehensive Spending Review period are developed.

Poverty and the tax system

20. The introduction of tax credits has contributed to the reduction in the number of households facing the highest marginal deduction rates of 70% or more from 740,000 before Budget 1998 to 240,000 under the 2006–07 system of tax and benefits. However, the number of households facing marginal deduction rates in the region of 60% to 70% has increased since 1997 and now appears to have levelled off at around 1.5 million households. We recommend that the Treasury analyse the characteristics and income distributions of households facing marginal tax rates in the region of 60% to 70% and the extent to which these high marginal tax rates are discouraging people from entering the workforce, from working longer hours or from acquiring additional skills. We further recommend that the Treasury publish the findings of such analysis at the time of the 2006 Pre-Budget Report. (Paragraph 85)

Budget 2006 reaffirmed the Government's commitment to making work pay by improving incentives to participate and progress in the labour market. The Government welcomes the Committee's interest in work incentives issues, and will continue to report on policy and progress in making work pay in future Pre-Budget and Budget Reports.

Research shows that the Government's policies, including more generous in-work support through tax credits and the National Minimum Wage, have made a significant contribution in encouraging people to enter the workforce and raising employment rates for disadvantaged groups such as lone parents. In addition, the lower rate of withdrawal under tax credits compared with previous systems of support has contributed to a reduction of around half a million in the number of households facing the highest marginal deduction rates of 70% or more.

Tackling the highest marginal withdrawal rates, and hence the worst work disincentives, has involved withdrawing support more slowly. However, this has the effect of extending support to more families and so increasing the number of people facing withdrawal rates of between 60% and 70% (although such calculations take no account of the £25,000 disregard in tax credits which significantly reduces shorter-term deduction rates). The trade-off is inevitable and, in the Government's view, has been struck in the right place. The Government recognises the importance of evaluation of this and other issues surrounding the introduction of tax credits. HM Revenue and Customs has actively promoted and published significant research into the impacts of the Working Families Tax Credit.[1] The evidence so far has not revealed any widespread adverse impacts on average

[1] Papers available on the HMRC website, www.hmrc.gov.uk/research

hours worked or on shorter-term wage progression. The Government will continue to consider the longer-term impacts, and to promote and to monitor the evidence base.

21. We recommend that, as part of its report, due to be published in mid-2006 on the challenges for the Comprehensive Spending Review, the Government set out in greater detail what existing measures it has in place to meet its target of halving child poverty by 2010–11, what additional measures it is considering, and what assessment it has made of the current likelihood that the 2010–11 target will be met. In particular, given that about one million more children are defined as living in poverty after housing costs are taken into account, as opposed to before housing costs are taken into account, we recommend that the Government set out how it intends to address further the issue of housing costs in order to reduce levels of child poverty. (Paragraph 92)

The Government agrees that the Comprehensive Spending Review will be an important opportunity to take stock of how it is taking forward its child poverty agenda. The Government has set out a comprehensive approach to tackling child poverty in the Child Poverty Review, published in 2004, and continues to keep progress under review. An analysis of progress against child poverty and other social inclusion goals will be published later this year as part of the Government's annual *Opportunity for All* report. Since 1998–99, the Government has lifted 700,000 children out of poverty on both a before housing costs and an after housing costs measure.

Environmental taxation

22. We urge the Government to re-examine whether it is making the fullest possible use of taxation instruments as a mechanism to achieve the Government's environmental targets. (Paragraph 99)

The Government is committed to protecting the environment and recognises that this is essential if strong economic growth is to be maintained in the long term. Taxation instruments are one of several possible tools for making progress towards environmental targets and, in its 1997 Statement of Intent on Environmental Taxation and the Treasury's publication *Tax and the Environment* in 2002, the Government highlighted that consideration of taxation instruments should take place within a principled framework. In particular, the decision to use taxation instruments to achieve environmental aims take account of the impact on wider economic and social objectives. Environmental taxes must also meet the tests of good taxation.

Within this framework, the Government has introduced a number of fiscal measures. To tackle climate change, the climate change levy package (including CCL; climate change agreements; enhanced capital allowances for energy-saving technologies) has been the main instrument used to encourage businesses to improve their energy efficiency. In the household sector, the Government has introduced reduced VAT rates for energy-saving materials, and launched the Landlords Energy Saving Allowance to correct particular market failures in the private rented sector. In the transport sector, the Government has introduced the Company Car Tax, carried out significant reforms to Vehicle Excise Duty (VED), and used duty differentials to encourage the development of environmentally-friendly fuels. The Government has also used taxation instruments to tackle other environmental issues, for instance making significant reforms to the landfill tax and introducing the aggregates levy.

As part of a wider package of measures, these measures have delivered significant environmental benefits. For instance, the climate change levy package has delivered emissions savings of over 28 million tonnes of carbon (MtC), which accounts for a quarter of the total emissions reductions the UK would need to achieve to meet its Kyoto commitment. Fuel duty and VED incentives have also contributed significantly to reducing greenhouse gas emissions. Landfill tax has contributed to a 28% fall in waste disposed to landfill between 1997 and 2005, and the aggregates levy has resulted in an increase in the production of recycled aggregates in England by over 3 million tones between 2001 and 2003. This progress has been achieved whilst also supporting progress towards wider economic and social objectives—in particular, strong and stable economic growth. And within the principled framework, the Government continues to look for ways to use the tax system to achieve environmental aims.

23. In particular, we are puzzled by the Government's justification of its decision to freeze air passenger duty (APD) for the fifth year running. In the context of the challenges facing the United Kingdom in reducing its greenhouse gas emissions, we find the Government's attempt to justify freezing air passenger duty (APD) for the fifth year running to be incoherent and unconvincing. It is telling that the only aviation-specific taxation measure contained in the Budget is to widen the scope of the European APD to include Croatia—meaning that it is now £15 cheaper to fly economy class to Croatia. (Paragraph 100)

Greenhouse gas emissions from aviation are making a significant and growing contribution to climate change. The Government recognises the importance of introducing a long-term, evidence-based strategy for tackling emissions from aviation, while noting that it is important to strike a balance between environmental, social and economic concerns. The Government believes that the best approach to tackling global aviation emissions is an international one, and that the most effective method for ensuring that aviation contributes to global climate stabilisation is to include aviation in the EU Emissions Trading Scheme (EU ETS).

The Government also recognises that its focus on including aviation in the EU ETS should not preclude further work on other policy instruments, including APD, to tackle emissions from aviation. But decisions on APD rates need to be considered in the context of wider social and economic factors, particularly the current volatile oil market.

All Member State and EU applicant countries are eligible for the EEA rates of APD. Croatia, given its new status as an applicant country, is now eligible for the EEA rate.

24. Consequently, we recommend that the Government give serious consideration to increasing rates of APD. In the context of the wider problem of climate change, we consider it entirely inappropriate that, between 2000 and 2004, tax receipts from APD should have fallen by 8% whilst passenger numbers have risen by 35%. If this trend continues, the Government risks allowing APD to become an ineffective policy instrument which does nothing to recognise or address the contribution made by aviation to greenhouse gas emissions. (Paragraph 101)

The Government believes that the best approach to tackling global aviation emissions is an international one, and that the most effective method for ensuring that aviation contributes to global climate stabilisation is to include aviation in the EU Emissions Trading Scheme (EU ETS).

However, the Government is aware that economic instruments, including APD, may provide a route through which improved environmental performance in the aviation sector can be incentivised and so will continue to explore options for developing further such measures.

25. We accept the point made by both the Chancellor of the Exchequer and officials that it is important to bring aviation within the EU Emissions Trading Scheme (ETS). Time is running out for aviation emissions to be subject to the ETS before 2012. Consequently, for the Government to say that it is seeking to bring aviation within the ETS is only a partial response to the pressing issue of climate change currently facing the United Kingdom. In addition to continuing to press for action at the EU level, the Government must also act at a domestic level. We refer the Government to its undertaking, in its Statement of intent on environmental taxation, to "aim to reform the tax system to increase incentives to reduce environmental damage". We recommend that the Government give urgent consideration to how it can best use the tax system to increase incentives to reduce the harmful environmental effects of aviation. (Paragraph 102)

The Government believes that the most effective approach to addressing the international challenge of aviation emissions is through a trading scheme and is continuing to press for inclusion of aviation in the EU ETS by 2008 or as soon as possible thereafter. Inclusion of aviation in the ETS by 2008 is still a feasible timescale and the Government will continue to push for this timetable to be adopted in the EU. However, the Government is aware that economic instruments, including APD, may also provide a route through which improved environmental performance in the aviation sector can be incentivised and so will continue to explore options for developing further such measures.

Changes to the tax treatment of trusts

26. We are concerned that a legitimate measure designed to reduce tax avoidance may penalise trusts established to protect family members and consider that the issue merits further consideration. We recommend that the Government provide detailed information about how it has arrived at its estimate that the new rules on the tax treatment of certain trusts will affect only "a minority of a minority" of 100,000 discretionary trusts. This information should be provided prior to consideration in Committee of the House of Commons of Clause 57 of, and Schedule 20 to, the Finance Bill. (Paragraph 109)

Clause 157 and Schedule 20 of the Finance Bill bring two types of trust—Accumulation & Maintenance (A&M) trusts and Interest In Possession (IIP) trusts—into the mainstream tax regime for discretionary trusts.

Under these rules trusts are subject to inheritance tax charges on any value exceeding the IHT threshold, currently £285,000 and rising to £325,000 in 2009, in addition to the IHT threshold that applies to a person's estate when they die. The assets someone might put in an A&M trust would exclude their main home (this would be charged as a gift with a reservation). Moreover, settlements made more than 7 years apart each benefit from their own IHT threshold.

The Finance Bill provisions also mean that IIP trusts in existence before Budget day are effectively grandfathered. There is a 2-year window in which the beneficiary of such a trust can be changed, and after this the trust will continue to be exempt from IHT trust charges going forward.

Taking into account these transitional provisions and the exemption for trusts with assets under the IHT threshold, of an estimated 100,000 discretionary and A&M trusts in existence before Budget day, only some are A&Ms and of these only some are large enough to be potentially subject to an inheritance tax charge under the new rules. The Government estimates there may be a maximum of 20,000 A&M trusts in this position.

27. In future, we suggest that the Treasury considers the benefits of undertaking appropriate consultation on measures such as those changing the tax treatment of certain trusts, where there is a strong argument that people have been quite properly planning their affairs on the basis of explicit exemptions in tax legislation. (Paragraph 110)

The Government always considers the benefits of undertaking consultation and tries to make as much room as possible for advance preparation ahead of changes to the tax regime. However this will not always be possible, for example in cases where there is a significant risk of large-scale forestalling.

The Private Finance Initiative

28. We note Professor Talbot's concerns at the length, terms and scope of some PFI contracts. We welcome publication of the Treasury document entitled *PFI: strengthening long-term partnerships* at the time of the Budget, which examines issues to which we will return in due course. (Paragraph 114)

The Government has noted the contributions made by Professor Talbot and that the Committee welcomed the document on PFI published alongside the Budget. As set out in *'PFI: Strengthening Long-Term Partnerships'*, the Government has identified areas where strengths in PFI procurement and contracts could be built upon based on the experience gained from previous projects. Contained within are recommendations relating to the support of operational projects and improvement of flexibility that address the issues raised by Professor Talbot. Further guidance for procuring authorities is being developed to this end.

Additional payments to pensioners

29. We note that the rise in council tax over 2005–06 and 2006–07 is forecast to be the lowest since 1997. However, it is important that the Government understands the effect of rises in council tax and household utility bills on pensioners and others on fixed incomes. We note that the Government does not propose to repeat the £200 council tax

rebate for pensioners. The Government should take action to improve the take-up of council tax benefit amongst pensioner households. We welcome the guarantee of the higher winter fuel payment of £200 and £300 for the over 80s for the rest of this Parliament, alongside the support for insulation and central heating for pensioner households. In the light of continued volatility in energy markets and announcements of future gas and electricity price rises, we recommend that the Government re-assess the situation at the time of the 2006 Pre-Budget Report and take further action if necessary. (Paragraph 116)

The Government understands the pressure that increases in bills can place on pensioners on fixed incomes. That is why the 2005 Pre-Budget Report announced the extension of Winter Fuel Payments—£200 for all pensioner households, £300 for a household with someone aged 80 or over—for the remainder of this Parliament, at a cost of around £700m a year, as well as support for insulation and central heating. Council Tax Benefit is available for the poorest pensioners. The Government has already taken steps to boost take-up of council tax benefit amongst pensioner households eg through joining up claims for Housing Benefit and Council Tax Benefit with those for Pension Credit, and through the Pension Service's 'Local Service' that offers full "benefit health checks" when visiting customers in their homes, and the Government will continue to look at ways of further improving take-up. As recommended, the Government will continue to assess the need for further action as part of the normal PBR and Budget cycle.

HM Treasury
3 July 2006