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Treasury Committee

The 2006 Pre–Budget Report

Second Report of Session 2006–07

Report, together with formal minutes, oral and written evidence

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Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk. Media inquiries should be addressed to Laura Humble on 020 7219 2003.

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The economy

The Treasury has revised upwards its forecast for economic growth in 2006, and also its estimate of trend growth in the next economic cycle. We welcome the recent rise in the growth rate of business investment, while noting that the previous weakness in business investment remains unexplained. Difficulties in measuring net migration and predicting the future path of net migration are a significant constraint on the reliability of economic forecasts, including the trend growth assumption that informs the Treasury's assessment of its compliance with fiscal rules.

The public finances

Despite the improved forecast for economic growth in 2006, the fiscal position has not improved since the 2006 Budget, as a result of pressures on current public spending in 2006–07 and the downward revision of forecast tax receipts as a proportion of GDP in subsequent years. We recommend that the Treasury review the golden rule to consider whether it could be made less dependent on the process of dating the economic cycle in the next economic cycle. We call on the Government to clarify how the sustainable investment rule will operate in the next economic cycle.

Other issues

We conclude that confidence in the Gershon efficiency programme would be enhanced by greater transparency and by measures to provide greater assurance that service quality has been maintained. We consider the extension of child benefit, from April 2009, to every mother-to-be from week 29 of their pregnancy in the context of the range of measures that will need to be considered if the Government is to meet its outstanding targets relating to the reduction and ending of child poverty. We examine some of the individual taxation measures set out in the 2006 Pre-Budget Report.

The role of the Pre-Budget Report

We propose steps to enable the strengthening of the central role of Pre-Budget Reports in consultation on fiscal measures under consideration for the Budget.

Introduction

Our inquiry

1. The Chancellor of the Exchequer, the Rt Hon Gordon Brown MP, delivered his tenth and latest Pre-Budget Report on 6 December 2006.[1] In accordance with past practice, we have undertaken an inquiry into the Pre-Budget Report.[2] We held three evidence sessions in the week following the Pre-Budget Report—from outside experts[3] on Monday 11 December, from Treasury officials on Tuesday 12 December and from the Chancellor of the Exchequer on Wednesday 13 December. We received a range of written evidence which is published with this Report. We also benefited from oral evidence which we took from the Governor of the Bank of England, Mr Mervyn King, and other members of the Monetary Policy Committee (MPC) of the Bank of England, on 30 November 2006 as part of our examination of the November 2006 inflation report.[4] We are most grateful to all those who gave evidence, and to Professor David Heald of Sheffield University and Professor Colin Talbot of Manchester Business School for their specialist advice.

Our other inquiries

2. Our examination of the 2006 Pre-Budget Report has complemented three other inquiries which we are undertaking. Some matters raised during evidence on the Pre-Budget Report were relevant to our inquiry on Globalisation: its impact on the real economy, on which we have been taking evidence in the second half of 2006 and on which we will report shortly. We will soon be taking oral evidence on two new inquiries, one on the Comprehensive Spending Review: emerging issues,[5] and another on Climate change and the Stern review: the implications for HM Treasury policy on tax and the environment.[6] Certain issues related to the 2006 Pre-Budget Report will be examined in more detail in the Reports arising from those inquiries.

1 HC Deb, 6 December 2006, cols 305–314; HM Treasury, *Pre-Budget Report: Investing in Britain's potential: Building our long-term future*, Cm 6984, December 2006 (hereafter Pre-Budget Report 2006)

2 Treasury Committee, Second Report of Session 2005–06, *The 2005 Pre-Budget Report*, HC 739 (hereafter HC (2005–06) 739), para 1

3 Divided into two part-sessions, the first broadly concentrating on macroeconomic issues (with Mr Robert Chote, Institute for Fiscal Studies, Professor David Miles, Morgan Stanley, Ms Bridget Rosewell, Volterra Consulting, and Dr Martin Weale, National Institute for Economic and Social Research) and the second examining microeconomic issues (with Professor Colin Talbot, Manchester Business School, and Mr John Whiting, PricewaterhouseCoopers, together with Mr Chote and Mr Weale).

4 Treasury Committee, *Bank of England November 2006 Inflation Report: Oral and Written Evidence*, HC (2006–07) 89–i

5 See Treasury Committee press notices No. 54 of Session 2005–06 and No. 13 of Session 2006–07, available at http://www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_press_notices.cfm.

6 See Treasury Committee press notice No. 14 of Session 2006–07, available at http://www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_press_notices.cfm.

1 The economy

Economic performance and forecasts

3. After a period when the Government's forecasts for growth in the economy have been subject to downward revision over time, the 2006 Pre-Budget Report marks a change, stating that United Kingdom GDP growth "has been stronger than expected at the time of Budget 2006. GDP has expanded by 0.7% in each of the past four quarters."[7] In turn, the Government raised the forecast for GDP growth in 2006 to 2¾%,[8] up from the 2006 Budget forecast of 2 to 2½%.[9] The Treasury's forecast for economic growth in 2007 of 2¾% to 3¼% remained unchanged since the 2006 Budget.[10] This was somewhat above the average figure supplied by independent forecasters of 2.4%.[11]

4. In contrast to the upward revision of its forecast for economic growth in 2006, the Government has revised down the economic growth forecast for 2008.[12] This followed a revision by the Office for National Statistics of its estimates of economic growth in previous years which meant that, according to the 2006 Pre-Budget Report, "since Budget 2006, estimates of growth in non-oil GVA [Gross Value Added] have been revised up by around a ¼ percentage point in each of 2003, 2004 and 2005".[13] This revision implied that the degree of spare capacity in the economy was smaller than had been anticipated at the time of the 2006 Budget, which Treasury officials explained meant that,

> with the output gap smaller, there is less room for future growth because our forecasting model, as set out in the Pre-Budget Report, assumes the economy comes back to trend over two or three years, so, if it is closer to trend now, it has less growth to make up to come back to trend and effectively growth is higher this year than in the past and it is 0.25% lower in 2008 as a result.[14]

Monetary policy and inflation

5. One change between the 2006 Budget and the 2006 Pre-Budget Report has been the forecast for Consumer Prices Index (CPI) inflation in 2006. At the time of the 2006 Budget, this was forecast to be 2% at the fourth quarter of 2006.[15] By the time of the 2006 Pre-Budget Report, this forecast had risen to 2½%.[16] The 2006 Pre-Budget Report stated that "the recent rise in CPI inflation has not been driven by domestic cyclical factors, but by

7 *Pre-Budget Report 2006*, para A.42, p 195

8 Ibid, Table A4, p 198

9 HM Treasury, Budget 2006: *A strong and strengthening economy: Investing in Britain's future*, HC (2005–06) 968, March 2006 (hereafter Budget 2006), Table B3, p 232

10 *Pre-Budget Report 2006*, Table A4, p 198; Budget 2006, Table B3, p 232

11 *Pre-Budget Report 2006*, Table A9, p 212

12 Ibid, Table A4, p 198; Budget 2006, Table B3, p 232

13 *Pre-Budget Report 2006*, para A.47, p 197

14 Q 171

15 *Budget 2006*, Table B3, p 232

16 *Pre-Budget Report 2006*, Table A4, p 198

energy and food prices".[17] In view of rising inflation, the Bank of England increased interest rates by 0.25 percentage points twice, once in August 2006, and once in November 2006.[18] The Chancellor of the Exchequer defended the Government's record on forecasting inflation, telling us that "our Budget inflation forecast was exactly similar to that of the Bank of England".[19]

6. On the future path of inflation, the 2006 Pre-Budget Report stated that "CPI inflation is expected to remain above target into the first half of 2007, before quickly returning to target, with monetary policy keeping inflation expectations firmly anchored".[20] This view was similar to that expressed to us by the Governor of the Bank of England in November 2006: "Inflation is expected to rise further above the target in the near term before falling back to the target as energy price inflation falls".[21] The Governor highlighted "particular uncertainty" around the supply side of the economy, given uncertainties around migration and the labour market.[22] On the risks around the Government's inflation forecast, Treasury officials explained that "the uncertainties we see are pretty much the same as the ones the Bank see" on the supply side.[23] The Chancellor of the Exchequer said that "I think that we are surmounting what has been an inflationary pressure on the economy better than other economies and you will see the inflation rate going down over the course of the next year".[24]

Business investment

7. In our Report on the 2006 Budget, we recommended that the Treasury "continue to monitor the performance of business investment".[25] This was after we had received evidence that, although there were favourable conditions for business investment at that time, there was little sign that this was flowing into the growth rate of business investment.[26] Sir John Gieve, Deputy Governor of the Bank of England, gave a speech in September 2006 which covered similar ground, noting that, "in 2005, business spending on investment in the United Kingdom was at its lowest relative to whole economy income since 1965, when official data were first collected".[27] At the time of the 2006 Budget, business investment was forecast to grow by 1 to 1½% in 2006.[28] The 2006 Pre-Budget Report estimated that business investment in the first three quarters of 2006 grew by 5¼% on a year earlier,[29] a substantial increase on the 3¼% growth in business investment

17 *Pre-Budget Report 2006*, para A.54, p 199

18 Ibid, para A.46, p 196

19 Q 329

20 *Pre-Budget Report 2006*, para A.55, p 199

21 HC (2006–07) 89–i, Q 2

22 Ibid

23 Q 154

24 Q 331

25 Treasury Committee, Fourth Report of Session 2005–06, *The 2006 Budget*, HC 994–I, para 25

26 HC (2005-06) 994–I, paras 21–24

27 Speech by Sir John Gieve, Deputy Governor, Bank of England, entitled "*The Puzzle of UK Business Investment*", at the University of the West of England, Tuesday 26 September 2006

28 *Budget 2006*, Table B6, p 240

29 *Pre-Budget Report 2006*, para A.70, p 204

reported for 2005.[30] The 2006 Pre-Budget Report went on to state that "though the Pre-Budget Report business investment forecast for 2006 has been revised up substantially compared with Budget 2006, there are still significant upside risks in 2007 and beyond".[31]

8. Dr Martin Weale of the National Institute for Economic and Social Research thought that "you would expect business investment to be rising … We are seeing a lagged response to an unexpected surge in the labour force."[32] He added that, "so far, we have not seen the sort of increase in the capital stock that you would expect, given the increase in the labour force that we have had, so the prospect does look fairly good".[33] He also noted that, "if you look at what people actually spend on business investment, although it has picked up, it is not terribly high and, given the profitability of business, I suppose I still find it disappointing".[34] Ms Bridget Rosewell, of Volterra Consulting, agreed, telling us that "I would still say that the level of investment is disappointing and likely to remain so".[35]

9. The 2006 Pre-Budget Report considered the issue of the under-reporting of certain types of investment, noting that, while the United Kingdom was developing into a knowledge-based economy, activities such as training and research and development were still classified as current expenditure rather than investment.[36] We raised this issue in our Report on the 2006 Budget,[37] and Ms Rosewell told us of her concerns during this inquiry:

> You could argue that much of what really is investment does not count as investment in the books, as it were, because it is not investment in plant and machinery; it is investment in intellectual property, it is investment in software and various things which do not count as such, at least in the national accounts. To some extent that must be right, that we have moved the mix of investment towards such sorts of asset.[38]

Professor David Miles of Morgan Stanley thought that the risks to future business investment were not well understood, and that the sense of the uncertainty was shared by the Treasury.[39] Mr Jon Cunliffe, Managing Director, International Finance, HM Treasury, repeated the message of the 2006 Pre-Budget Report, stating that the Treasury saw an upside risk to its forecast for business investment because of strong profits and cheap corporate financing.[40] **We welcome the recent rise in the growth rate of business investment, although we note that, given the supportive conditions at the time, the previous weakness in business investment remains unexplained. In these circumstances, although there may be an upside risk to the Treasury's forecast for**

30 *Pre-Budget Report 2006*, Table A7, p 206

31 Ibid, para A.72, p 206

32 Q 10

33 Q 12

34 Ibid

35 Q 13

36 *Pre-Budget Report 2006*, Box A8, p 205

37 HC (2005–06) 994–I, para 23

38 Q 13

39 Q 14

40 Q 123

business investment, it needs to be borne in mind that there is also a downside risk in that the previous weakness remains unexplained, and it is possible that this period of weaker than expected performance may be resumed.

Consumption

10. Consumption is the most significant expenditure component of GDP.[41] In our Report on the 2006 Budget, we noted that, "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".[42] The 2006 Pre-Budget Report stated that real private consumption growth had been revised down in 2004 and 2005 by a ¼ percentage point since the 2006 Budget.[43] The Governor of the Bank of England told us in November 2006 that, over that period since the start of 2006, "official estimates of the growth of consumer spending have been volatile".[44] The 2006 Pre-Budget Report noted that "private consumption is forecast to grow at slightly slower rates than the overall economy, reflecting the lagged effect of higher than expected inflation on real incomes, the effect of recent interest rate increases and a higher propensity to save".[45] The 2006 Pre-Budget Report also set out the risks around the forecast for consumption:

> Surveys of consumers' saving intentions suggest that the pick-up in the household saving ratio over the past year could continue and exceed the Pre-Budget Report forecast, and recent interest rate increases could constrain consumer spending more than expected given levels of household gearing. Offsetting that, developments in the housing market have been somewhat stronger than expected and could be associated with higher consumption growth.[46]

Ms Rosewell told us of her concerns about consumption in 2007:

> We are seeing at the moment, for example, another Christmas which is looking a bit shaky as far as the retailers are concerned. That, of course, may change. They can be volatile people, these consumers. If you think back a year ago we were quite nervous about the consumer for 2006 and the 2005 Christmas was looking bad and then it all seemed to sort itself out during the year, but I think that nervousness of the consumer is still a particular issue and we could well see 2007 looking weak.[47]

Dr Weale expressed a more benign view for consumption in 2007. He thought that "the household sector has, more by luck or more by rising house prices than anything else, acquired quite a lot of wealth over the last ten years and it is showing a willingness to spend some of that wealth so I believe it has a cushion of wealth which, if you like, protects consumer demand from the sort of nervousness that you are talking about".[48] Treasury

41 *Pre-Budget Report 2006*, para A.57, p 201

42 HC (2005–06) 994–I, para 13

43 *Pre-Budget Report 2006*, para A.59, p 202

44 HC (2006–07) 89–i, Q 2

45 *Pre-Budget Report 2006*, para A.56, p 201

46 Ibid, para A.105, p 213

47 Q 16

48 Q 34

officials maintained that the Treasury forecast on consumption was balanced: "We have to look very closely at what is happening on the side of household finances, but whilst we factor it into our risk assessment, I think the consumption forecast that we have at the macro level is a measured one and there are upside and downside risks to it".[49]

11. One important risk to the consumption forecast stems from the outlook for house prices. In November 2006, a report by Professor Miles and Melanie Baker of Morgan Stanley suggested that "sharp falls in real house prices may not come for a year or so, but come they probably will".[50] In contrast, the 2006 Pre-Budget Report indicated that the risk to consumption forecasts from house prices might be on the upside because "developments in the housing market have been somewhat stronger than expected and could be associated with higher consumption growth".[51] Explaining the Treasury's analysis, Mr Cunliffe identified the following channels via which house prices influence consumption: a 'wealth channel', whereby people whose assets had grown felt more confident in spending; and a 'liquidity channel', where asset price rises increased the collateral against which households could borrow.[52] Mr Cunliffe thought that the link between house prices and consumption "is not as strong as it was and certainly, although house prices have come back, we have not seen consumption come back".[53] Mr Dave Ramsden, Director, Macroeconomic and Fiscal Policy, HM Treasury, also stressed that

> even though house price [rises] are in double-digit rates, they are still moderated from where they were and we expect them to continue to come down to grow more in line with income, but we are not expecting the kind of real house price falls that some forecasters were projecting; we have not seen any evidence of that.[54]

12. Another concern about future consumption has been the recent rise in the level of personal insolvencies. The Governor of the Bank of England told us in November 2006 that

> the real problems in indebtedness are not in the mortgage market, but in the unsecured debt market where a number of people have got themselves into desperately serious trouble, and for them and for their families that is a really serious problem".[55]

Mr Charlie Bean, Chief Economist for the Bank of England, told us then that about 8% of households in the Bank of England's sample regarded their debt as a heavy burden, but that those household corresponded to only around 5% of the income total, because they were poorer households. The fraction of households going into an Individual Voluntary Arrangement or bankruptcy was even smaller at 0.2% of households per year.[56] The

49 Q 141

50 David Miles and Melanie Baker, '*UK Housing: How did we get here*', Morgan Stanley, 22 November 2006, p 11

51 *Pre-Budget Report 2006*, para A.105, p 213

52 Q 137

53 Q 138

54 Q 141

55 HC (2006–07) 89–i, Q 19

56 Ibid

Governor therefore considered that "there are not enough of them [those in serious debt] and they are not rich enough to mean that this is likely to have a significant impact on total household spending".[57] He did note that Individual Voluntary Arrangements were probably changing behaviour, and that their purpose was to ensure continued consumption while debts were restructured.[58] Treasury officials acknowledged that concerns had been raised over the marketing of Individual Voluntary Arrangements, which the Financial Services Authority was examining, but Treasury officials were muted in their concern as to the risk posed by the rising levels of insolvencies to the macro-economic outlook, telling us "we have to look very closely at what is happening on the side of household finances, but whilst we factor it into our risk assessment … the consumption forecast that we have at the macro level is a measured one".[59]

13. The 2006 Pre-Budget Report also stated that "the possibility of a larger increase [in the savings ratio] represents a downside risk to the consumption forecast".[60] The saving rate increased last year, but this was in part due to increased employer contributions to employees' pensions. These contributions, regarded as saving by households in the national accounts, may not have been taken into account by households themselves when they considered how much they were saving.[61] Treasury officials explained that this posed a risk to the consumption growth forecast if households decided to consume less to save more, a risk exemplified by a finding that, "in surveys, households seem to be saying that their saving intentions are greater than their actual saving is".[62]

14. **We note there are several risks around the consumption growth forecast. These include the potential for house prices to fall, for an increase in the influence of insolvencies on consumer spending, and for an increase in the overall saving rate of households, which then dampens consumption. We note the rise in the numbers of households using official forms of insolvency, especially Individual Voluntary Arrangements. We may return to examine matters relating to the regulation of the marketing of Individual Voluntary Arrangements, as well as further considering the economic implications of the rise in personal insolvencies.**

Net trade

15. In the 2006 Budget, the Government forecast that net trade would provide a zero input to GDP growth in 2006.[63] The Government's revised forecast in the 2006 Pre-Budget Report was for net trade to detract from GDP growth in 2006 by a quarter of a percentage point. However, the Government again forecast that net trade from 2007 would be a zero input to GDP growth.[64] The Pre-Budget Report acknowledged that the trade statistics were currently distorted by Missing Trader Intra-Community (MTIC) fraud, which meant that

57 HC (2006–07) 89-i, Q 19

58 Ibid

59 Qq 141–142

60 *Pre-Budget Report 2006*, para A.62, p 202

61 Qq 135–136

62 Q 135

63 *Budget 2006*, Table B4, p 235

64 *Pre-Budget Report 2006*, Table A5, p 201

"estimates of MTIC-related activity are subject to inevitable measurement difficulties, which in practice may carry over to estimates of net trade".[65] We examine the revenue implications of this fraud later in this Report.[66]

16. The 2006 Pre-Budget Report outlined a downside risk to the Treasury's export forecast from a weaker than expected US economy, and an upside risk from the European Union.[67] This position was reiterated to us by Treasury officials, when the possibility of a downturn in the US housing market spreading to affect the US economy as a whole was discussed.[68] Evidence taken during our hearing with the Bank of England on the November 2006 Inflation Report confirmed that the US economy might be a risk to the GDP growth forecasts, with Monetary Policy Committee members Mr Charlie Bean and Professor David Blanchflower citing a greater than expected downturn in the US economy as a downside risk.[69] In evidence during the inquiry into the 2006 Pre-Budget Report, Ms Rosewell also highlighted the risk from the USA, telling us that "At the time of the Budget it looked like the US economy was slowing. I think that the potential for a much stronger downturn in that economy has probably increased since then, although we are still by no means certain about it."[70] Dr Weale, when discussing the sterling/dollar exchange rate, reiterated that "certainly trade with the United States will be harder but, as the Governor of the Bank of England said, that is only 15% of total United Kingdom trade".[71] Professor Miles, on the other hand, provided a more upbeat assessment of what would happen to the United Kingdom economy should the US economy falter:

> The rest of Europe is something like three times more important to the United Kingdom just in terms of trade and all the rest of it, so it would not take much of an increase in growth in the rest of Europe to offset even quite a significant slowdown in the US. I am fairly optimistic on all that and I do not think one should believe that what happens in the US is the real driver of what happens in Europe in general and the United Kingdom in particular.[72]

Treasury officials highlighted the risks "around the US economy and whether the housing market downturn will broaden into a more widespread slowdown of the US economy" as a downside risk to the economic outlook for the United Kingdom economy, but were also keen to point out that "the export forecasts … are affected more by the forecasts for the eurozone".[73] Asked if they expected some rebalancing in exports between the US and the eurozone, Mr Cunliffe replied "Yes, and I am expecting the very sharp decline in exports to

65 *Pre-Budget Report 2006*, para A.75, p 208

66 See paragraphs 84–88.

67 *Pre-Budget Report 2006*, para A.107, p 214

68 Q 123

69 HC (2006–07) 89–i, Q 23

70 Q 3

71 Q 15

72 Q 17

73 Qq 123,149

the euro area that we saw in the first three or four years of this century to correct somewhat".[74]

17. During our inquiry into the 2006 Budget we examined the potential of a disorderly unwinding of global economic imbalances to affect the United Kingdom's economy.[75] The 2006 Pre-Budget Report again highlighted a disorderly unwinding of global imbalances as a current risk to the economic forecast.[76] When asked whether the recent movements in the US dollar could be considered as part of the unwinding of these global imbalances, Mr Cunliffe replied:

> The question on global imbalances is not so much whether they will unwind, because I think most economists think they will, but how and whether they unwind in an orderly way. Actually the dollar depreciation that we have seen over the past four years has been pretty orderly. The very recent one that we saw at the end of November was not as big as the dollar depreciation against the euro certainly in the spring, but it has been quite an orderly process.[77]

He went on to state that "[The dollar] has appreciated against the Renmimbi yuan [the Chinese currency] a little bit and it has appreciated against the yen, but clearly a more global rebalancing of the exchange rates must be part of the overall global rebalancing story".[78]

The labour market

18. At the time of the 2006 Budget, we recommended that the Treasury monitor the implications of what then appeared to be a slight weakening in the labour market.[79] A weakening labour market would pose a potential risk to both consumption growth and the Government's spending plans. While the 2006 Pre-Budget Report referred to "robust employment growth",[80] it also noted the "recent rise in unemployment".[81] Ms Rosewell thought that this combined rise in employment and unemployment might be explained by migration, and that "it would not be therefore any surprise that, if you have got much larger numbers of new people entering the labour force, you might simultaneously get rising employment and rising unemployment, depending on the particular locality that you are looking at".[82] Treasury officials thought that the rise in the labour force stemmed from migration, natural population growth and the fall in the inactivity rate.[83] However, Mr Cunliffe told us that the Treasury forecast was that "claimant unemployment has already flattened off … by at least 15/16,000 over the last six months and we expect that to

74 Q 150

75 HC (2005–06) 994–I, para 27

76 *Pre-Budget Report 2006*, para A.101, p 213

77 Q 151

78 Q 152

79 HC (2005–06) 994–I, para 16

80 *Pre-Budget Report 2006*, para A.50, p 197

81 Ibid, Box A5, p 195

82 Q 6

83 Q 127

continue and probably reverse and unemployment on the other side, the labour force survey model, we expect to turn around as the demand in the economy picks up".[84] On 13 December the Chancellor of the Exchequer told us that that day's set of labour market statistics showed that "unemployment is actually down 7,000 and the claimant count is down 5,700".[85]

19. One aspect of the labour market that continues to be shrouded in mystery is the impact of migration on that market. We recommended in April 2006 that the Government study the effects of migration on the overall economy more thoroughly.[86] In November 2006 the Governor of the Bank of England told us of his concerns about the net migration statistics. He questioned the validity of a system of counting migrants based on self-declaration, and concluded that "we do not have in the United Kingdom any particularly accurate method of measuring migration, either gross or net".[87] Ms Rosewell echoed this concern, stating that "one of the difficulties is that we do not really know how big the labour force is".[88] She went on to explain the consequences that arose from uncertainty about the level of migration, telling us that "understanding either what is happening to productivity, employment or unemployment is quite difficult".[89] Treasury officials admitted that the poor quality of migration statistics meant that there was a "risk that the effective labour force is larger than we think and, therefore, there is more slack in the economy and more room for growth".[90] However, they did assure us that the Office for National Statistics had a programme of work in place to try and ensure that the migration statistics improved.[91] The Chancellor of the Exchequer thought that the Office for National Statistics would report on this work soon.[92] **The rise in the employment rate is welcome. However, the lack of robust statistics on migration means that it is difficult to assess the overall functioning of the labour market. We note that the Office for National Statistics is undertaking work on these statistics, and we recommend that the Government summarise the results of that work in the 2007 Budget.**

The trend growth assumption

20. The trend growth assumption is an important part of the fiscal framework that operates in the United Kingdom. Essentially, the trend growth assumption is the estimated level of economic growth at which the economy can operate, without there being undue inflationary pressure. The trend growth rate assumption is thus an integral part of the measurement of the level of the output gap, and thus the timing of the economic cycle and

84 Q 128

85 Q 345

86 HC (2005–06) 994–I, para 16

87 HC (2006–07) 89–i, Q 43

88 Q 6

89 Ibid

90 Q 123

91 Q 124

92 Q 479

the achievement of the fiscal rules which we consider later in this Report.[93] The 2006 Pre-Budget Report announced a change to the Treasury's trend growth assumption:

> The Treasury has revised the neutral estimate of trend output growth for the post-2006 period in line with the ¼ percentage point upward revision to working-age population growth. Instead of falling to 2½% a year, for the 2006 Pre-Budget Report the trend output growth projection will continue at the same 2¾% rate as since 2001.[94]

This change was audited by the National Audit Office. The Comptroller and Auditor General stated that, "given the market sensitive nature of the assumption for the underlying growth rate, I was not able to consult as fully as would otherwise have been possible".[95] He nevertheless concluded that "the revised Treasury assumption is reasonable and cautious".[96] Ms Rosewell told us that, "if you look at the long-term performance of the economy, the 2.5% looks pretty solid; 2.75% over the forthcoming cycle looks to me to be optimism".[97] Treasury officials explained to us their reasoning for maintaining the trend growth assumption at 2.75%, stating that they had originally intended to reduce the trend growth assumption because of the effect of the retirement of post-baby boom female workers, but now thought that this effect would be "offset by the increase in the population of about 0.2%, and that comes mainly from an assessment of current migration trends".[98] **The change to the trend growth rate assumption, post-2006, though audited by the National Audit Office, is mainly based on migration statistics of questionable quality. We note that any significant error in this assumption will have implications for the Government's assessment of its compliance with its fiscal rules.**

93 See paragraphs 27–39.

94 *Pre-Budget Report 2006*, para A.34, p 191

95 Audit of Assumptions for the 2006 Pre-Budget Report, National Audit Office, December 2006, para 46, p 9

96 Ibid, para 47, p 9

97 Q 22

98 Q 156

2 The public finances

The overall fiscal position

The current budget balance

21. As we have already noted, the Treasury has revised output growth for 2006 from 2½% in the 2006 Budget to 2¾% in the 2006 Pre-Budget Report.[99] A more optimistic forecast of economic growth would generally be expected to lead to a more optimistic forecast of the position of the Government's finances—in this case a reduction in the forecast public sector current budget deficit in 2006–07. The expectation would be for tax revenues to increase as a result of higher household incomes and higher receipts from business. However, the Treasury forecast a slightly higher current budget balance deficit in the 2006 Pre-Budget Report than it had forecast at the time of the 2006 Budget. Its forecast of the current budget deficit for 2006–07 was £7.9 billion in the 2006 Pre-Budget Report,[100] compared to a forecast deficit of £7 billion at the time of the 2006 Budget.[101] A comparison of the forecasts of current receipts and expenditure in the two documents shows that this movement in the forecast fiscal position in 2006–07 results from changes in the forecasts of current expenditure rather than changes in revenue forecasts. The Treasury has increased its forecasts of current taxation for 2006–07, as would be expected given the higher level of output growth, but its forecasts of current expenditure and depreciation for 2006–07 have also risen.[102]

22. The 2006 Pre-Budget Report also contained a downward revision of forecasts of the current budget balances in the medium term compared to the forecasts at the time of the 2006 Budget. In March 2006, the current budget balances were forecast to be surpluses of £1 billion (0.1% of GDP) in 2007–08, £7 billion (0.5% of GDP) in 2008–09 and £10 billion (0.7% of GDP) in 2009–10.[103] In December 2006, the comparable forecasts were for a deficit of £1 billion in 2007–08 and surpluses of £4 billion (0.3% of GDP) in 2008–09 and £7 billion (0.5% of GDP) in 2009–10.[104] These downward revisions of forecasts of the current budget balance as a proportion of GDP result principally from revised forecasts for current receipts as a proportion of GDP rather than spending changes. In the 2006 Budget, current receipts as a percentage of GDP were forecast to be 40.9% in 2007–08, rising to 41.0% in 2008–09 and 2009–10.[105] In the 2006 Pre-Budget Report, tax receipts were forecast to be 40.2% of GDP in 2007–08, rising to 40.4% in 2008–09 and 2009–10.[106] Professor Miles saw the Treasury's overall forecasts as "quite a realistic assessment", albeit "a more pessimistic one than was made at the beginning of this year".[107] **Despite the**

99 See paragraph 3.

100 *Pre-Budget Report 2006*, Table B8, p 229

101 *Budget 2006*, Table C4, p 259

102 *Pre-Budget Report 2006*, Table B8, p 229; Budget 2006, Table C4, p 259

103 *Budget 2006*, Tables C4 and C5, p 259

104 *Pre-Budget Report 2006*, Tables B8 and B9, p 229

105 *Budget 2006*, Table C5, p 259

106 *Pre-Budget Report 2006*, Table B9, p 229

107 Q 37

improved forecast for economic growth in 2006, the Treasury has not forecast an improvement in the fiscal position compared with its forecasts in the 2006 Budget, partly as a result of downward revision of forecasts for tax receipts in future years as a percentage of GDP. The Treasury's current fiscal forecasts may well be realistic, but they indicate the medium-term constraints that will form part of the context for the conduct of the 2007 Comprehensive Spending Review.

Tax receipts

23. In our Report on the 2005 Pre-Budget Report we noted that the Treasury had over-estimated tax receipts for the current fiscal year for five consecutive years. We considered it important that "official forecasts for tax receipts avoid any systemic bias either to exaggerate or underestimate revenue, particularly towards the end of the economic cycle when forecasts are likely to come under particular scrutiny".[108] Table 1 sets out how forecasts for what is the current fiscal year at the time of the Pre-Budget Report have varied between the preceding Budget and each Pre-Budget Report. For each year up to 2005–06, Table 1 compares performance in each forecast with the outturn.

Table 1: Current tax receipts for fiscal year current at the time of the Pre-Budget Report

	Forecast at Budget £ billion	Forecast at Pre-Budget £ billion	Outturn £ billion	Difference between Budget and actual £ billion
1998–99	333	335.9	335.9	2.9
1999–2000	345	352.1	358.7	13.7
2000–01	375.6	380.3	382.9	7.3
2001–02	398.4	391.2	390	-8.4
2002–03	407.2	399.7	393.2	-14
2003–04	428.3	422.8	419.2	-9.1
2004–05	454.7	451	451.9	-2.8
2005–06	486.6	483	485.3	-1.3
2006–07	516	517.9	–	–

Sources: Budgets, Pre-Budget Reports and End of year fiscal reports

Table 1 shows that the 2006 Pre-Budget Report has been the first Pre-Budget Report for five years in which the Treasury has not reduced its forecast of tax receipts in the current year. This may be attributable to higher than forecast output growth boosting income tax and Corporation tax receipts, along with more realistic forecasts on the part of the Treasury. The Table also demonstrates that the outturn for tax receipts in 2005–06 was above that forecast in the 2005 Pre-Budget Report and nearer to that foreseen at the time of the 2005 Budget.

108 HC (2005–06) 739, para 61

24. The 2006 Pre-Budget Report contained revised forecasts for tax receipts in the years subsequent to 2006–07. The most notable change was to North Sea oil revenues for 2007–08, which, in December 2006, were forecast to be £2.8 billion (21%) below the total revenues forecast in the 2006 Budget.[109] Treasury officials attributed this downward revision to three factors:

- increases in capital and operating costs in the oil industry, arising from increased competition for equipment and personnel;
- a reduction in oil production in 2006, which had been significantly greater than the underlying, yearly downward trend; and
- the depreciation of the US Dollar against Sterling, which had caused the oil price to fall in Sterling terms, leading to lower tax revenues for the United Kingdom.[110]

Mr Robert Chote of the Institute for Fiscal Studies argued that a distinction ought to be made between the Treasury's over-optimistic projections for 2007–08 North Sea oil tax revenues in its 2006 Budget and its over-optimistic projections of tax receipts in general between the 2001 and the 2005 Budgets. Previously, the Treasury had been over-estimating corporation tax receipts, in particular with regard to the rebounding of financial sector corporation tax receipts after the decline in the stock market between 2000 and 2002. However, he thought the Treasury now appeared to have corrected this forecasting error, making its forecast for corporation tax receipts "more sensible". Mr Chote told us that the shortfalls in the oil tax revenue would have been more difficult to predict, implying that this was not due to a systemic upward bias.[111] Ms Rosewell agreed that there was "an element of bad luck" with regard to the Treasury's over-optimistic forecasts of North Sea oil tax revenues in the 2006 Budget.[112] The Chancellor of the Exchequer told us that the downward revision of North Sea oil tax revenue was primarily due to a change in the production cycle in the North Sea and a change in the dollar exchange rate—both factors which were not within the Treasury's control.[113] **We welcome the fact that the past concerns of the Treasury Committee about the apparent over-optimism of Treasury forecasts of tax receipts, and of corporation tax receipts in particular, appear at the moment to have been addressed. We note the significant downward revision of forecast North Sea oil revenues in 2007–08, and look forward to seeing whether the more cautious forecast proves to be accurate.**

Expenditure

25. The 2006 Pre-Budget Report forecast that public spending in 2006–07 measured in terms of Total Managed Expenditure would be £2.3 billion above the total projected at the time of the 2006 Budget.[114] Total Managed Expenditure is divided between spending

109 *Pre-Budget Report 2006*, Table B12, and Box B2, pp 232, 233

110 Q 199

111 Q 31

112 Q 32

113 Q 328

114 *Pre-Budget Report 2006*, Table B17, p 241

within Departmental Expenditure Limits—firm three-year limits for departments' programme expenditure—and Annually Managed Expenditure, including that on social security benefits, which is not subject to firm multi-year limits.[115] The increase in the forecast for Total Managed Expenditure for 2006–07 is caused by a £0.1 billion increase in the capital budget within Departmental Expenditure Limits and a £2.2 billion increase in the forecast of Annually Managed Expenditure since the time of the 2006 Budget, comprised of increases in the forecasts of social security benefits, tax credits, net public service pensions, central government gross debt interest and public corporations own-financed capital expenditure.[116] In order for the expenditure outturn in 2006–07 to be in line with the Treasury's forecasts of expenditure in the 2006 Pre-Budget Report, current expenditure can only be 5.0% above that in 2005–06.[117] According to the Institute for Fiscal Studies, expenditure in the first seven months of 2006–07 had been 7.1% above that in the equivalent months of 2005–06, suggesting that the Treasury expects a slowdown in expenditure towards the end of the financial year.[118]

26. Public expenditure in the years from 2008–09 to 2010–11 will be determined by the outcome of the Comprehensive Spending Review. The 2006 Pre-Budget Report contained an unchanged assumption that public sector current expenditure will grow by 2.0% in real terms in 2008–09 and by 1.9% in real terms in the three following years.[119] Current expenditure was forecast to fall as a proportion of GDP from 38.9% in 2006–07 to 38.2% in 2011–12, whereas net investment was forecast to be maintained at 2.2% of GDP.[120] When questioned about whether an actual slowdown in spending in line with the current assumptions was feasible, Dr Weale said that "governments can limit growth in public spending if they set their mind to it and the fact that we have had a period of rapid expansion is not an obstacle to that".[121] However, Mr Chote pointed out that tight public spending in the years 2000 to 2003 occurred when unemployment and debt interest rates were falling.[122] Such circumstances might not be present in the next economic cycle, making a slow down in the growth of public spending more difficult to deliver. Dr Weale drew attention to the possibility that increases in immigration might place an upward pressure on public spending in coming years. He stated that there was no evidence that the impact of net immigration on public spending had been taken into account in the 2006 Pre-Budget Report.[123] Mr Chote contended that an increase in net immigration would lead to a reduction in public spending per head of population, with implications for the quality of public services.[124] On the other hand, Treasury officials noted that some studies "suggest that immigrants contribute more fiscally than they consume".[125] We expect to consider

115 *Pre-Budget Report 2006*, para B.67, p 239

116 Ibid, Table B17, p 241

117 Ibid, Table B8, p 229

118 IFS Public Finance Bulletin, November 2006

119 Ibid, para B.26, p 223

120 Ibid, Table B9, p 229

121 Q 36

122 Ibid

123 Q 23

124 Q 24

125 Q 162

these issues further when we report on our inquiry into the Comprehensive Spending Review: emerging issues.

The golden rule

27. Since 1997 the Government has put in place and sought to adhere to a new fiscal policy framework set out in the Code for Fiscal Stability. The Code requires the Government to state the rules through which fiscal policy will be operated. There are currently two fiscal rules—the sustainable investment rule, which is discussed further below,[126] and the golden rule. The golden rule states that, over the economic cycle, the Government will borrow only to invest and not to fund current spending. Compliance with the golden rule is evaluated by calculating the average of the Government's annual current budget balances as a percentage of GDP over the economic cycle. The current budget balance represents the difference between current receipts and current expenditure, including depreciation.[127]

28. The 2006 Pre-Budget Report stated:

> The Government's judgement is that the current cycle started in 1997–98. Based on assumptions used in these projections the economy will return to its trend level, ending the current cycle in early 2007. The 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 0.1% 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 £8 billion in this cycle. [128]

In the 2006 Pre-Budget Report, the Treasury changed its forecast of the end-date of the economic cycle from 2008–09, which was its forecast at the time of the 2006 Budget, to early 2007. The Institute for Fiscal Studies stated that, "with just 3 months left to run, it is now highly unlikely that the golden rule will be missed".[129] Morgan Stanley's analysis of the 2006 Pre-Budget Report stated that, although the golden rule was likely to be met over this current economic cycle, "we are less optimistic that the public finances are on track to meet the golden rule over the next cycle".[130] The forecasts in the 2006 Pre-Budget Report showed that the current budget was predicted to return to surplus only in 2008–09.[131] Thus, if the economic cycle were to end as currently forecast in early 2007, and 2006–07 were to be counted as the first year of the next economic cycle, the next economic cycle would begin with two years of current budget deficits. This differs from the projection in the 2006 Budget, under which the new economic cycle would have begun in 2008–09, with the Government's current budget in surplus.[132] **On the basis of its current forecasts of the length of the current economic cycle, the Government appears to be on track to meet the golden rule in the current economic cycle. However, the Treasury's forecasts also**

126 See paragraphs 36–39.

127 *Pre-Budget Report 2006*, para 2.54, p 30

128 Ibid, para B.7, p 218

129 IFS Press Release, '*Analysis of the Pre-Budget Report*', 7 December 2006

130 Morgan Stanley, '*Pre-Budget: Not much of a change*', 6 December 2006

131 *Pre-Budget Report 2006*, Table B9, p 229

132 *Budget 2006*, Table C5, p 259

indicate that the Government will start the next economic cycle with its current budget in deficit, compared to the projections outlined in the 2006 Budget, which foresaw the Government starting the next economic cycle with its current budget in surplus.

29. Dating the beginning and end of an economic cycle relies on measuring the output gap in the economy. The output gap is the difference between the actual and potential output of the economy and requires knowledge of both the actual and trend rate of growth. Mr Cunliffe told us that the Treasury had changed its forecast of the end-date of the economic cycle for the 2006 Pre-Budget Report because economic growth in the years from 2003 to 2006 had been revised upwards. This led the Treasury to infer that the level of GDP was "closer to trend level", and consequently that the output gap was smaller than previously envisaged, making it more likely that the cycle would end earlier, in early 2007, rather than in 2008–09.[133] The Treasury provided a fuller explanation of how it measured trend growth and the output gap in its publication *Evidence on the UK Economic Cycle* in July 2005. For complete past cycles, the trend rate of output growth was estimated to be the average rate of growth between the points where the economy was on trend within the economic cycle. The Treasury stated that it used various sources of information to determine when the economy was on trend, including business surveys of capacity utilisation and recruitment difficulties; other labour utilisation indicators such as average hours worked, unemployment and vacancy rates; and indicators of inflationary pressure. A different approach had to be used for estimating the trend rate of growth for the latest (incomplete) cycle. This was based on disaggregating trend output over past cycles into trend labour productivity measured as output per hour worked; trend average hours worked per worker; the trend proportion of the working age population in employment; and the working-age population.[134]

30. In December 2005, the National Audit Office stated:

> There is little doubt that dating the economic cycle is an uncertain process. There is no clear best methodology among those available for identifying on-trend points, and each has its advantages and disadvantages. The Treasury's method of using cyclical indicators to identify on-trend points is a reasonable one, bringing information of an economic nature to bear, though it is necessary to make judgements about the emphasis to be given to the indicators used, which may vary from assessment to assessment, and are difficult to make transparent.[135]

Mr Cunliffe admitted that "there is an element of judgement" in determining both the trend rate of economic growth and also where the economy was in the cycle.[136] Ms Rosewell noted that

> there are still no well-established and empirically-verified theories of the cycle which could be used to anchor points at which a cycle begins or ends. Each cycle is unique.

133 Q 171

134 HM Treasury, *Evidence on the UK Economic Cycle*, July 2005, paras 2.36–2.39

135 *Audit of Assumptions for the 2005 Pre-Budget Report*, Report by the Comptroller and Auditor General, HC (2005–06) 707, 5 December 2005, paras 72–73

136 Q 165

> In these circumstances, policy has been locked onto a base which can only be created by the application of considerable amounts of judgement.[137]

According to the Treasury, since 1997, "the amplitude of the cycle has been much lower than in preceding cycles since the early 1970s, and lower than that experienced in the 1950s and 1960s".[138] Mr Chote had previously told us that this meant that the economic cycles were less easily identifiable, making the Treasury's task in judging where the cycle began and ended much harder.[139]

31. Dr Weale challenged the Treasury's judgement as to when the current economic cycle began.[140] He noted that the revisions to the data by the Office for National Statistics meant that the economy appeared to be above trend in 2003–04 as could be seen in Chart A3 in the 2006 Pre-Budget Report. He told us that the most obvious interpretation of the data would be that there were two economic cycles in the last decade, one which ended in 2003 or early 2004 and another which began in the same year, but which would draw to its close in early 2007. He further argued that "a three-year cycle is slightly rapid, but it is much closer to the normal sort of business cycle than the protracted ten-year cycle that the Chancellor of the Exchequer is describing".[141] Ms Rosewell called for the Treasury to clarify its judgements on the timing of the economic cycle.[142] Mr Chote was concerned that the 2006 Pre-Budget Report did not make an explicit statement that the Treasury had changed its forecast of the end-date of the economic cycle.[143]

32. Mr Cunliffe told us that the Treasury did not interpret 2003–04 as a "decisive move through trend", because other indicators such as inflation, earnings and some of the capacity indicators used to confirm the cycle did not suggest it.[144] However, the 2006 Pre-Budget Report did not contain further analysis of the role of these different factors in the overall Treasury judgement about the likely end-date of the current economic cycle. **We understand that forecasting the start and end of the economic cycle is a complex matter and that there are no clear cut answers. We recommend that, in future Budgets and Pre-Budget Reports, the Treasury provide a fuller explanation of its current forecast of the start and end dates of the current economic cycle. Such an explanation should include, if applicable, the reasons why any movements in economic growth above or below trend have not been interpreted as marking the beginning or the end of an economic cycle.**

33. There have been two other changes to the Treasury's estimates of the start and end dates of the current economic cycle in the past two years. In July 2005, the Treasury changed its estimate of the start-date of the economic cycle from 1999–2000 to 1997–98, a change which arose from the upward revision of figures on the United Kingdom's

137 Ev 72

138 HM Treasury, *Evidence on the UK Economic Cycle*, July 2005, para 3.12

139 HC (2005–06) 739, Q 55

140 Ev 70; *Pre-Budget Report 2006*, Chart A3, p 198

141 Q 28

142 Q 35

143 Q 30

144 Q 164

economic growth in 1997 and 1998 by the Office for National Statistics. At the time of the 2005 Pre-Budget Report, the Treasury revised the end-date of the economic cycle from early 2006 to 2008–09 as a result of a downward revision of growth forecasts at that time for 2005–06, which led it to infer that the economy was further below trend than previously envisaged and therefore that the cycle would end later. As we noted previously in our Report on the 2005 Pre-Budget Report, these changes had the impact of increasing the Government's chances of meeting the golden rule in the current economic cycle, all other things being equal.[145]

34. With regard to the latest change to the end-date of the economic cycle in the 2006 Pre-Budget Report from 2008–09 to early 2007, Mr Cunliffe told us that this was only provisional and could be subject to revision at a later date. He explained that the dating of the cycle is "a backwards-looking exercise" and that he could not confirm the new economic cycle would begin in early 2007 until the Office for National Statistics data was published in mid-2007.[146] The Chancellor of the Exchequer stated that, "the end of the cycle can only be judged after we have the full provision [of data] available to us… We assume that the cycle could end in 2007, but we are not making any statement that it has ended."[147] The Institute for Fiscal Studies stated in its analysis of the 2006 Pre-Budget Report that "there remains a strong case for an independent body to date the cycle".[148] The Chancellor of the Exchequer told us that the National Audit Office would be asked to audit the timings of the end of the economic cycle once the Treasury had made a firm judgement.[149] In our Report on the 2005 Pre-Budget Report, we recommended that the results of the National Audit Office audit should "be conducted and published alongside the Treasury's announcement of that judgment".[150]

35. The Treasury evaluates whether the golden rule is met through measuring the current budget balances over the economic cycle because it considers that this allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting automatic stabilisers to operate to help smooth the path of the economy in the face of variations in demand.[151] However, the difficulties in determining the start and end-dates of an economic cycle have led the International Monetary Fund to recommend that the golden rule be amended so that its application need not rely on the precise dating of the economic cycle: "Staff suggested that an exclusively forward-looking interpretation of the golden rule—for example, a rolling target of balance 3 years hence for the current budget—would reduce these drawbacks [of precisely measuring the economic cycle]".[152] Mr Chote shared this view, telling us that it would be better "to abandon the idea of trying to meet the golden rule over a fixed cycle but to say where you want to be over a sensible time horizon of three or five years and to approach it in a forward-looking way".[153] In our Report on the

145 HC (2005–06) 739, paras 43, 45

146 Qq 166–167

147 Qq 319–320

148 IFS Press Release, '*Analysis of the Pre-Budget Report*', 7 December 2006

149 Qq 321–322

150 HC (2005–06) 739, para 54

151 Pre-Budget Report 2006, para 2.8, p 15

152 *IMF Article IV Report on the United Kingdom*, March 2006, para 22

153 Q 35

2005 Pre-Budget Report, we too argued that the "golden rule's focus should be on ensuring that fiscal policy is sustainable on a forward-looking basis, rather than encouraging changes to tax levels or spending now as a consequence of data revisions relating to growth several years ago".[154] There also appear to be uncertainties as to how to the golden rule will be applied in the next economic cycle. When asked whether the last year of the economic cycle would be counted as the first year of the next economic cycle for the purposes of assessing whether the Government had complied with the golden rule, Mr Cunliffe replied that this was what the Treasury had done in the past, but that he did not know whether this was what they would do in the future.[155] The Governor of the Bank of England told our predecessors that, with regard to the golden rule, "looking backwards [over the economic cycle] is not entirely helpful". He thought that "what [is] significant is the need to look forward, and that is to look at the rules in terms of whether it is plausible in a forward looking sense that the rules will be met".[156] **There is a tension between fiscal planning, which is a forward-looking process, and the assessment of whether or not the golden rule stands to be met in the present cycle, which is primarily a backwards-looking exercise. We recommend that the Treasury review the golden rule and consider the merits of whether that rule could be made more forward-looking and its application less dependent on estimates of the dating of the economic cycle. We further recommend that the Treasury clarify in its response to this Report whether the last year of the economic cycle will count as the first year of the next economic cycle, for the purposes of judging whether the golden rule has been met.**

The sustainable investment rule

36. The objective of the sustainable investment rule is to ensure that the Government maintains sound public finances in the medium term. In order to meet the sustainable investment rule in the current economic cycle, the Government aims to maintain net debt below 40% of GDP in each and every year of the economic cycle.[157] The 2006 Pre-Budget Report forecast that the sustainable investment rule would be met over the current economic cycle. The projections for net debt in that document for what is currently expected to be the next economic cycle indicated that net debt would stabilise at 38.7% in 2009–10, before falling in 2011–12.[158] We have previously referred to concerns, which we heard again during our current inquiry, that 40% represents an arbitrary figure, but have also acknowledged "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".[159] In our Report on the 2005 Pre-Budget Report, we asked that the Treasury clarify whether, during the subsequent economic cycle, it proposed to interpret the sustainable investment rule as requiring that net debt be maintained below 40% of GDP in each and every year of that cycle.[160] Mr Chote told us that it was still unclear

154 HC (2005–06) 739, para 55

155 Qq 169–170

156 Treasury Committee, Oral and Written evidence, *Bank of England February 2005 Inflation Report*, HC (2004–05) 500–i, Q 22

157 *Pre-Budget Report 2006*, para 2.58, p 31

158 Ibid, Table B1, p 218

159 HC (2005–06) 994–I, para 45: Q 38

160 HC (2005–06) 739, para 56

whether the Treasury would adopt this approach or whether it would aim to maintain net debt at an *average* of below 40% of GDP over the course of that economic cycle as a whole.[161]

37. Dr Weale suggested that the decision as to whether to undertake investment projects or not should not be determined by the sustainable investment rule, but be based on the projected returns to the projects compared to the costs of providing for them, including the costs of taxes which would be used to fund them. He further argued that maintaining the 40% limit risked the possibility that worthwhile investment projects with a positive rate of return would not be implemented.[162] Ms Rosewell thought that a distinction ought to be made between projects which generated revenues and ones which not did when determining Government levels of investment.[163]

38. Net debt increased by 0.4% of national income in 2006–07 as a result of the decision of the Office for National Statistics to classify some previously off-balance sheet debt as on-balance sheet. The revision occurred as a result of including estimates of finance lease liabilities in Private Finance Initiative (PFI) contracts, where the judgement was made that the Government had taken over the risks and rewards of the asset concerned.[164] The Government's estimate of its payments for PFI contracts for the financial years from 2006–07 to 2030–31 in the 2006 Pre-Budget Report was £158 billion, which was an increase of 11% (£15.6 billion) from its 2006 Budget estimate.[165] The amount of these forecast future payments indicates that any decision to classify more PFI liabilities as on-balance sheet has the potential to increase net debt by a significant amount. The Institute for Fiscal Studies stated that "a significant addition to net debt would increase the risk that the 40% ceiling will be breached over the medium term", while noting that "it could be argued that a significant change in the definition of net debt should be accompanied by an equivalent change in the ceiling under the sustainable investment rule".[166] Dr Weale argued that there could be a case for including public sector pension liabilities in net debt. He considered that one of the objectives of the fiscal rules ought to be to ensure that future taxes were kept constant as a proportion of GDP and, in order to do that, the rules would need to take into account the future payments arising from public sector pensions.[167] Both he and Mr Chote stated that, if public sector net debt were to include public sector pension liabilities, the upper limit of the sustainable investment rule ought to be adjusted accordingly.[168]

39. **We continue to believe that the sustainable investment rule has considerable value in helping to assess the sustainability of public sector investment and the potential burden on future generations. However, with the Treasury now forecasting that a new economic cycle will begin in 2007 and the Comprehensive Spending Review underway, we believe that the time is ripe for the Government to clarify how the sustainable**

161 Q 41

162 Q 39

163 Q 40

164 IFS Public Finance Bulletin, September 2006, p 2

165 *Budget 2006*, Table C19, p 278; Pre-Budget Report, Table B24, p 248

166 IFS Public Finance Bulletin, July 2006, p 2

167 Q 51

168 Qq 53, 54

investment rule will operate in the next economic cycle. We therefore recommend that, either in the 2007 Budget or in reporting the outcome of the Comprehensive Spending Review, the Government—

a) **state whether it proposes to interpret the sustainable investment rule over the next economic cycle as requiring that net debt be maintained below 40% of GDP in each and every year of that economic cycle;**

b) **set out an analysis of steps it has taken to ensure that the sustainable investment rule does not operate so as to prevent the implementation of appropriate public sector investment projects with positive rates of return; and**

c) **clarify its position as to whether possible changes to the measurement of net debt would necessitate changes to the sustainable investment rule.**

3 Other issues

Efficiency savings and the Civil Service workforce

The Gershon efficiency programme: reporting and transparency

40. Alongside the 2004 Spending Review, the Government set out an efficiency programme for the financial years 2004–05, 2005–06, 2006–07 and 2007–08. Based on a review conducted by Sir Peter Gershon, the Government identified targets for annual savings amounting to £21.48 billion across central and local government, savings which were incorporated in the spending settlements announced in July 2004.[169] Under this programme, savings are expressed in annualised terms, so that a saving first achieved in one financial year will, if it is recurring, be reported in the annual total reported within the next financial year. At the time of the 2005 Pre-Budget Report, the Government reported total annual gains achieved by September of that year of £4.7 billion.[170] In the 2006 Budget, the Government reported total annual efficiency savings of £6.4 billion by the end of December 2005.[171] In the 2006 Pre-Budget Report, the Government reported total annual efficiency gains across central and local government of "£13.3 billion by the end of September 2006, more than halfway towards the target of over £21 billion by 2007–08".[172]

41. We have previously examined progress on the Gershon efficiency programme in our Reports on the 2005 Pre-Budget Report and on the 2006 Budget. On each occasion, we have argued that public and parliamentary confidence in the progress achieved would be enhanced by fuller and more transparent reporting by the Treasury.[173] Despite our recommendations, the quality and quantity of information in Red Books and Pre-Budget Reports about the efficiency programme has diminished over time, with only one paragraph in the 2006 Pre-Budget Report being devoted to an account of progress, compared with a much fuller account in the equivalent document the preceding year.[174] Professor Talbot criticised the quality of information available at the time of the 2006 Pre-Budget Report:

> We seem to have an interesting law operating here, which is the higher the claimed savings the less information is published about the detail of where these savings have actually come from. It seems to me that the Government must have fairly simple savings by department, given that they are targeted by department, and in turn broken down by the six work streams that were announced in the Gershon Review … We are more or less in the dark about where this £13.3 billion has come from.[175]

169 *Releasing resources to the front line: Independent Review of Public Sector Efficiency*, Sir Peter Gershon CBE, July 2004

170 *Pre-Budget Report 2005*, paras 6.11–6.13, p 129

171 *Budget 2006*, para 6.13 and Box 6.2, pp 132–133

172 *Pre-Budget Report 2006*, para 6.18, p 140

173 HC (2005–06) 739, para 74; HC (2005–06) 994–I, para 76

174 *Pre-Budget Report 2006*, para 6.18, p 140; Pre-Budget Report 2005, paras 6.11–6.13 and Box 6.1, pp 129–130

175 Q 66

42. We have previously argued that the provision of further detail in a single source would enhance confidence in the effectiveness of the central coordinating role played by the Office of Government Commerce.[176] However, in evidence to us, Treasury officials maintained that it was appropriate that departmental details should be reported on only by departments themselves, because those departments were accountable for ensuring delivery of the targets.[177] Following the completion of our oral evidence, most departments have published their Autumn Performance Reports for 2006, and Table 2 sets out the progress to the end of September 2006 as reported in those documents.

176 HC (2005–06) 994–I, para 76

177 Qq 207–208

Table 2: Annual efficiency savings reported by Government departments to end of September 2006

Department	Agreed efficiency target to end of 2007–08 £ million[1]	Reported progress to end September 2006 £ million[2]	Progress to end September 2006/ final target %
Crown Prosecution Service	35	65	186
Communities & Local Government[3]	620	728	117
Home Office	1,970	1,954	99
Work and Pensions	960	874	91
Trade and Industry	380	304	80
HM Treasury	20	15	75
UK Trade & Investment	35	26	74
Constitutional Affairs	290	205	71
Transport	785	529	67
Northern Ireland Office	90	59	66
Culture, Media and Sport	260	159	61
Defence	2,830	1,684	60
International Development	310	187	60
Health	6,470	3,700	57
Environment, Food and Rural Affairs	610	342	56
Foreign and Commonwealth Office	120	60	50
HM Revenue & Customs	505	225	45
Cabinet Office	25	11[4]	44[4]
Education and Skills	4,350	1,213	28
Total efficiency savings	**20,665[5]**	**12,340**	**60**

Notes: (1) Figures for targets are rounded to nearest £5 million; (2) figures for progress are rounded to nearest £1 million; (3) the target for the Department for Communities and Local Government was originally set for the Office of the Deputy Prime Minister; (4) the reported savings for the Cabinet Office are an estimate based on illustrative information provided in the Cabinet Office Autumn Performance Report 2006; (5) the total target does not match that given in the Gershon Review because figures in column 2 for the Crown Prosecution Service, HM Revenue & Customs, HM Treasury and UK Trade & Investment are derived from 2006 Autumn Performance Reports, because certain smaller departments for which reported progress information is not readily available have been excluded and because local authority efficiency savings targets are excluded unless reported by central Government departments against their own targets.

Sources: Releasing resources to the front line: Independent Review of Public Sector Efficiency, Sir Peter Gershon CBE, July 2004, Table 4.1, p 30; Department for Education and Skills, Autumn Performance Report 2006, Cm 6992, p 58; Department of Health, Autumn Performance Report 2006, Cm 6985, p 19; Department for Transport Autumn Performance Report 2006, Cm 6976, p 40; Department for Communities and Local Government Autumn Performance Report 2006, p 56; Home Office Targets: Autumn Performance Report 2006, Cm 6995, p 11; Department for Constitutional Affairs Autumn Performance Report 2006, Cm 6973, p 25; Crown Prosecution Service Autumn Performance Report 2006, Cm 6982, p 11; Ministry of Defence Autumn Performance Report 2006,

p 20; Foreign & Commonwealth Office Autumn Performance Report 206, p 38; Department for International Development 2006 Autumn Performance Report, Cm 6978, p 51; Department of Trade and Industry Autumn Performance Report 2006, p 57; Department for Environment, Food and Rural Affairs Autumn Performance Report 2006, p 69; DCMS Autumn Performance Report 2006, p 36; DWP Autumn Performance Report 2006, p 68; Northern Ireland Office Autumn Performance Report 2006, Cm 6991, p 11; HM Revenue & Customs Annual Report 2005–06 and Autumn Performance Report 2006, Cm 6983, p 54; HM Treasury Autumn Performance Report 2006, Cm 6990, p 26; Cabinet Office Autumn Performance Report 2006, Cm 7004, p 30; UK Trade & Investment Autumn Performance Report 2006, Cm 7001, p 9

43. The information provided in Table 2 is not comprehensive. First, around £2.3 billion of efficiency savings reported to the end of September 2006 are attributable to local government and much of this total is not included in totals reported by Government departments.[178] The difficulty in attributing local authority savings to individual departments' totals has been noted before by us, and was acknowledged by the Treasury.[179] Second, certain departments which contribute to efficiency totals are not obliged to publish Autumn Performance Reports and have not done so.[180] For example, the Chancellor of the Exchequer's departments together have an efficiency target of £550 million, but departments responsible for £25 million of that target do not publish Autumn Performance Reports. Third, Treasury guidance explicitly requires departments to provide a breakdown of progress towards the overall efficiency target up to the end of the second quarter of 2006–07, but the Cabinet Office Autumn Performance Report fails to comply with this requirement.[181] Such weaknesses continue despite past proposals for improvement in departmental efficiency reporting made by the House of Commons Committee Office Scrutiny Unit.[182]

44. In our Report on the 2006 Budget, we recommended that future Budgets and Pre-Budget Reports provide information on reported efficiency savings according to each Government-wide theme or "work stream" identified in the Gershon review.[183] The Government's response to that Report made no reference to that recommendation, and it has not been implemented in the 2006 Pre-Budget Report. On the day after the 2006 Pre-Budget Report was published, the Chief Secretary to the Treasury provided information about three "work streams", telling the House of Commons that, of the £13.3 billion-worth of savings reported, £5.5 billion came from procurement, £2.4 billion came from productive time, and £1.5 billion came from policy funding and regulation.[184] In oral evidence, Treasury officials did not respond to a request for a complete breakdown of the total of £13.3 billion by work stream, although we subsequently learned that such a breakdown had been published by the Treasury separately and shortly before the 2006 Pre-Budget Report.[185] Such a breakdown is important, as Professor Talbot demonstrated in his

178 The estimate of £2.3 billion is arrived at by combining the figure of "around £1.9 billion" of efficiency savings to the end of March 2006 (Pre-Budget Report 2006, para 6.18, p 140) with the total of £442.2 million of new gains reported by councils for the period April–September 2006: "Local Government on track to deliver a further £1.3 billion efficiency gains", Communities and Local Government News Release 2006/0182.

179 HC (2005–06) 739, para 73; Q 214

180 HM Treasury, 'Publication of 2006 Autumn Performance Reports', PES (2006) 08, para 4

181 Ibid, para 9; Cabinet Office, *Autumn Performance Report 2006*, December 2006, Cm 7004, pp 29–30

182 "Scrutiny Unit Review of 2005 Departmental Annual Reports", available at www.parliament.uk under Liaison Committee memoranda, chapter 4

183 HC (2005–06) 994–I, para 76

184 HC Deb, 7 December 2006, col 435

185 Q 210; Public Finance, Supplement on Government Efficiency, December 2006, p 21. £0.9 billion of savings were attributed to corporate services, £0.5 billion to transactions and £2.5 billion to "Other".

analysis, which noted that procurement had proved to be the most productive of the work streams, with 70% of the total target to April 2008 already achieved, while progress was less rapid in more labour-intensive areas.[186]

45. In February 2006, the National Audit Office published an initial report on the efficiency programme which indicated that many of the savings reported in the 2005 Pre-Budget were not yet verified.[187] Following the 2006 Budget, we recommended that future Budget and Pre-Budget documents provide an update on verification.[188] The 2006 Pre-Budget Report announced that the Office of Government Commerce had developed, in consultation with the National Audit Office, a framework and criteria against which reported efficiency gains could be assessed.[189] The new guidance establishes an objective for departments to classify gains as "preliminary", "interim" or "final".[190] The Department of Health helpfully uses the new classification in its 2006 Autumn Performance Report, indicating that, of its declared efficiency gains of £3,700 million to the end of September 2006, £2,459 million are final, £1,241 million are interim and none are classified as preliminary.[191]

46. Speaking in the House of Commons on 7 December 2006, the Chief Secretary to the Treasury noted "the importance of providing full information on the [Gershon efficiency] programme, because the more transparency there is, the better the chances of success."[192] **We agree with the Chief Secretary to the Treasury that a high level of transparency in the Gershon efficiency programme would improve its chances of success. There is likely to be a correlation between the quality and effectiveness of reporting on the efficiency programme by the Treasury, the Office of Government Commerce and individual departments and the extent of parliamentary and public confidence in the true extent of the progress achieved. We are not persuaded by the Treasury's contention that departmental totals for reported efficiency gains can be issued only by departments themselves because they are responsible for delivery: departments are accountable for their expenditure, but the Treasury is still expected by Parliament to report on departmental expenditure performance. We recommend that future Budgets and Pre-Budget Reports provide a breakdown of reported efficiency gains by department.**

47. **We welcome the steps taken by the Office of Government Commerce, in consultation with the National Audit Office, to establish a new framework for assessing and reporting efficiency gains, but we continue to believe that the quality and consistency of reporting could be improved. To enhance transparency and enable effective scrutiny, we recommend that the Treasury require departments, in their departmental annual reports and Autumn Performance Reports in 2007 and subsequent years, to provide consistent and comprehensive information on progress**

186 Ev 77

187 National Audit Office, *Progress in improving government efficiency*, February 2006, HC (2005–06) 801–I, p 5

188 HC (2005–06) 994–I, para 76

189 *Pre-Budget Report 2006*, para 6.19, p 140

190 Office of Government Commerce, '*SR04 Efficiency Delivery: Assessing, reporting and signing off gains*', www.ogc.gov.uk

191 Department of Health, *Autumn Performance Report 2006*, Cm 6985, December 2006, p 20

192 HC Deb, 7 December 2006, col 435

against efficiency targets, including by "work stream" in each case, and to classify all reported gains as preliminary, interim or final. We further recommend that Budget and Pre-Budget Report documents provide a comprehensive breakdown of all reported gains by "work stream" and according to their classification as preliminary, interim or final.

Progress towards the Gershon efficiency targets

48. Notwithstanding the inadequacies of reporting, it is evident that progress has been made towards the Gershon efficiency targets. Where gains are reported on an annualised basis, assessment of progress in percentage terms may not be especially revealing. Nevertheless, the reported total of £13.3 billion annual efficiency gains represents around 62% of the total target for annual gains to be achieved by March 2008, and central Government departments taken together have reported achievement of about 60% of their overall annual target on the same basis. Table 2 shows that several departments are well-advanced in identifying and reporting efficiency savings. The Crown Prosecution Service was able to report savings of £65.2 million to the end of September 2006, compared with an original target of £34.1 million for the entire period to the end of March 2008.[193] The Department for Communities and Local Government has also already exceeded its original overall target, reporting gains of £727.5 million against an initial target of £620 million.[194] The Home Office claimed that it had, by the end of September 2006, already achieved 99% of its target up to the end of March 2008.[195]

49. Other departments reveal significantly slower progress towards their targets. The Department for Education and Skills was able to indicate progress of only 28% towards its final target, but remained confident that the target would be achieved, attributing lags to reporting systems which operated by academic year and to the time taken to gather data from frontline institutions.[196] HM Revenue & Customs reported savings of only £225 million by September 2006, compared with an overall target of £507 million to be achieved by the end of March 2008, although nearly two thirds of the reduction in staff planned for the current spending period had taken place.[197] The Department for Environment, Food and Rural Affairs admitted to having been assigned a "Red" assessment by the Office of Government Commerce in the most recent review of the Department's efficiency programme in November 2006, which we presume uses a traffic light system comparable to that employed for Gateway reviews. To ensure that there is sufficient contingency to meet any under-delivery from those programmes in the Department for Environment, Food and Rural Affairs which it initially expected to deliver the efficiency savings, additional efficiencies have been identified across the wider Department, particularly around procurement activity.[198]

193 Crown Prosecution Service, *Autumn Performance Report 2006*, Cm 6982, December 2006, p 11

194 Department for Communities and Local Government, *Autumn Performance Report 2006*, pp 55–56

195 Home Office, Home Office Targets: *Autumn Performance Report*, Cm 6995, p 11

196 Department for Education and Skills, *Autumn Performance Report 2006: Achievement against Public Service Agreement targets*, Cm 6992, December 2006, p 58

197 HM Revenue & Customs, *HM Revenue & Customs Annual Report 2005–06 and Autumn Performance Report 2006*, Cm 6983, December 2006, pp 53–55

198 Department for Environment, Food and Rural Affairs, *Autumn Performance Report 2006*, December 2006, p 67

50. Progress measured in numerical terms represents only part of the story. As we have noted before, one of the principles underlying the efficiency programme is that the savings identified must be delivered without affecting the quality of the service provided.[199] In February 2006, the National Audit Office concluded that "the biggest risk [to the efficiency programme] is that efficiency gains are accompanied by unintended falls in the quality of service delivery".[200] During our inquiry into the 2006 Budget, Treasury officials acknowledged that further work was needed to ensure that there were measures in place to verify that the quality of service was not adversely affected by efficiency measures.[201] Professor Talbot highlighted some of the challenges facing the Government in taking forward such work. For example, savings in procurement would require verification that cheaper products or services did not lead to higher failure rates. More generally, measures of public sector outputs were not sufficiently "fine-grained" to verify the effect of efficiency measures.[202] Anecdotal evidence is available which would support the contention that efficiency measures have led to a reduction in the quality of service. For example, the Institute of Chartered Accountants in England and Wales suggested to us that the efficiency programme in HM Revenue & Customs had led to a deterioration in the quality of service which HM Revenue & Customs provided to its customers.[203] When we asked Treasury officials whether the risk of efficiency savings leading to lower quality services had materialised, we were told:

> The answer to that must be no, because the precautions we have taken have been to include measures of service quality as part of the assessment that is made when the Office of Government Commerce are assessing whether an efficiency saving has been made. So in order to know whether an efficiency saving has been made rather than a service cut been delivered, that will be clear.[204]

51. **We are concerned that the Treasury and the Office of Government Commerce, in their oversight of and reporting on the Gershon efficiency programme, may not have made sufficient allowance for the risk that claimed efficiency savings might not be delivered without a reduction in the quality of service. Departments have every incentive to assert that reductions in service have been avoided in order that efficiency savings can be recorded and targets can be met. If the Government simply asserts that service quality has been maintained if efficiency savings are reported and then accepted by the Office of Government Commerce, there is a risk that the credibility of the overall efficiency programme might be undermined. We recommend that the Treasury and the Office of Government Commerce undertake research into the quality of measures in place within departments to provide assurance that efficiency savings do not lead to a reduction in the quality of services delivered or products provided, and publish the outcome of such research no later than the 2007 Pre-Budget Report.**

199 HC (2005–06) 994–I, para 74

200 HC (2005–06) 994–II, Ev 66

201 HC (2005–06) 994–I, para 74

202 Q 68; Ev 78

203 Ev 61

204 Q 216

Workforce reductions

52. As part of the 2004 Spending Review, Government departments were set targets for reductions in Civil Service numbers resulting from the Gershon efficiency programme. We have noted before that the targets relate to workforce reductions directly attributable to the programme and that delivery of those targets might not lead to an overall reduction in Civil Service numbers where other factors bring about increases.[205] When we last considered the progress of the programme, we noted that an added difficulty in assessing the reductions in the Civil Service workforce arose from the fact that departmental reports on headcount reductions were not subject to formal review and challenge by the Office of Government Commerce.[206] Since then, the Committee of Public Accounts has recommended that the Treasury "provide a reconciliation of claimed headcount reductions with data from the Office for National Statistics on changes in the overall size of the Civil Service".[207] No such reconciliation was provided in the 2006 Pre-Budget Report, which stated that there had been "strong progress" towards the overall gross target of 84,150 posts by April 2008, with 14,600 posts removed between December 2005 and the end of September 2006, resulting in gross reductions of nearly 55,000. The Government concluded that "the programme remains on course to meet its targets".[208] Table 3 provides further information about progress by individual departments, based on information in Autumn Performance Reports.

205 HC (2005–06) 739, para 75

206 HC (2005–06) 994–I, para 78

207 Committee of Public Accounts, Fifty-fifth Report of Session 2005–06, *Progress in improving government efficiency*, HC 978, Recommendation 6

208 *Pre-Budget Report 2006*, para 6.20, p 140

Table 3: Gross reductions in posts as a result of efficiency gains reported by Government Departments to end of September 2006

Department	Agreed target to end of 2007–08 Number of posts[1]	Reported progress to end September 2006 Number of posts	Reported progress against final target %
Trade and Industry	1,280	1,293	101
International Development	170	164	96
Health	720	679[2]	94[2]
UK Trade and Investment	200	185	93
HM Treasury	150	128	85
Education and Skills	1,960	1,645	84
Foreign and Commonwealth Office	310	256	83
Work and Pensions	40,000	27,004[3]	68
Defence[4]	15,000	9,965	66
HM Revenue & Customs	16,000	10,461	65
Transport	700	457[5]	65[5]
Communities & Local Government[6]	400	223	56
Constitutional Affairs	1,100	581	53
Home Office	2,700	1,234	46
Environment, Food and Rural Affairs	2,400	416	17
Culture, Media and Sport	30	3	10
Cabinet Office	150	–28	–19
Total efficiency savings	**83,270[7]**	**54,666**	**66**

Notes: (1) See notes to Releasing resources to the front line: Independent Review of Public Sector Efficiency, Sir Peter Gershon CBE, July 2004, Table 4.2, p 31 for further information about definitions and rounding; (2) reduction for Department of Health may include reductions arising from transfers to other NHS bodies not included within Gershon target; (3) the figure for the Department for Work and Pensions only includes posts re-deployed to customer-facing roles up to March 2006; (4) Ministry of Defence figures combine Civil Service and military posts in administrative and support functions; (5) the reported reductions in the Department for Transport include a number of vacancies which the Department is intending to fill; (6) the target for the Department for Communities and Local Government was originally set for the Office of the Deputy Prime Minister; (7) the total does not match that given in the Gershon Review because certain departments for which reported progress information is not readily available have been excluded.

Sources: Releasing resources to the front line: Independent Review of Public Sector Efficiency, Sir Peter Gershon CBE, July 2004, Table 4.2, p 31; Department for Education and Skills, Autumn Performance Report 2006, Cm 6992, p 60; Department of Health, Autumn Performance Report 2006, Cm 6985, p 23; Department for Transport Autumn Performance Report 2006, Cm 6976, p 39; Department for Communities and Local Government Autumn Performance Report 2006, p 57; Home Office Targets: Autumn Performance Report 2006, Cm 6995, p 11; Department for Constitutional Affairs Autumn Performance Report 2006, Cm 6973, p 25; Ministry of Defence Autumn Performance Report 2006, p 24; Foreign & Commonwealth Office Autumn Performance Report 206, p 38; Department for International Development 2006 Autumn Performance Report, Cm 6978, p 51; Department of Trade and Industry Autumn Performance Report 2006, p 58; Department for Environment, Food and Rural Affairs

Autumn Performance Report 2006, p 69; DCMS Autumn Performance Report 2006, p 37; DWP Autumn Performance Report 2006, p 68; HM Revenue & Customs Annual Report 2005–06 and Autumn Performance Report 2006, Cm 6983, p 54; HM Treasury Autumn Performance Report 2006, Cm 6990, p 29; Cabinet Office Autumn Performance Report 2006, Cm 7004, p 30; UK Trade & Investment Autumn Performance Report 2006, Cm 7001, p 9

53. Table 3 does not provide a complete picture of reported gross post reductions. The total available from Autumn Performance Reports is slightly lower than the total of 54,963 to which Treasury officials referred in oral evidence.[209] This may be partly the result of reductions in smaller departments which do not produce Autumn Performance Reports. Also, the Northern Ireland Office Autumn Performance Report for 2006 does not include a figure for headcount reductions to September 2006.[210] The Department of Health figures may include headcount reductions which do not fall within the Gershon efficiency programme because that Department reports performance against its own Change Programme which includes transfers to other National Health Service bodies.[211] Autumn Performance Reports also indicate variations in departmental practice in measurement, including in the treatment of agency staff.[212] The Department for Transport reports a headcount reduction total which includes a number of vacancies that the Department is intending to fill, an approach which seems to run contrary to the spirit of the Gershon efficiency programme.[213]

54. Table 3 indicates that there are significant variations in departmental performance in relation to post reduction targets. The Department of Trade and Industry has already exceeded its Gershon target for workforce reductions up to April 2008.[214] The Department for Environment, Food and Rural Affairs, in contrast, reports only limited progress towards its target of a reduction of 2,400 in headcount by April 2008 and is now forecasting a reduction of only 1,100 by that time. The Department explains that this forecast is the result of the fact that it does not expect to secure post reductions in the Rural Payments Agency within the Spending Review period.[215] It is also notable that there are significant variations between departments in performance in relation to monetary efficiency targets as compared with performance in relation to workforce targets. Thus, the Home Office, which has already met 99% of its overall Gershon efficiency target in monetary terms, needs to secure a further workforce reduction of 1,466 in order to meet its headcount target.[216] The Confederation of British Industry has argued that the reported reductions in Civil Service numbers arising from the Gershon efficiency programme lack credibility because of variations in counting methodology between departments and because of the risk that reductions which lead to a deterioration in service will still be counted as "efficiencies".[217] **We note that there are significant divergences between reported**

209 Q 221

210 Northern Ireland Office, *Autumn Performance Report 2006*, Cm 6991, December 2006, p 12

211 Cm 6985, p 23

212 Department for Culture, Media and Sport, *Autumn Performance Report 2006*, p 37; Department for Environment, Food and Rural Affairs, Autumn Performance Report 2006, December 2006, p 69

213 Department for Transport, *Autumn Performance Report 2006*, Cm 6976, December 2006, p 39

214 Department of Trade and Industry, *Autumn Performance Report 2006*, December 2006, p 58

215 Department for Environment, Food and Rural Affairs, *Autumn Performance Report 2006*, p 69

216 Cm 6995, p 11

217 Confederation of British Industry, 'CBI Analysis of the Gershon Efficiency Savings', December 2006, p 1

progress against overall efficiency targets by some departments and their progress on workforce reduction targets agreed as part of the same programme; for example, the Home Office claims to have very nearly met its overall efficiency target, but needs to secure a further workforce reduction of 1,466 in order to meet its headcount target. We support the recommendation of the Committee of Public Accounts that the Treasury provide a reconciliation of claimed headcount reductions arising from the Gershon efficiency programme with data from the Office for National Statistics on changes in the overall size of the Civil Service, and we recommend that such a reconciliation be included in future Budget and Pre-Budget Reports. We further recommend that the Office of Government Commerce undertake a formal review of future departmental returns on headcount reductions to satisfy itself, Parliament and the public that such returns are being reported on a consistent and comparable basis.

Relocation and local pay arrangements

55. As part of the efficiency reporting process, departments indicate the progress they have made towards the target established following the publication in March 2004 of a report by Sir Michael Lyons on public sector relocation. That report called for 20,000 Civil Service posts to be relocated away from London and the South East by 2010.[218] At the time of the 2005 Pre-Budget Report, the Government indicated that 6,300 posts had been relocated by the end of September 2005 and that over 7,800 posts would have been relocated by April 2006.[219] In the 2006 Pre-Budget Report, the Government stated that, "as at the end of September 2006, over 10,500 posts have been successfully relocated", including over 2,400 posts relocated to Wales, over 2,200 relocated to Yorkshire and the Humber and over 2,000 relocated to the North West.[220] The following day, during Treasury questions in the House of Commons, the Chancellor of the Exchequer referred to the fact that "10,179 posts have already been *announced* for relocation".[221] In oral evidence, Treasury officials confirmed that 10,574 posts had actually been moved outside London and the South East.[222]

56. Although the Civil Service relocation programme is reported on together with the wider efficiency programme, Professor Talbot argued that there was a potential tension between relocation and efficiency in the short-term. Relocation was costly, and would not necessarily bring savings without regional differentials in pay.[223] Treasury officials pointed to the wider benefits from relocation, including the benefit to local economies and the benefit of different labour market conditions. Treasury officials suggested that relocation might solve recruitment and retention difficulties, although both they and the Chancellor of the Exchequer re-stated the long-standing Treasury support for local variation in Civil Service pay reflecting local labour market conditions.[224] **We recommend that, in reporting the outcome of the Comprehensive Spending Review, the Treasury report on the**

218 Sir Michael Lyons, *Well placed to deliver?—Shaping the pattern of Government service*, March 2004

219 *Pre-Budget Report 2005*, para 6.16, p 131

220 *Pre-Budget Report 2006*, para 6.21, p 141

221 HC Deb, 7 December 2006, col 426; emphasis added.

222 Q 219

223 Qq 70, 119

224 Qq 220, 226–234, 388

economic benefits of relocation to the receiving locations and on the extension of locally flexible pay in the public sector, and estimates the contribution of both factors to achieving Treasury targets on reducing the differences of Gross Value Added per head across regions and countries.

Efficiency, value for money and the Comprehensive Spending Review

57. When we last examined the Gershon efficiency programme, we drew attention to the potential to carry forward the benefits of the Gershon efficiency programme into the spending period to be covered by the Comprehensive Spending Review. We also emphasised the potential to learn some of the lessons from the limitations of the Gershon programme in the design of a programme for the period up to 2010–11.[225] In response, the Government confirmed that:

> 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.[226]

58. The 2006 Pre-Budget Report contained announcements relevant to this new framework. The Chancellor of the Exchequer announced that, "for the years to 2011, I have reached agreement with Secretaries of State for net efficiency savings in their overall budgets of 3% a year; and to cut their administration budgets by 5% a year".[227] The Treasury also indicated that the focus of the value for money programme within the Comprehensive Spending Review would be on delivering net cashable savings, which differs from the Gershon programme in which savings have largely been calculated and reported in terms of gross savings.[228] We intend to report further on these announcements in our forthcoming Report on the Comprehensive Spending Review: emerging issues.

Expenditure on education

59. The overall scale of expenditure on education in the period from 2007–08 onwards will be set out in the Comprehensive Spending Review later in 2007. In advance of the outcome of that Review, the 2006 Pre-Budget Report contained two announcements relating to expenditure on education. First, the Chancellor of the Exchequer announced that payments direct to schools in 2007–08 would be increased: the typical primary school would receive £50,000, compared with £39,000 in 2006–07; the typical secondary school would receive £200,000, compared with £150,000 in 2006–07.[229] These increases mean that direct payments to schools will rise to an average of £200 per pupil for primary schools and £225 per pupil for secondary schools.[230] Second, the Chancellor of the Exchequer

225 HC (2005–06) 994–I, paras 77–79

226 Treasury Committee, Fourth Special Report of Session 2005–06, *The 2006 Budget: Government Response to the Committee's Fourth Report of Session 2005–06*, HC 1472 (hereafter HC (2005–06) 1472), p 8

227 HC Deb, 6 December 2006, col 312

228 *Pre-Budget Report 2006*, para 6.26, p 142; HC (2005–06) 994–I, para 75

229 HC Deb, 6 December 2006, col 314

230 *Pre-Budget Report 2006*, para 6.73, p 153

announced new totals for capital expenditure in education up to 2010–11, of £8.3 billion in 2007–08, £8.6 billion in 2008–09, £9.1 billion in 2009–10 and £10.2 billion in 2010–11.[231] The totals announced for the period from 2008–09 to 2010–11 mean that capital expenditure on education will see an annual average growth in real terms of 4.1% over that period.[232]

60. Mr Chote described the way in which capital expenditure increases in education had been announced as "opaque".[233] His interpretation was that all of the newly-announced capital expenditure in education for 2007–08 was for higher and further education, amounting to £0.1 billion in real terms, so that capital expenditure on schools would be in line with the previously-announced total.[234] Taking the latest announcements into account, he calculated that capital expenditure in education would increase by 4.3% a year in real terms in the period from 2007–08 to 2010–11, compared with an annual increase in real terms of 15.9% in the period from 1997–98 to 2007–08.[235] Mr Chote also suggested that, of the new totals for payments direct to schools set out in the 2006 Pre-Budget Report, only £20 per pupil arose from additional spending commitments in the Pre-Budget Report itself, as opposed to prior spending announcements.[236]

61. In oral evidence, Treasury officials indicated that the new education capital expenditure announced in the Pre-Budget Report was £250 million, all of which was for further education colleges.[237] This was later confirmed by the Chancellor of the Exchequer in a correction to his oral evidence, which had originally given a lower figure for capital expenditure in further education of £100 million.[238] However, in oral evidence, the Chancellor of the Exchequer pointed out that direct payments to schools might give rise to capital spending.[239] He also confirmed that around £20 per pupil of the increase in direct payments—around 10% of the totals referred to in the Pre-Budget Report statement—arose from new spending commitments announced in the Pre-Budget Report.[240] Looking forward to capital expenditure on schools up to 2010–11, the Chancellor of the Exchequer indicated that "the test of this is going to be the number of primary schools that are given new facilities and the number of secondary schools that are given new facilities".[241] Success will thus depend on the effective delivery of the Primary Capital Programme and of the Building Schools for the Future Programme. The Primary Capital Programme was announced in 2005 and aims to rebuild or refurbish at least half of all primary schools in 15 years from 2008–09, subject to future spending decisions. There are approximately 17,500 primary schools in England. The Government has already allocated £150 million to the

231 HC Deb, 6 December 2006, col 314

232 *Pre-Budget Report 2006*, para 6.47, p 148

233 Q 74

234 Q 73

235 Ibid

236 Q 76

237 Q 242

238 See footnote to Q 402.

239 Qq 398–399

240 Qq 405–406

241 Q 413

programme in 2008–09 and £500 million in 2009–10 and 2010–11, "with investment expected to continue at least at this level into the future".[242] The Building Schools for the Future Programme was launched in February 2004 with the aim of rebuilding or refurbishing 3,100 out of 3,500 secondary schools over 15 years.[243] Over £2 billion a year, including PFI, is available for that Programme in the period up to 2007–08. The Treasury recognised that "there have been some delays to the early roll-out of the programme", but the Chancellor of the Exchequer indicated that it would move into "higher gear" in future years and cover more local authorities.[244] Given the central role assigned to education expenditure in the presentation of the 2006 Pre-Budget Report, we would have expected Treasury officials to be better prepared to provide information on the detail of education spending. **We are seriously dissatisfied at the lateness and vagueness of the information supplied to the Committee subsequent to our oral evidence, which fails to meet the detailed questions put to both officials and the Chancellor of the Exchequer at the meeting. It would be premature to reach an assessment of the overall trend of public expenditure on education in advance of the announcement of the outcome of the Comprehensive Spending Review. However, the early announcement of capital spending plans for education up to 2010–11 provides a welcome opportunity for the path of expenditure on an annual basis up to 2010–11 on major capital programmes, including the Building Schools for the Future Programme, to be set out at an early stage. We recommend that such information be provided at the time of the announcement of the outcome of the Comprehensive Spending Review.**

Child poverty

Background

62. In delivering the 2006 Pre-Budget Report to the House, the Chancellor of the Exchequer underlined the Government's commitment to addressing child poverty:

> To ensure that every child and young person has the best start in life … we must address the causes and roots of child poverty. In April [2007], child benefits paid to the poorest child, which were only £28 a week in 1997, will rise to £64 a week. These tax credits are the main vehicle that has ensured that, since 1997, 2 million children have been taken out of absolute poverty and almost 1 million children out of relative poverty.[245]

In its effort to address child poverty, and as part of the 2004 Spending Review, the Government set itself ambitious Public Service Agreement targets: between 1998–99 and 2010–11, to halve the number of children in relative low-income households; by 2020, to end child poverty. The targets are the joint responsibility of HM Treasury and the Department for Work and Pensions. The Government defines child poverty as the number of children living in households with equivalised household income—that is, income after

242 Ev 85

243 *Pre-Budget Report 2006*, para 6.46, p 147; Qq 427, 430, 435, 476

244 Ev 85; Q 427

245 HC Deb, 6 December 2006, col 308

deducting direct taxes and adding tax credits and benefit payments—below 60% of the median household income. The 2004 Spending Review targets followed on from an earlier target, set in the 2002 Spending Review, to reduce the number of children in low-income households by at least a quarter between 1998–99 and 2004–05. As we discussed in our Report on the 2006 Budget, although the Government took significant steps towards meeting this target, the target was not met.[246] Data published by the Department for Work and Pensions in March 2006 showed that, against the Government's Spending Review 2002 target, child poverty before housing costs fell by 22.6%, from 3.1 million to 2.4 million children, but by only 17% after housing costs, from 4.1 million to 3.4 million children.[247]

2006 Pre-Budget Report announcements

63. The 2006 Pre-Budget Report announced that, from April 2009, "every mother-to-be will become eligible for child benefit from week 29 of their pregnancy".[248] Currently, parents cannot claim child benefit until a child is born. The Government explained its decision to extend child benefit in this way by reference to "the importance of a healthy diet in the final weeks of pregnancy and the additional costs faced by parents when their children are born".[249] According to the Pre-Budget Report, this extension in child benefit would mean that "women will be up to £200 better off by the birth of their first child and up to £130 better off at the birth of subsequent children", although there is no explanation of the basis on which these calculations were made.[250] The Pre-Budget Report did not set out the estimated cost of extending child benefit in this way from April 2009. Following the conclusion of our oral evidence sessions, the Government told us that the reason child benefit was not scheduled to be extended to pregnant women until April 2009 was that, in order to implement the extension, the Government would need to "make the necessary legislative changes, which will require primary legislation, and put in place the administrative arrangements, including changes to the IT system, to deliver the new entitlement".[251]

64. The 2006 Pre-Budget Report also confirmed the announcement made in that year's Budget that the Government would continue to increase the child element of the child tax credit at least in line with earnings until the end of this Parliament, in order to "provide a solid foundation for meeting the target to halve child poverty".[252] The Pre-Budget Report stated that, as a consequence of this earlier announcement, from April 2007 the child element of the child tax credit would increase by £80 to £1,845 a year, representing a total increase of £400 since the introduction of tax credits in April 2003.[253] The Pre-Budget

246 HC (2005–06) 994–I, para 86

247 Department for Work and Pensions press notice, '*New figures show good progress on poverty—Hutton*', 9 March 2006

248 *Pre-Budget Report 2006*, para 5.11, p 103

249 Ibid

250 *Pre-Budget Report 2006*, para 5.11, p 103; currently, for the tax year 2006–07, parents receive £17.45 a week for the eldest child (£17.55 lone parent rate) and £11.70 a week for each additional child; from 2007–08, the lone parent rate will be abolished. See www.hmrc.gov.uk and Pre-Budget Report 2006 press notice, 'Income tax allowances, national insurance contributions, child and working tax credit, fuel duty and air passenger duty rates', 6 December 2006.

251 Ev 83

252 *Budget 2006*, para 5.6, p 98

253 *Pre-Budget Report 2006*, para 5.9, p 103

Report also noted that, since Budget 2006, projected expenditure on the child and working tax credits had been revised upwards, due to "new information about 2005–06 show[ing] higher levels of entitlement than forecast, which resulted from a number of factors including lower earnings growth among low-income households".[254]

Meeting the 2010–11 target

65. We discussed with Mr Chote what more the Government needed to do in order to meet its 2010–11 child poverty reduction target. He commented that the Chancellor of the Exchequer had "not found very much extra money" in the Pre-Budget Report to contribute towards meeting the 2010–11 target.[255] Mr Chote argued that, in order to meet the 2010–11 target, the Government

> would need to have gone from roughly about 2.7 million children, approximately 21%, in poverty on the new 2010 target definition in 2004–05 and it would need to drop by a million, that is to 1.7 million or approximately 13% in 2010–11 for the target to be met. [The Institute for Fiscal Studies and the Joseph Rowntree Foundation have] estimated that this would cost around £4.5 billion. If, for example, the Government were to … either put the money into the child element of the child tax credit, which is the most well targeted element, or, if you wish to minimise some of the means testing involved, to split it between payments on the child tax credit and additional child benefit payments for larger families, which tends to be poorer families … that would have cost about £4.5 billion. In the absence of spending that money we would expect the level of child poverty to rise from 2.7 million in 2004–05 to 2.8 million or thereabouts in 2010–11.[256]

Following the publication of the 2006 Pre-Budget Report, both the Child Poverty Action Group and One Parent Families called on the Government to invest a further £4 billion in order to achieve its 2010–11 target.[257] The Child Poverty Action Group commented that "the Chancellor of the Exchequer must do much more in next year's Budget and [the Comprehensive Spending Review], or the Government will fail to meet this important target".[258]

66. We asked Treasury officials what there was in the Pre-Budget Report that demonstrated how the Government intended to meet its 2010–11 target. Officials told us that the Government remained committed to achieving this target and that its strategy for doing so remained that set out in a strategy document published alongside the 2001 Pre-Budget Report.[259] When asked whether the Government expected the steps outlined in the strategy document to be sufficient to meet the 2010–11 target, officials responded that the

254 *Pre-Budget Report 2006*, para B.80, p 242

255 Q 93

256 Q 93; see Joseph Rowntree Foundation, *What will it take to end child poverty?* , 6 July 2006.

257 Child Poverty Action Group press notice, '*CPAG welcomes new money for child benefit, but much more needed to meet 2010 child poverty target*', 6 December 2006; One Parent Families press notice, 'Follow-up action needed to PBR 2006', 6 December 2006

258 Child Poverty Action Group press notice, '*CPAG welcomes new money for child benefit, but much more needed to meet 2010 child poverty target*', 6 December 2006

259 Q 266; HM Treasury, *Tackling child poverty: giving every child the best possible start in life*, December 2001

Government "will take stock of progress over time because progress is affected by movements in earnings and there will be measures in future Pre-Budget Reports and Budgets".[260] We raised with the Chancellor of the Exchequer the question of how the Government intended to achieve its 2010–11 target of halving child poverty, given that, according to the Institute for Fiscal Studies, child poverty needs to fall by half as much again in the next six years as it has in the past six years if the target is to be reached.[261] The Chancellor of the Exchequer told us that he did not "necessarily accept" the estimate of the Institute for Fiscal Studies and the Joseph Rowntree Foundation that it would cost the Government £4.5 billion to reach its 2010–11 target, in part because he considered that that estimate did not take proper account of the contribution to be made by getting more people into work. He expanded on this point:

> There is a whole series of ways that you can reduce child poverty. The most important way … is to get people back into work. If people are in work, earning a wage and able to contribute to their children's upbringing that is the best way by which you can reduce child poverty. We are determined, obviously, to get more people into work. We have had some success—2.5 million more in work—but there is more to be done. That will [be] the principal means by which—getting more people into work—we give families higher incomes.[262]

Nor did the Chancellor of the Exchequer appear to accept that the Government had not achieved its 2004–05 target. When we asked whether he accepted that the Government was not currently on course to achieve its 2010–11 target, he responded:

> We actually met our previous target, which was for the first five years. So we met our previous target and we have got to do what we can to meet the next target but, as I say, there is a range of things that a government can do to meet these targets.[263]

Measures available for meeting the 2010–11 target

67. The Government's decision to extend child benefit to pregnant women has been welcomed by child poverty campaigners. The Child Poverty Action Group described it as a "tremendous boost" for parents and considered that it would "help the poorest children [to] get a better start in life".[264] However, members of the Campaign to End Child Poverty, including the Child Poverty Action Group and Save the Children, called for the Chancellor of the Exchequer to go further and increase child benefit for younger children to the rate received for the older child, which they considered would lift 250,000 children out of poverty.[265] The Paymaster General, the Rt Hon Dawn Primarolo MP, has told the House of

260 Q 268

261 IFS press notice, '*Government misses child poverty targets*', 9 March 2006

262 Q 448

263 Q 450

264 Child Poverty Action Group press notice, '*CPAG welcomes new money for child benefit, but much more needed to meet 2010 child poverty target*', 6 December 2006

265 Child Poverty Action Group press notice, '*CPAG welcomes new money for child benefit, but much more needed to meet 2010 child poverty target*', 6 December 2006; Save the Children UK briefing, '*Hard Times*', 13 November 2006. Major funding members of the campaign to end child poverty are: Barnardo's, Child Poverty Action Group, The Children's Society, The Frank Buttle Trust, NCH, NSPCC, and Save the Children.

Commons that the cost of raising the value of child benefit for all children to the rate payable for the eldest child would be £1.7 billion in 2006–07, and estimated that taking such a step could lower child poverty by between 250,000 and 300,000 children.[266] When we sought the Chancellor of the Exchequer's opinion on the possible introduction of such a measure, he said only that "it is right that in this period, when we are looking at the issues related to child poverty, we look at all the representations and I cannot give you any particular new answer today".[267]

68. In addition to the Government's decision to extend child benefit to pregnant women, we also discussed with witnesses the most appropriate measures for delivering financial support to low-income families. Mr Chote described tax credits as "the most targeted measure", and thus as a more effective way of achieving the 2010–11 target than child benefit:

> If you want to get to the target by 2010–11, if you were to do it not by tax credits but by child benefit, for example, then that is much more expensive because it is that much less well targeted.[268]

However, the effect of tax credits on achievement of the 2010–11 target was by no means certain:

> Even the targeted measures are imperfect partly because of take-up and … you do not know from one year to the next what the trend in pre-tax and benefit earnings is going to be at different points in the income distribution. For example, if median earnings are growing particularly quickly then the hurdle to get over gets that much higher.[269]

We asked Treasury officials how confident the Government was that tax credits were the most effective mechanism for dealing with child poverty. Officials told us that, although tax credits were "one mechanism among a number", the Treasury had carried out "a great deal" of modelling which "specifically" compared the impact of increases in child benefit with increases in tax credits.[270] This modelling had shown that "raising the child element of tax credits is a more cost-effective way of raising the incomes of low income families than increases in child benefit".[271] In subsequent written evidence, the Government stated that "increases in both child benefit and the child element of the child tax credit can reduce the numbers of children living in poverty".[272] The Government referred to modelling showing that, if around one million more children were to have been lifted out of poverty before housing costs in 2005–06, by means of child benefit or tax credits, the Government would have needed either to increase child benefit by £15 per week in all rates of child benefit, at a

266 HC Deb, 25 October 2006, col 1942W; based on a 60% contemporary median income poverty threshold, and depending on the choice of equivalisation scale for household incomes.

267 Q 465

268 Q 97

269 Ibid

270 Qq 269–272

271 Q 269

272 Ev 83

cost of £10 billion in 2005–06, or to increase the child element of the child tax credit by £14 per week, at a cost of £5 billion.[273]

69. We asked the Chancellor of the Exchequer why he had chosen to deliver additional financial support to expectant mothers by means of child benefit, which is available to all families regardless of their income, rather than by means of tax credits. He considered that it was the universal nature of child benefit that made it the most appropriate means of delivering additional support. He accepted that child benefit did not target those on low incomes, but emphasised the importance of assisting

> all mothers at this particular point in their lives … not simply the poorest mothers … There are issues about nutrition and about the health of the mother as well as issues about the health of the child … I felt in these circumstances it is right to help all mothers and not just some mothers … I believe in child benefit.[274]

He said that assistance for low-income families was the "second aspect" of the Government's policy, coming "on top of child benefit", in the form of the child tax credit.[275] The Chancellor of the Exchequer described the child tax credit as the "biggest single factor in reducing child poverty in this country in recent years, and the reason we met our first target and the reason we have reduced child poverty continuously".[276] Finally, he suggested that the Government was already "doing quite a lot" to help expectant mothers:

> Support available for low-income families after 29 weeks includes a [Sure Start] maternity grant at £500 … There is a second element of our help as well, and that is support for diet and nutrition, where we provide between £6 and £12 a week for mothers for the nutrition of the mother-to-be and, then for the nutrition of the child in the years from 0 to 1. So for low-income families, in addition to child tax credit at a higher level, there is also available the maternity grant and, as I have just said, help in particular payments for nutritious food, including milk and other baby foods. So I think we are doing quite a lot to help mothers at this stage in their pregnancy and at the point at which a child is born …[277]

Our conclusions

70. **The Chancellor of the Exchequer told us that the Government had "actually met" the first of its targets to reduce child poverty—namely, to reduce the number of children in low-income households by at least a quarter between 1998–99 and 2004–05. This conflicts with earlier statements by the Secretary of State for Work and Pensions, the Rt Hon John Hutton MP, acknowledging that the Government had not achieved this target.** In March 2006, when the final figures showing the Government's performance

273 Ev 83; HC Deb, 18 April 2006, col 541W

274 Qq 451–452

275 Q 452

276 Q 454

277 Q 456; eligible parents—essentially those receiving income support, jobseeker's allowance or tax credits—can claim the Sure Start maternity grant at any time from week 29 of pregnancy until the child is three months old. The grant is worth £500 per child and is intended to help with the additional costs associated with pregnancy and a new baby.

against its 2004–05 targets were released, the Department for Work and Pensions described the 2004–05 target as "only narrowly missed before housing costs (BHC) are deducted, with a reduction of 23%. The reduction achieved AHC [after housing costs] was 17%."[278] The Secretary of State for Work and Pensions acknowledged that, despite the Government's achievements in reducing child poverty, "we have not quite reached our first target on child poverty …".[279] **Given that the Government has previously accepted that, although significant steps were taken towards achieving the target, the target was not met, we expect the Chancellor of the Exchequer to explain the basis of his statement in the Government's response to this Report.**

71. In the 2004 Spending Review, the Government set itself a second target of reducing child poverty by 50% between 1998–99 and 2010–11. There are some indications that the Government is not currently on course to achieve this target. The Institute for Fiscal Studies and the Joseph Rowntree Foundation have estimated that it would cost the Government £4.5 billion more than it is currently spending on reducing child poverty to achieve this target by means of the tax credits or child benefit systems. Shortly before the 2006 Budget, the Institute for Fiscal Studies commented that it was "already too late for the Government to influence child poverty rates in 2005–06 and 2006–07 by changing benefit and tax credit rates".[280] This meant that "a third of the next target period has in effect already elapsed—and we do not know if progress will have improved or worsened over this period".[281] When we took evidence from Treasury officials on the 2006 Budget, on 29 March 2006, officials could tell us only that it was "too early to say … exactly what other measures may be needed to reach the [2010–11] target".[282] We note also the mention in the 2006 Pre-Budget Report that the earnings of low-income households have grown less than the Government expected.[283] **The Government's initiative to end child poverty is now focused on its second target—to reduce child poverty by 50% between 1998–99 and 2010–11. We are concerned that the 2006 Pre-Budget Report fails to set out clearly how the Government proposes to meet its target to halve child poverty by 2010–11. We recommend that, either in the 2007 Budget or in reporting the outcome of the Comprehensive Spending Review, the Government outline its strategic position with respect to the 2010–11 target. The Government should both set out its progress to date towards achieving the target, including the measures it has implemented to date, and specify how it intends to achieve the target, including the extent to which it expects various measures to contribute towards achieving the target.**

72. **The announcement in the Pre-Budget Report that child benefit will be extended to every mother-to-be from week 29 of her pregnancy will lead to a welcome boost in income for all mothers-to-be. However, we are concerned that the changes to child benefit will not come into effect until April 2009.** The Treasury's modelling has shown that raising the child element of tax credits is a more cost-effective way of raising the

278 Department for Work and Pensions press notice, '*New figures show good progress on poverty—Hutton*', 9 March 2006

279 Ibid

280 IFS press notice, '*Government misses child poverty targets*', 9 March 2006

281 Ibid

282 HC (2005–06) 994–I, para 91

283 *Pre-Budget Report 2006*, para B.80, p 242

incomes of low-income families than is increasing child benefit. As the Government itself notes in the Pre-Budget Report, and as the Chancellor of the Exchequer pointed out to us in oral evidence, low-income families are already able to claim the Sure Start maternity grant, worth £500 per child, to help with the additional costs associated with pregnancy and a new baby.[284] **Both universal and means-tested benefits have a legitimate contribution to make towards the Government meeting its target to halve child poverty by 2010–11. If the Government is to meet the 2010–11 target, it will need to channel additional resources directly to low-income families, for example by increasing the child element of the child tax credit or the Sure Start maternity grant. Such measures would allow the Government to achieve its aim of assisting parents financially in the final weeks of pregnancy: eligibility for the child element of child tax credits could be extended to 29 weeks, and the Sure Start maternity grant is already available from week 29 of pregnancy.**

73. Finally, we note a concern that arose during oral evidence from Treasury officials. In our Report on the 2006 Budget, we discussed the changes in levels of high marginal deduction rates which have taken place under the current Government.[285] Marginal deduction rates show how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefits or tax credits. We concluded:

> 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.[286]

We therefore recommended 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 were discouraging people from entering the workforce, from working longer hours or from acquiring additional skills. We further recommended that the Treasury publish the findings of such analysis at the time of the 2006 Pre-Budget Report.[287]

74. The Government response to our Report in July 2006 indicated that it would "continue to report on policy and progress in making work pay in future Pre-Budget and Budget Reports", but did not address our specific recommendations.[288] Given that the Government had not published the analysis we recommended, either in its response or alongside the 2006 Pre-Budget Report, we asked Treasury officials what progress the Government had made with our recommendation. Officials told us that the Government had "a great deal of standing analysis of the impact of marginal deduction rates", but were unable to point to

284 *Pre-Budget Report 2006*, para 5.11, p 103; Qq 451, 456

285 HC (2005–06) 994–I, paras 83–85

286 Ibid, para 85

287 Ibid

288 HC (2005–06) 1472, p 9

any specific analysis carried out in response to our April 2006 recommendation.[289] In the absence of any specific analysis, officials pointed us to Table 4.2 in the 2006 Pre-Budget Report, which sets out the impact of the Government's reforms on high marginal deduction rates.[290] Table 4.2 updates data which has appeared in every Budget document since at least 1998. Written evidence subsequently provided by the Treasury stated that the Government recognised "the importance of evaluation of this and other issues surrounding the introduction of tax credits" and noted that HM Revenue & Customs had "actively promoted and published significant research into the impacts of the Working Families Tax Credit".[291] The Working Families Tax Credit replaced Family Credit in October 1999, and was itself replaced by the new tax credits in April 2003. HM Revenue & Customs' research had not so far revealed "any widespread adverse impacts on average hours worked or on shorter-term wage progression".[292] **We have previously noted the significant reduction in households facing marginal tax rates of 70% or more between 1998 and 2006–07, while recommending further Treasury analysis of the characteristics and income distributions of households facing marginal tax rates in the region of 60% to 70%. We are disappointed that the Treasury appears to have taken no action about this recommendation. At the very least, we expect the Treasury to notify us if it does not intend to act on one of our recommendations, giving reasons why. We intend to return to the issue of high marginal deduction rates when we examine the 2007 Budget, by which time we expect the Treasury to have published the findings called for in our earlier recommendation.**

Delays in improvements to the tax credits regime

75. In the 2005 Pre-Budget Report, the Government announced a package of measures to reform the tax credits regime, most of which were scheduled for implementation between April 2006 and April 2007. The following two measures were included in the package:

- "from 2006 the deadline for the return of end-of-year information will be moved from the end of September to the end of August. This will reduce the time that recipients are being paid on the basis of information rolled forward from the previous tax year, which is often out-of-date …
- to provide greater certainty of award for claimants, from November 2006 HM Revenue & Customs will apply automatic limits on recovery of excess amounts paid where awards are adjusted in-year following a reported change. This will reduce the effect of the change on continuing payments. These limits will be the same as the current limits on cross-year overpayment recovery, and will ensure that no low- to middle income family faces unexpected reductions in their tax credit payments …"[293]

76. Several announcements with implications for the administration of tax credits were made in or at the time of the 2006 Pre-Budget Report. The Report itself announced that,

289 Qq 275–277

290 Q 277; *Pre-Budget Report 2006*, Table 4.2, p 98

291 Ev 84

292 Ibid

293 *Pre-Budget Report 2005*, Box 5.2, p 97

following the move, in 2006, of the deadline for the return of end-of-year information from the end of September to the end of August, in 2007 the deadline would be moved again, to the end of July, thus further shortening the renewal period to four months. The Government stated that this change "will further reduce the time over which claimants are paid on potentially out-of-date information".[294] On the same day that the Chancellor of the Exchequer delivered his Pre-Budget Report, the Paymaster General made a written statement to the House on tax credits, announcing that HM Revenue & Customs had concluded that it was "not possible to make a risk-free introduction" of the automatic limits on recovery of excess amounts announced to the "original timetable"—that is, the date of November 2006 announced in the 2005 Pre-Budget Report.[295] The Paymaster General said that:

> Introducing fully automatic limits remains a key priority, and from April 2007 I have instructed HM Revenue & Customs to introduce an IT solution to ensure that claimants will benefit from reduced rates of recovery without them having to ask for this service.[296]

In the interim, HM Revenue & Customs was taking steps to try to ensure claimants could access the reduced rates. The Paymaster General also made two further announcements: that the Government would not now begin migration of the remaining income support/jobseeker's allowance recipients with children to the child tax credit in 2007, and that HM Revenue & Customs was "putting in place special arrangements for a small proportion of claimants who may experience disruption in their payments following the processing of changes in their circumstances, and will update the IT system in April 2007 to prevent this".[297]

77. At the time of the Paymaster General's 6 December 2006 announcement, the Low Incomes Tax Reform Group expressed concern that the delay in implementing automatic limits on recovery "could put the more vulnerable claimants at risk of financial hardship" and called for HM Revenue & Customs to "suspend collection of all overpayments from those claimants until the technology is in place to deliver the improvement".[298] This statement echoed earlier concerns raised with us by the Low Incomes Tax Reform Group, Citizens Advice and the Chartered Institute of Taxation in December 2005, when the November 2006 timetable for implementation was first announced, that delaying introduction of automatic limits on recovery until November 2006 would be detrimental to claimants. These groups argued that the limits ought to be put in place prior to that date.[299] During oral evidence, Treasury officials confirmed that the Paymaster General's statement meant that HM Revenue & Customs would be required to have an IT solution *operational* from April 2007.[300] Officials ruled out suspending collection of overpayments, as mooted by the Low Incomes Tax Reform Group, on the basis that it would not "be appropriate to

294 *Pre-Budget Report 2006*, para 5.15, p 105

295 HC Deb, 6 December 2006, col 14WS

296 Ibid

297 Ibid

298 Low Incomes Tax Reform Group press notice, '*Christmas risk for tax credits claimants*', 7 December 2006

299 Treasury Committee, Sixth Report of Session 2005–06, *The administration of tax credits*, HC 811–II, Ev 100, 104, 122

300 Qq 279–280

cancel all demands for repayment because not all households will be facing hardship and difficulty".[301] Officials were unable to tell us to which categories of claimants the Paymaster General was referring when she said that "special arrangements" were being put in place for "a small proportion of claimants who may experience disruption in their payments".[302] In subsequent written evidence, Treasury officials clarified that the Paymaster General was referring to those claimants who "report a new change of circumstance before the IT system is updated in April 2007".[303]

78. We also discussed with Treasury officials the Paymaster General's announcement that the Government would not now begin migration of the remaining income support/jobseeker's allowance recipients with children to the child tax credit in 2007. This migration was originally scheduled to take place from April 2004.[304] In February 2006, a senior official at the Department for Work and Pensions, Mr Adam Sharples, told the Work and Pensions Committee that that Department and HM Revenue & Customs had agreed to migrate the remaining 330,000 families receiving income support or jobseeker's allowance to tax credits between July 2006 and April 2007.[305] Treasury officials confirmed to us that the Paymaster General's announcement represented a further delay to the Government's timetable.[306] The affected families would be migrated across to the child tax credit "as soon as the IT is robust enough to permit that to happen without risk or any interruption to their income", although officials were unable to specify when that might be.[307]

79. **We are concerned to learn that HM Revenue & Customs has failed to meet its original timetable of applying, from November 2006, automatic limits on recovery of excess amounts paid in cases where tax credits awards are adjusted in-year following a reported change. We will be watching closely to see whether HM Revenue & Customs manages to comply with the Paymaster General's instruction to introduce such automatic limits in April 2007. We are concerned by the Paymaster General's announcement that the timetable for migrating the remaining 330,000 families who receive income support or jobseeker's allowance—some of the poorest families in the country—to the child tax credit has slipped yet again, given that these families were due to be migrated from April 2004. We intend to take these matters up with the Government in the first half of 2007, when we follow up our June 2006 Report on The administration of tax credits.**[308]

301 Q 282

302 Q 281

303 Ev 83

304 Number Ten, HM Treasury and Inland Revenue, *The Child and Working Tax Credits: The Modernisation of Britain's Tax and Benefit System*, April 2002, para B13

305 Oral evidence taken before the Work and Pensions Committee on 6 February 2006, HC (2005–06) 895, Qq 33–34

306 Qq 285–288

307 Qq 283–284

308 Treasury Committee, Sixth Report of Session 2005–06, *The administration of tax credits*, HC 811–I

Climate change and environmental taxation

80. In the 2006 Pre-Budget Report, the Government welcomed the Stern Review on *The Economics of Climate Change*, stating that the review's key conclusions were "in line with the Government's existing policy, including … using multilateral emissions trading as a primary means of pricing carbon in the economy … and incentivising behavioural change especially on energy efficiency".[309] Prior to the Pre-Budget Report, we had announced our intention to undertake an inquiry into the implications for HM Treasury policy of climate change and the Stern review, following the publication of Sir Nicholas Stern's review of *The Economics of Climate Change* on 30 October 2006.[310] We published our terms of reference on 14 December and expect to take evidence on this inquiry early in 2007.[311] In this section, we summarise the main relevant announcements in the 2006 Pre-Budget Report; we will examine these announcements in greater detail in the course of our forthcoming inquiry.

81. In presenting the 2006 Pre-Budget Report to the House, the Chancellor of the Exchequer stated that the Government intended to use market mechanisms and incentives to work towards global carbon trading, and that the Government aimed to "make London the world's leading centre for carbon trading".[312] The Pre-Budget Report described the EU emissions trading scheme as "the world's most significant step towards carbon pricing", and as the United Kingdom's "principal pricing instrument and a key component in a comprehensive United Kingdom framework to effectively mitigate climate change".[313] The Pre-Budget Report reiterated the Government's aim of developing the EU scheme "as the basis of a global carbon market" and "forging an EU agreement to a post-2012 framework".[314] In evidence to us, Treasury officials described the EU scheme as "the only game in town in terms of an international trading system that helps us establish a price for carbon", although officials also agreed the EU scheme had had "very significant teething problems".[315] According to officials, the Government drew

> very significant comfort from the [European] Commission's recent announcements on the national allocations where every country other than the United Kingdom had their provisional allocations rejected and the Commission is proposing to tighten up their allocations. That is absolutely vital to the working of the [EU emissions trading] scheme.[316]

82. The 2006 Pre-Budget Report stated that the Government recognised "the role that air passenger duty can play in tackling the climate change impact of aviation" and that it

309 *Pre-Budget Report 2006*, para 7.12, p 160; Stern Review on the Economics of Climate Change, 30 October 2006

310 Treasury Committee press notice, '*Treasury Committee announces new inquiry into climate change and the Stern review*', 22 November 2006; available at www.parliament.uk/treascom.

311 Treasury Committee press notice, '*New inquiry: Climate change and the Stern review: the implications for HM Treasury policy on tax and the environment*', 14 December 2006; available at www.parliament.uk/treascom.

312 HC Deb, 6 December 2006, col 309

313 *Pre-Budget Report 2006*, para 7.16, p 161

314 Ibid, para 7.18, p 162

315 Qq 299, 301

316 Q 299

would therefore double existing air passenger duty rates with effect from 1 February 2007.[317] Table 4 shows the changes in rates of Air Passenger Duty since 1994.

Table 4: Changes in air passenger duty rates since 1994 (rate levied per passenger)

		1 Nov 1994	1 Nov 1997	1 Apr 2001	1 Feb 2007
Domestic flights and flights to an EEA destination	*Combined rate*[318]	£5	£10		
	Economy rate			£5	£10
	Non-economy rate			£10	£20
Flights to a destination outside the EEA	*Combined rate*	£10	£20		
	Economy rate			£20	£40
	Non-economy rate			£40	£80

Source: HM Revenue and Customs, 'Air passenger duty: Summary of chargeable passengers, liability declared and receipts', September 2006 bulletin, and Pre-Budget Report 2006, para 7.82, p 176

The Government considered that the doubling of rates would have significant environmental benefits, delivering carbon savings of around 0.3 million tonnes of carbon (MtC) a year by 2010–11: "when the effect of non-carbon dioxide emissions is taken into account this has a climate change impact equivalent to saving around 0.75 MtC per year by 2010-11.[319] The Government estimated that the increases announced in the 2006 Pre-Budget Report would generate an additional £3.465 billion for the Exchequer between 2006–07 and 2009–10.[320] We discuss the timing of the implementation of the increase in air passenger duty rates later in this Report.[321]

83. The 2006 Budget announced that the main fuel duty rates would rise in line with inflation from 1 September 2006.[322] However, in July 2006, the Government announced that, due to sustained oil market volatility, the increase would not in fact go ahead in September and the position would be reviewed at the time of the 2006 Pre-Budget Report.[323] The 2006 Pre-Budget Report announced that the Government would increase the main fuel duty rates in line with inflation by 1.25 pence per litre, from midnight on 6 December 2006.[324] According to the 2006 Pre-Budget Report, "it is the Government's policy that fuel duty rates should rise each year at least in line with inflation as the United Kingdom seeks to reduce polluting emissions and fund public services".[325] The Chancellor of the Exchequer confirmed in the House that he would not restore the fuel duty escalator

317 *Pre-Budget Report 2006*, para 7.82, p 176

318 That is, both economy and non-economy rates.

319 Ibid, para 7.82, p 176

320 *Pre-Budget Report 2006*, Table B4, p 226

321 See paragraphs 97–100.

322 *Budget 2006*, para 7.59, p 164

323 *Pre-Budget Report 2006*, para 7.53, p 170

324 Ibid

325 Ibid

and that he had rejected a real terms increase in fuel duty.[326] The Pre-Budget Report noted that "rates remain 15% lower in real terms than they were in 1999, when the fuel duty escalator was abolished": since the abolition of the fuel duty escalator, the Government has raised duty rates on the main fuels only once, in the 2003 Budget.[327]

Other taxation issues

Missing Trader Intra-Community fraud

84. The Government defines Missing Trader Intra-Community (MTIC) VAT fraud (sometimes called "carousel fraud") as "a large-scale organised criminal attack on the EU VAT system, with the aim of creating large unpaid VAT liabilities and fraudulent VAT repayment claims".[328] As part of its strategy against MTIC fraud, the Government has been seeking to secure a derogation from European Union VAT law to permit the introduction of a reverse charge VAT system for goods most commonly used in MTIC frauds. Such a reverse charge would change the system for collecting VAT on certain goods so that it would be collected only at the point of sale to the consumer, rather than at different points in the supply chain—a change which the Government states will remove the mechanism by which the fraudster steals VAT in the supply chain.[329]

85. Alongside the 2006 Pre-Budget Report, HM Revenue & Customs published its 2005–06 estimates of attempted MTIC fraud and actual losses resulting from such fraud:

> HM Revenue & Customs' current assessment, based on operational data, is that attempted MTIC fraud in 2005–06 was in the range £3.5 billion to £4.75 billion. A significant proportion of these attempted frauds are stopped so the potential impact on VAT receipts is substantially smaller. HM Revenue & Customs estimate that for 2005–06 VAT receipts could have been reduced by between £2 billion and £3 billion due to MTIC fraud.[330]

HM Revenue & Customs reached these estimates using a different methodology from that it had previously used to obtain estimates of losses resulting from MTIC fraud between 2000–01 and 2004–05. HM Revenue & Customs considered it necessary to change its methodology because "fraudsters have changed the way they operate".[331] Table 5 shows HM Revenue & Customs' estimates of losses resulting from MTIC fraud between 2000–01 and 2004–05, obtained using the earlier methodology:

326 HC Deb, 6 December 2006, col 310

327 *Pre-Budget Report 2006*, para 7.53, p 170; *HM Revenue and Customs, Hydrocarbon oils: Historical duty rates*, available at www.hmrc.gov.uk

328 *Pre-Budget Report 2006*, para 5.133, p 126

329 Ibid, para 5.135, p 127; BBC News website, 'Key UK anti-fraud rule delayed', 7 November 2006; Q 316

330 HM Revenue & Customs, *Measuring indirect tax losses—2006*, 6 December 2006, para 2.12

331 Ibid, para 2.10

Table 5: Estimates of losses resulting from MTIC fraud between 2000–01 and 2004–05

Financial year	Lower estimate	Upper estimate
2000–01	£1.3 billion	£2.5 billion
2001–02	£1.7 billion	£2.5 billion
2002–03	£1.5 billion	£2.3 billion
2003–04	£1.1 billion	£1.7 billion
2004–05	£1.1 billion	£1.9 billion
Totals	**£6.7 billion**	**£10.9 billion**

Source: HM Revenue & Customs, Measuring indirect tax losses—2006, 6 December 2006, Table B3

In addition to the estimates published alongside the 2006 Pre-Budget Report, the Paymaster General wrote to the Committee setting out some additional information on MTIC fraud.[332] The Paymaster General acknowledged that, although HM Revenue & Customs' anti-fraud activities "did help to mitigate the negative impact [of MTIC fraud] on VAT receipts" in 2005-06, "the increasingly complex nature of the fraud meant that over this period HM Revenue & Customs did not always have sufficient evidence necessary to deny all suspect claims".[333] She noted that HM Revenue & Customs had re-deployed a further 600 additional staff to the MTIC strategy, bringing the total number of staff to over 1,400, and concluded that "operational indicators" pointed to "a much improved position in 2006–07".[334]

86. At his appearance before us on 13 December 2006, the Chancellor of the Exchequer provided us with an update on recent developments in the Government's fight against MTIC fraud, which he described as "the biggest single attack on the taxation systems of the European Union".[335] The Chancellor of the Exchequer informed us that, on 12 December 2006:

> an agreement was reached on the derogation we have sought with France and, with the support now of other Member States, I am confident that the derogation will be adopted … The reverse charge will move the mechanism for stealing VAT from around 90% of goods currently traded in carousel fraud … I am pleased that the measure that we have sought in the European Union is now going to be acted on immediately.[336]

The Chancellor of the Exchequer noted that, for the purposes of the public finances and in line with the Code for Fiscal Stability, the Government had "cautiously estimated" the

332 Ev 82

333 Ibid

334 Ibid

335 Q 316

336 Ibid

impact of the reverse charge as yielding an additional £500 million in 2007–08, "although the true impact will obviously depend on the levels of fraud in future years".[337]

87. Earlier, we had discussed with Mr Chote and Mr John Whiting of PricewaterhouseCoopers the potential effectiveness of the reverse charge sought by the Government. Mr Chote described the reverse charge as "a good way forward", but said that it was not guaranteed to solve the problem of MTIC fraud, because the reverse charge moved the risk of fraud from those goods subject to the reverse charge to other types of goods.[338] Mr Whiting commented that, in arguing for the reverse charge at EU level, the Government's reasoning appeared to be that "we need to block what we know about", whereas "the French and certain other countries" had reasoned that "we have to block everything in one go".[339]

88. **The scale of Missing Trader Intra-Community fraud appears to have tripled between 2004–05 and 2005–06, to between £3.5 billion and £4.75 billion in 2005-06, with an estimated negative impact on VAT receipts during the year of between £2 billion and £3 billion. We welcome the Chancellor of the Exchequer 's announcement that the United Kingdom Government has reached an agreement with France to secure a derogation from European Union VAT law to combat such fraud. We trust that the European Union will now act promptly upon this measure and we will make our own representations to our opposite members in other national parliaments. The Government has predicted that the reverse charge will move the mechanism for stealing VAT from around 90% of the goods currently traded in Missing Trader Intra-Community fraud. Following the implementation of the measure, we will look for the emergence of evidence that the Government's prediction has in fact been borne out.**

Taxation of Alternatively Secured Pensions

89. Alternatively Secured Pensions (ASP) were established with effect from April 2006. They are available to people aged 75 and over who do not want to buy an annuity and they work in a similar way to unsecured pensions, but have slightly different rules. The 2006 Pre-Budget Report stated that "ASPs were introduced to meet the specific need of certain groups that have a principled religious objection to the pooling of mortality risk in annuities. It was never the intention that ASPs would become a mechanism to avoid compulsory annuitisation, or to leave a tax-favoured lump sum that could then be passed on."[340] Accordingly, the 2006 Pre-Budget Report announced the Government's intention to propose legislative changes in order to deter people from using ASPs to pass funds on to heirs. There would be a requirement to withdraw a minimum level of income each year from an ASP fund, and the transfer of funds from ASPs on death as a lump sum to pension funds would attract an unauthorised payments charge. The Government also warned that, "if these proposals prove unworkable, or there is continued evidence of the use of pensions tax relief to provide capital sums throughout retirement, the Government will consider whether to remove access to ASPs altogether".[341] Mr Whiting thought that the Treasury's

337 Q 316

338 Q 103

339 Q 104

340 *Pre-Budget Report 2006*, para 5.75, p 118

341 *Pre-Budget Report 2006*, para 5.76, p 118

earlier plans had inadvertently raised hopes that "ASPs could be used to preserve capital that could be bequeathed in some way". He also argued that, "if the ASP route is to be tightened as outlined, the tax charges involved—which could amount to 70% with a 40% scheme administrator charge—need to be reviewed and made fairer".[342] Treasury officials told us that the reason that "the Government has taken the action they have is because they [the ASPs] have been marketed primarily to wealthy people as a way of using tax relief to build up large capital sums to pass on their death".[343] The Treasury stated that changes made to the regulations in ASPs in the Pre-Budget Report protected its revenues.[344]

Planning-gain Supplement

90. In the 2005 Pre-Budget Report the Government began a process of consultation on a possible Planning-gain Supplement, designed to capture the benefits from the grant of planning permission, with the proceeds to be used to finance local infrastructure projects. When we first examined the proposals, we asked the Treasury to give full consideration to applying lower rates of or a total exemption from Planning-gain Supplement for brownfield sites.[345] Following the 2006 Budget, we noted positive comments about the process of consultation that was taking place in relation to Planning-gain Supplement.[346] As part of that process, the Communities and Local Government Committee has reported on the Planning-gain Supplement, advocating a clear funding formula to determine how much revenue from the Supplement is returned to each local authority and arguing against discounts or exemptions for brownfield sites.[347]

91. In the 2006 Pre-Budget Report, the Government indicated that it would move forward with the implementation of Planning-gain Supplement if, after further consultation, the levy continued to be deemed workable and effective. The Government stated that Planning-gain Supplement would not be introduced earlier than 2009. The Government suggested that it was not minded to introduce a lower rate of the Supplement for brownfield sites. The Government proposed that at least 70% of revenues from the Supplement would be hypothecated for local infrastructure priorities and would be returned to the local authority area in which they were generated. Remaining funds would be returned to the regions to help finance strategic infrastructure projects.[348] In oral evidence, Treasury officials confirmed that the money to be allocated to local authority areas would be given directly to local authorities to invest in the infrastructure needed to support new development.[349] They also indicated that they expected the revenue yield from Planning-gain Supplement to be greater than that available to local authorities as a result of

342 Ev 75

343 Q 291

344 Ev 81

345 HC (2005–06) 739, para 88

346 HC (2005–06) 994–I, para 111

347 Communities and Local Government Committee, Fifth Report of Session 2005–06, *Planning Gain Supplement*, HC 1024–I, paras 73, 46

348 *Pre-Budget Report 2006*, paras 3.116–3.123, pp 69–70

349 Q 307

section 106 agreements.[350] **We welcome the measured way in which the Government is consulting on and taking forward proposals for a Planning-gain Supplement.**

The Leitch Review on skills

92. The Final Report of the Leitch Review of skills was published the day before the 2006 Pre-Budget Report 2006. The aim of the Review was to address the issue that a large proportion of people in the United Kingdom have low skills. As set out in the interim report of the Review,

> over one third of adults in the United Kingdom do not have a basic school-leaving qualification, double the proportion of Canada and Germany; five million people have no qualifications at all; and one in six do not have the literacy skills expected of an 11 year old and half do not have these levels of functional numeracy.[351]

The Chancellor of the Exchequer told us that that "we have got to do better at the adult skills level and we have got to do better at getting young people, with apprenticeships and with other college qualifications, the skills that are necessary for the future".[352]

93. One of the main recommendations of the final report of the Leitch Review was that all public funding for adult vocational skills in England, apart from community learning, should be routed through Train to Gain schemes and Learner Accounts.[353] Learner Accounts are a mechanism to provide people with some Government funding, which they can spend at an accredited learning provider of their choice.[354] Train to Gain schemes involve the Government providing support to firms to train their employees up to Level 2 (five good GCSEs) and Level 3 (2 A levels).[355] When asked how effective the recommendations in the Leitch Review Final Report would be in addressing the United Kingdom's skill deficit, Dr Weale said that providing basic skills training to adults was likely to raise their aspirations, which would eventually have a positive impact on employment, but he thought that this would be a slow process.[356] Mr Chote pointed to evidence suggesting that a large proportion of funding in previous Government-subsidised training schemes was "deadweight", in the sense that funding went to firms which would have paid for training for their employees anyway. [357] It is envisaged that the Train to Gain schemes would employ skill brokers to target "hard to reach" businesses to counteract this problem.[358] **We welcome the Leitch Review Final Report's aspiration of making the United Kingdom a world leader in skills by 2020. We expect to comment further on the**

350 Qq 308–309

351 Leitch Review, *The Skills in the UK: The long-term challenge, Interim Report*, Executive Summary, December 2005, p 3

352 Q 346

353 *Prosperity for all in the global economy—world class skills: Final Report of the Leitch Review of skills*, December 2006, p 4

354 *The Leitch Review Final Report*, Box6.3, p 111

355 Ibid, Box 4.1, p 75

356 Q 80

357 Q 82

358 *The Leitch Review Final Report*, Box 4.1,p 75

economic importance of skills training when we report on the outcome of our inquiry into Globalisation: its impact on the real economy.

4 The role of the Pre-Budget Report

Fiscal consultation

94. According to the Code for Fiscal Stability which was given statutory force in 1998, a Pre-Budget Report is intended to be consultative in nature. The Pre-Budget Report is expected to include, "so far as reasonably practicable, proposals for any significant changes in fiscal policy under consideration for introduction in the Budget", although the Pre-Budget Report "shall not be taken as an indication of all tax policy areas where the Government may choose to act".[359] Following the 2005 Pre-Budget Report, and again following the 2006 Pre-Budget Report, some witnesses questioned whether the Pre-Budget Report had retained its consultative character, with suggestions that the extent of concrete announcements had made the December statement more like a Budget and militated against a rounded debate on what measures should appear in the Budget.[360] During our current inquiry, and having previously been critical of the level of consultation about some technical tax changes, Mr Whiting noted the volume of material about tax measures released by the Treasury and HM Revenue & Customs and the level of consultation that implied, which he thought was "very much to be applauded".[361] We have already commented on the measured way in which the Government is taking forward proposals for a Planning-gain Supplement.[362]

95. The Chancellor of the Exchequer rejected suggestions that the Pre-Budget Report was insufficiently consultative in character:

> No, it is a pre-Budget document and I think this year in particular emphasises why it is a discussion prior to the Budget. We have published probably more significant long-term reviews about what we need to do as a country than at any point in the last ten years. We are really looking ahead to how an economy like ours faces up to the global economic challenge … so we are preparing the way for the Budget in that particular respect. These reports are now out for consultation and we expect to hear people's views on them. Some of the proposals are more controversial than others, but I think this is exactly in the spirit of what you would expect a Pre-Budget Report to be.[363]

A number of the reviews published leading up to or at the time of the 2006 Pre-Budget Report have a direct bearing on economic policy over the next decade, and some, including the Stern review on the Economics of Climate Change and the Barker review on Land Use Planning, have a direct bearing on future tax policy. **We welcome the Government's decision to commission and publish a range of reviews informing future economic policy, including tax policy. However, it is important that the Pre-Budget Report retains a focus on consultation on fiscal measures that may be included in the**

359 HM Treasury, *The Code for Fiscal Stability*, November 1998, para 18

360 HC (2005–06) 739, Qq 110, 32, 116

361 HC (2005–06) 994–I, para 105; Ev 74

362 See paragraph 91.

363 Q 317

forthcoming Budget. Although the 2006 Pre-Budget Report is accompanied by a considerable volume of material on technical tax changes, there is less discussion on more substantive tax measures under consideration for inclusion in the Budget. We wish to see such consultation more to the fore in future Pre-Budget Reports.

Notice

96. The Treasury gave only 18 days' notice of the date of the 2005 Pre-Budget Report, attributing the short notice in part to international commitments, including those arising from the United Kingdom Presidencies of the European Union and the G7/8. In our Report on that Pre-Budget Report, we recommended that the Treasury give at least four weeks' notice of the date of the Pre-Budget Report and that, in any case where this target was not met, the Treasury explain the reasons.[364] The date of the 2006 Pre-Budget Report was announced on 16 November, a notice period of 20 days.[365] No explanation was given as to why a longer period of notice was not possible. **We continue to believe that the effectiveness of the Pre-Budget Report as an instrument of fiscal consultation would be enhanced if Parliament and the public were given greater notice of the date of the Pre-Budget Report. We re-state our recommendation that the Treasury announce the date of the Pre-Budget Report at least four weeks before the statement is due to be made and, in any case where the target is not met, give an account of the reasons.**

The implementation of new rates of Air Passenger Duty

97. In the course of the statement on the 2006 Pre-Budget Report, the Chancellor of the Exchequer announced that Air Passenger Duty would be doubled with effect from 1 February 2006.[366] As we have already noted, we intend to comment further on the environmental implications of this tax change when we report on our forthcoming inquiry into Climate change and the Stern review: the implications for HM Treasury policy on tax and the environment.[367] In this section, we are concerned with the timing of the implementation of the new rates of Air Passenger Duty. It is quite usual for tax changes to come into force very soon after their announcement in a Budget. As the Chancellor of the Exchequer pointed out, changes to fuel duty often come into force almost immediately.[368] The 2006 Pre-Budget Report included an announcement that the increase in fuel duty approved in principle by the House of Commons after the 2006 Budget would come into force from midnight on 6 December.[369] It is an established practice for tax avoidance measures to be announced in the Pre-Budget Report as well as in the Budget and to have immediate effect. The Code for Fiscal Stability makes clear that "consultation may not be possible in areas which: (a) carry the risk of significant forestalling activity by existing or

364 HC (2005–06) 739, para 3

365 HC Deb, 16 November 2006, col 1WS

366 HC Deb, 6 December 2006, col 310

367 See paragraphs 80–82.

368 Q 341

369 HC Deb, 6 December 2006, col 310

prospective taxpayers; or (b) could lead to significant temporary distortions in taxpayer and market behaviour, including disruption in financial markets".[370]

98. The last significant changes to rates of Air Passenger Duty were announced on 21 March 2000 and came into force on 1 April 2001. On that occasion, the Government explained the length of the period between the announcement and the implementation by stating that this would "allow airlines and tour operators plenty of time to adjust their marketing and pricing strategies to the new structure".[371] Both the Board of Airline Representatives in the UK and Mr Whiting drew attention to the administrative difficulties and cost implications of the much shorter notice period on the current occasion, particularly in relation to tickets purchased before 6 December 2006 for flights on or after 1 February 2007, where airlines had to decide whether to charge such passengers or bear the costs of the duty themselves.[372] Treasury officials stressed that Air Passenger Duty was "a tax on airlines", not on individual passengers, and the Chancellor of the Exchequer characterised it as "a departures tax … not a bookings tax … not a ticket tax", so that it was for airlines to decide whether to pass on the additional costs to passengers.[373] The Chancellor of the Exchequer indicated that the additional yield from the increased rates amounted to about £80–90 million a month, and the Treasury estimates that around £165 million of additional revenue will accrue from the implementation of the higher rates during the current financial year.[374]

99. The increases in Air Passenger Duty announced in the 2006 Pre-Budget Report can be viewed as retrospective in two senses. The first element of retrospection is that airlines will be liable to pay the tax for departures on or after 1 February 2007 regardless of whether tickets were purchased before the new rates were announced. The second element of retrospection is that the liability to pay Air Passenger Duty at the new higher rates will effectively be incurred before the House of Commons has authorised the increase; such authorisation will take place only after the Budget.[375] Treasury officials initially asserted that the announcement of changes in the rates of duties which would come into force before the Budget and the ensuing parliamentary approval was a "perfectly standard procedure" and offered to "come back" to us with "specific instances" when such changes had been announced in a Pre-Budget Report which would then come into force before the Budget.[376] The Treasury has not subsequently provided us with any such instances.

100. Pre-Budget Reports share many of the characteristics of a Budget, but they remain different in terms of the procedure of the House of Commons. A Budget is followed directly by the passage of financial resolutions which provide initial and provisional parliamentary authority for the collection of taxes and duties at higher rates pending the passage of the Finance Bill. The Pre-Budget Report does not give rise to any such formal decisions of the House of Commons. **Where tax changes carry a significant risk of**

370 HM Treasury, *Code for Fiscal Stability*, November 1998, para 16

371 HM Treasury, Budget 2000, '*Air Passenger Duty slashed for most travellers*', HM Customs and Excise press notice 4

372 Ev 75–76, 80–81

373 Qq 183–185, 341

374 Q 350; *Pre-Budget Report 2006*, Table B4, p 226

375 Qq 188, 344

376 Qq 188, 194

forestalling activity or could distort market behaviour, it is often appropriate for those changes to come into effect immediately upon their announcement, even if formal parliamentary approval cannot be granted for some time thereafter. However, we have received no evidence to suggest that such considerations apply to the changes to the rates of Air Passenger Duty announced in the 2006 Pre-Budget Report. As a general rule, we consider that, where increases in rates of duties or taxes are proposed in the Pre-Budget Report, those increases should not come into force until after the House of Commons has had an opportunity to come to a formal decision on the proposed increase following the Budget. We draw the attention of the House of Commons to the unusual timing of the implementation of the increases in Air Passenger Duty, for which the Treasury has not cited any relevant precedents.

Conclusions and recommendations

The economy

Business investment

1. We welcome the recent rise in the growth rate of business investment, although we note that, given the supportive conditions at the time, the previous weakness in business investment remains unexplained. In these circumstances, although there may be an upside risk to the Treasury's forecast for business investment, it needs to be borne in mind that there is also a downside risk in that the previous weakness remains unexplained, and it is possible that this period of weaker than expected performance may be resumed. (Paragraph 9)

Consumption

2. We note there are several risks around the consumption growth forecast. These include the potential for house prices to fall, for an increase in the influence of insolvencies on consumer spending, and for an increase in the overall saving rate of households, which then dampens consumption. We note the rise in the numbers of households using official forms of insolvency, especially Individual Voluntary Arrangements. We may return to examine matters relating to the regulation of the marketing of Individual Voluntary Arrangements, as well as further considering the economic implications of the rise in personal insolvencies. (Paragraph 14)

The labour market

3. The rise in the employment rate is welcome. However, the lack of robust statistics on migration means that it is difficult to assess the overall functioning of the labour market. We note that the Office for National Statistics is undertaking work on these statistics, and we recommend that the Government summarise the results of that work in the 2007 Budget. (Paragraph 19)

The trend growth assumption

4. The change to the trend growth rate assumption, post-2006, though audited by the National Audit Office, is mainly based on migration statistics of questionable quality. We note that any significant error in this assumption will have implications for the Government's assessment of its compliance with its fiscal rules. (Paragraph 20)

The public finances

The overall fiscal position

5. Despite the improved forecast for economic growth in 2006, the Treasury has not forecast an improvement in the fiscal position compared with its forecasts in the 2006 Budget, partly as a result of downward revision of forecasts for tax receipts in

future years as a percentage of GDP. The Treasury's current fiscal forecasts may well be realistic, but they indicate the medium-term constraints that will form part of the context for the conduct of the 2007 Comprehensive Spending Review. (Paragraph 22)

6. We welcome the fact that the past concerns of the Treasury Committee about the apparent over-optimism of Treasury forecasts of tax receipts, and of corporation tax receipts in particular, appear at the moment to have been addressed. We note the significant downward revision of forecast North Sea oil revenues in 2007–08, and look forward to seeing whether the more cautious forecast proves to be accurate. (Paragraph 24)

The golden rule

7. On the basis of its current forecasts of the length of the current economic cycle, the Government appears to be on track to meet the golden rule in the current economic cycle. However, the Treasury's forecasts also indicate that the Government will start the next economic cycle with its current budget in deficit, compared to the projections outlined in the 2006 Budget, which foresaw the Government starting the next economic cycle with its current budget in surplus. (Paragraph 28)

8. We understand that forecasting the start and end of the economic cycle is a complex matter and that there are no clear cut answers. We recommend that, in future Budgets and Pre-Budget Reports, the Treasury provide a fuller explanation of its current forecast of the start and end dates of the current economic cycle. Such an explanation should include, if applicable, the reasons why any movements in economic growth above or below trend have not been interpreted as marking the beginning or the end of an economic cycle. (Paragraph 32)

9. There is a tension between fiscal planning, which is a forward-looking process, and the assessment of whether or not the golden rule stands to be met in the present cycle, which is primarily a backwards-looking exercise. We recommend that the Treasury review the golden rule and consider the merits of whether that rule could be made more forward-looking and its application less dependent on estimates of the dating of the economic cycle. We further recommend that the Treasury clarify in its response to this Report whether the last year of the economic cycle will count as the first year of the next economic cycle, for the purposes of judging whether the golden rule has been met. (Paragraph 35)

The sustainable investment rule

10. We continue to believe that the sustainable investment rule has considerable value in helping to assess the sustainability of public sector investment and the potential burden on future generations. However, with the Treasury now forecasting that a new economic cycle will begin in 2007 and the Comprehensive Spending Review underway, we believe that the time is ripe for the Government to clarify how the sustainable investment rule will operate in the next economic cycle. We therefore recommend that, either in the 2007 Budget or in reporting the outcome of the Comprehensive Spending Review, the Government—

a) state whether it proposes to interpret the sustainable investment rule over the next economic cycle as requiring that net debt be maintained below 40% of GDP in each and every year of that economic cycle;

b) set out an analysis of steps it has taken to ensure that the sustainable investment rule does not operate so as to prevent the implementation of appropriate public sector investment projects with positive rates of return; and

c) clarify its position as to whether possible changes to the measurement of net debt would necessitate changes to the sustainable investment rule. (Paragraph 39)

Other issues

Efficiency savings and the Civil Service workforce

11. We agree with the Chief Secretary to the Treasury that a high level of transparency in the Gershon efficiency programme would improve its chances of success. There is likely to be a correlation between the quality and effectiveness of reporting on the efficiency programme by the Treasury, the Office of Government Commerce and individual departments and the extent of parliamentary and public confidence in the true extent of the progress achieved. We are not persuaded by the Treasury's contention that departmental totals for reported efficiency gains can be issued only by departments themselves because they are responsible for delivery: departments are accountable for their expenditure, but the Treasury is still expected by Parliament to report on departmental expenditure performance. We recommend that future Budgets and Pre-Budget Reports provide a breakdown of reported efficiency gains by department. (Paragraph 46)

12. We welcome the steps taken by the Office of Government Commerce, in consultation with the National Audit Office, to establish a new framework for assessing and reporting efficiency gains, but we continue to believe that the quality and consistency of reporting could be improved. To enhance transparency and enable effective scrutiny, we recommend that the Treasury require departments, in their departmental annual reports and Autumn Performance Reports in 2007 and subsequent years, to provide consistent and comprehensive information on progress against efficiency targets, including by "work stream" in each case, and to classify all reported gains as preliminary, interim or final. We further recommend that Budget and Pre-Budget Report documents provide a comprehensive breakdown of all reported gains by "work stream" and according to their classification as preliminary, interim or final. (Paragraph 47)

13. We are concerned that the Treasury and the Office of Government Commerce, in their oversight of and reporting on the Gershon efficiency programme, may not have made sufficient allowance for the risk that claimed efficiency savings might not be delivered without a reduction in the quality of service. Departments have every incentive to assert that reductions in service have been avoided in order that efficiency savings can be recorded and targets can be met. If the Government simply asserts that service quality has been maintained if efficiency savings are reported and

then accepted by the Office of Government Commerce, there is a risk that the credibility of the overall efficiency programme might be undermined. We recommend that the Treasury and the Office of Government Commerce undertake research into the quality of measures in place within departments to provide assurance that efficiency savings do not lead to a reduction in the quality of services delivered or products provided, and publish the outcome of such research no later than the 2007 Pre-Budget Report. (Paragraph 51)

14. We note that there are significant divergences between reported progress against overall efficiency targets by some departments and their progress on workforce reduction targets agreed as part of the same programme; for example, the Home Office claims to have very nearly met its overall efficiency target, but needs to secure a further workforce reduction of 1,466 in order to meet its headcount target. We support the recommendation of the Committee of Public Accounts that the Treasury provide a reconciliation of claimed headcount reductions arising from the Gershon efficiency programme with data from the Office for National Statistics on changes in the overall size of the Civil Service, and we recommend that such a reconciliation be included in future Budget and Pre-Budget Reports. We further recommend that the Office of Government Commerce undertake a formal review of future departmental returns on headcount reductions to satisfy itself, Parliament and the public that such returns are being reported on a consistent and comparable basis. (Paragraph 54)

Expenditure on education

15. We recommend that, in reporting the outcome of the Comprehensive Spending Review, the Treasury report on the economic benefits of relocation to the receiving locations and on the extension of locally flexible pay in the public sector, and estimates the contribution of both factors to achieving Treasury targets on reducing the differences of Gross Value Added per head across regions and countries. (Paragraph 56)

16. We are seriously dissatisfied at the lateness and vagueness of the information supplied to the Committee subsequent to our oral evidence, which fails to meet the detailed questions put to both officials and the Chancellor of the Exchequer at the meeting. It would be premature to reach an assessment of the overall trend of public expenditure on education in advance of the announcement of the outcome of the Comprehensive Spending Review. However, the early announcement of capital spending plans for education up to 2010–11 provides a welcome opportunity for the path of expenditure on an annual basis up to 2010–11 on major capital programmes, including the Building Schools for the Future Programme, to be set out at an early stage. We recommend that such information be provided at the time of the announcement of the outcome of the Comprehensive Spending Review. (Paragraph 61)

Child poverty

17. The Chancellor of the Exchequer told us that the Government had "actually met" the first of its targets to reduce child poverty—namely, to reduce the number of children in low-income households by at least a quarter between 1998–99 and 2004–05. This

conflicts with earlier statements by the Secretary of State for Work and Pensions, the Rt Hon John Hutton MP, acknowledging that the Government had not achieved this target. Given that the Government has previously accepted that, although significant steps were taken towards achieving the target, the target was not met, we expect the Chancellor of the Exchequer to explain the basis of his statement in the Government's response to this Report. (Paragraph 70)

18. The Government's initiative to end child poverty is now focused on its second target—to reduce child poverty by 50% between 1998–99 and 2010–11. We are concerned that the 2006 Pre-Budget Report fails to set out clearly how the Government proposes to meet its target to halve child poverty by 2010–11. We recommend that, either in the 2007 Budget or in reporting the outcome of the Comprehensive Spending Review, the Government outline its strategic position with respect to the 2010–11 target. The Government should both set out its progress to date towards achieving the target, including the measures it has implemented to date, and specify how it intends to achieve the target, including the extent to which it expects various measures to contribute towards achieving the target. (Paragraph 71)

19. The announcement in the Pre-Budget Report that child benefit will be extended to every mother-to-be from week 29 of her pregnancy will lead to a welcome boost in income for all mothers-to-be. However, we are concerned that the changes to child benefit will not come into effect until April 2009. Both universal and means-tested benefits have a legitimate contribution to make towards the Government meeting its target to halve child poverty by 2010–11. If the Government is to meet the 2010–11 target, it will need to channel additional resources directly to low-income families, for example by increasing the child element of the child tax credit or the Sure Start maternity grant. Such measures would allow the Government to achieve its aim of assisting parents financially in the final weeks of pregnancy: eligibility for the child element of child tax credits could be extended to 29 weeks, and the Sure Start maternity grant is already available from week 29 of pregnancy. (Paragraph 72)

20. We have previously noted the significant reduction in households facing marginal tax rates of 70% or more between 1998 and 2006–07, while recommending further Treasury analysis of the characteristics and income distributions of households facing marginal tax rates in the region of 60% to 70%. We are disappointed that the Treasury appears to have taken no action about this recommendation. At the very least, we expect the Treasury to notify us if it does not intend to act on one of our recommendations, giving reasons why. We intend to return to the issue of high marginal deduction rates when we examine the 2007 Budget, by which time we expect the Treasury to have published the findings called for in our earlier recommendation. (Paragraph 74)

Delays in improvements to the tax credits regime

21. We are concerned to learn that HM Revenue & Customs has failed to meet its original timetable of applying, from November 2006, automatic limits on recovery of excess amounts paid in cases where tax credits awards are adjusted in-year following a reported change. We will be watching closely to see whether HM Revenue & Customs manages to comply with the Paymaster General's instruction to introduce

such automatic limits in April 2007. We are concerned by the Paymaster General's announcement that the timetable for migrating the remaining 330,000 families who receive income support or jobseeker's allowance—some of the poorest families in the country—to the child tax credit has slipped yet again, given that these families were due to be migrated from April 2004. We intend to take these matters up with the Government in the first half of 2007, when we follow up our June 2006 Report on The administration of tax credits. (Paragraph 79)

Other taxation issues

22. The scale of Missing Trader Intra-Community fraud appears to have tripled between 2004–05 and 2005–06, to between £3.5 billion and £4.75 billion in 2005-06, with an estimated negative impact on VAT receipts during the year of between £2 billion and £3 billion. We welcome the Chancellor of the Exchequer 's announcement that the United Kingdom Government has reached an agreement with France to secure a derogation from European Union VAT law to combat such fraud. We trust that the European Union will now act promptly upon this measure and we will make our own representations to our opposite members in other national parliaments. The Government has predicted that the reverse charge will move the mechanism for stealing VAT from around 90% of the goods currently traded in Missing Trader Intra-Community fraud. Following the implementation of the measure, we will look for the emergence of evidence that the Government's prediction has in fact been borne out. (Paragraph 88)

23. We welcome the measured way in which the Government is consulting on and taking forward proposals for a Planning-gain Supplement. (Paragraph 91)

The Leitch Review on skills

24. We welcome the Leitch Review Final Report's aspiration of making the United Kingdom a world leader in skills by 2020. We expect to comment further on the economic importance of skills training when we report on the outcome of our inquiry into Globalisation: its impact on the real economy. (Paragraph 93)

The role of the Pre-Budget Report

Fiscal consultation

25. We welcome the Government's decision to commission and publish a range of reviews informing future economic policy, including tax policy. However, it is important that the Pre-Budget Report retains a focus on consultation on fiscal measures that may be included in the forthcoming Budget. Although the 2006 Pre-Budget Report is accompanied by a considerable volume of material on technical tax changes, there is less discussion on more substantive tax measures under consideration for inclusion in the Budget. We wish to see such consultation more to the fore in future Pre-Budget Reports. (Paragraph 95)

Notice

26. We continue to believe that the effectiveness of the Pre-Budget Report as an instrument of fiscal consultation would be enhanced if Parliament and the public were given greater notice of the date of the Pre-Budget Report. We re-state our recommendation that the Treasury announce the date of the Pre-Budget Report at least four weeks before the statement is due to be made and, in any case where the target is not met, give an account of the reasons. (Paragraph 96)

The implementation of new rates of Air Passenger Duty

27. Where tax changes carry a significant risk of forestalling activity or could distort market behaviour, it is often appropriate for those changes to come into effect immediately upon their announcement, even if formal parliamentary approval cannot be granted for some time thereafter. However, we have received no evidence to suggest that such considerations apply to the changes to the rates of Air Passenger Duty announced in the 2006 Pre-Budget Report. As a general rule, we consider that, where increases in rates of duties or taxes are proposed in the Pre-Budget Report, those increases should not come into force until after the House of Commons has had an opportunity to come to a formal decision on the proposed increase following the Budget. We draw the attention of the House of Commons to the unusual timing of the implementation of the increases in Air Passenger Duty, for which the Treasury has not cited any relevant precedents. (Paragraph 100)

Formal minutes

Tuesday 16 January 2007

Members present:
Mr John McFall, in the Chair

Jim Cousins	Kerry McCarthy
Angela Eagle	Mr George Mudie
Mr Michael Fallon	Mr Brooks Newmark
Mr David Gauke	John Thurso
Ms Sally Keeble	Mr Mark Todd
Mr Andrew Love	Peter Viggers

The 2006 Pre-Budget Report

The Committee considered this matter.

Draft Report (The 2006 Pre-Budget Report), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 19 read and agreed to.

Paragraph 20 read, amended and agreed to.

Paragraphs 21 to 31 read and agreed to.

Paragraph 32 read, amended and agreed to.

Paragraph 33 read and agreed to.

Paragraphs 34 and 35 read, amended and agreed to.

Paragraphs 36 to 43 read and agreed to.

Paragraph 44 read, amended and agreed to.

Paragraph 45 read and agreed to.

Paragraph 46 read, divided and agreed to (now paragraphs 46 and 47).

Paragraphs 47 to 54 (now paragraphs 48 to 55) read and agreed to.

Paragraph 55 (now paragraph 56) read, amended and agreed to.

Paragraphs 56 to 59 (now paragraphs 57 to 60) read and agreed to.

Paragraph 60 (now paragraph 61) read, amended and agreed to.

Paragraph 61 (now paragraph 62) read and agreed to.

Paragraph 62 (now paragraph 63) read, amended and agreed to.

Paragraphs 63 to 66 (now paragraphs 64 to 67) read and agreed to.

Paragraph 67 (now paragraph 68) read, amended and agreed to.

Paragraphs 68 and 69 (now paragraphs 69 and 70) read and agreed to.

Paragraphs 70 and 71 (now paragraphs 71 and 72) read, amended and agreed to.

Paragraph 72 (now paragraph 73) read and agreed to.

Paragraph 73 (now paragraph 74) read, amended and agreed to.

Paragraphs 74 and 75 (now paragraphs 75 and 76) read and agreed to.

Paragraph 76 (now paragraph 77) read, amended and agreed to.

Paragraphs 77 to 86 (now paragraphs 78 to 87) read and agreed to.

Paragraph 87 (now paragraph 88) read, amended and agreed to.

Paragraphs 88 to 99 (now paragraphs 89 to 100) read and agreed to.

Summary read, amended and agreed to.

Resolved, That the Report, as amended, be the Second Report of the Committee to the House.

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

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

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

* * * * *

[Adjourned till Tuesday 23 January at 9.45 am.

List of witnesses

Monday 11 December 2006

Mr Robert Chote, Institute for Fiscal Studies, **Professor David Miles**, Imperial College London and Morgan Stanley, **Ms Bridget Rosewell**, Volterra Consulting, and **Dr Martin Weale**, National Institute of Economic and Social Research — Ev 1

Mr Robert Chote, Institute of Fiscal Studies, **Professor Colin Talbot**, Manchester Business School, **Mr John Whiting**, PricewaterhouseCoopers, and **Dr Martin Weale**, National Institute of Economic & Social Research — Ev 9

Tuesday 12 December 2006

Mr Jon Cunliffe, Managing Director, International and Finance, **Mr Dave Ramsden**, Dorector, Macroeconomic and Fiscal Policy, **Mr Mark Neale**, Managing Director, Budget, Tax and Welfare, **Mr John Kingman**, Managing Director, Public Service and Growth, and **Ms Mridul Brivati**, Joint Director, Public Spending, HM Treasury — Ev 18

Wednesday 13 December 2006

Rt Hon Gordon Brown MP, Chancellor of the Exchequer, **Mr Jon Cunliffe**, Managing Director, International, **Mr Dave Ramsden**, Director, Macroeconomics and Fiscal Policy, **Mr Mark Neale**, Managing Director, Budget, Tax and Welfare, **Ms Mridul Brivati**, Joint Director, Public Spending, and **Mr Michael Ellam**, Director of Policy and Planning, HM Treasury — Ev 38

List of written evidence

List of Reports from the Treasury Committee during the current Parliament

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		Report
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Session 2005–06

		Report
First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111
Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	"Banking the unbanked": banking services, the Post Office Card Account, and financial inclusion	HC 1717

Oral evidence

Taken before the Treasury Committee

on Monday 11 December 2006

Members present:

John McFall, in the Chair

Jim Cousins
Angela Eagle
Mr Michael Fallon
Mr David Gauke
Mr Andrew Love
Mr Brooks Newmark
Mr Mark Todd

Witnesses: **Mr Robert Chote,** Institute for Fiscal Studies, **Professor David Miles,** Imperial College London and Morgan Stanley, **Ms Bridget Rosewell,** Volterra Consulting, and **Dr Martin Weale,** National Institute of Economic and Social Research, gave evidence.

Q1 Chairman: Good afternoon and welcome. Thank you for coming to assist us with the examination of the Pre-Budget Report. We have got two sessions, this session which I hope to finish round about five past five, and then the one on the microeconomics which will finish about 10 to six. When you are asked a question one of you take it and if anybody has got a real pressing need to give us their particular take on it, you can do it but do it briefly. Can you please introduce yourselves for the record?
Dr Weale: Martin Weale, the Director of the National Institute of Economic and Social Research.
Mr Chote: Robert Chote, the Institute for Fiscal Studies.
Professor Miles: David Miles, Morgan Stanley.
Ms Rosewell: Bridget Rosewell, Volterra Consulting and the Greater London Authority.

Q2 Chairman: I want to start on the uncertainty issue. We have had evidence from the inflation report hearing with the Governor of the Bank of England about the uncertainties, and he was saying that they are "genuinely uncertain as to how price setting in the economy will respond to large movements in certain costs, such as energy prices". Would you say that the economic outlook, both for inflation and GDP growth, are more uncertain at the moment than at the time of the Budget?
Dr Weale: I would be reluctant to say that. I think that at the time of the Budget things were happening to fuel prices. Basically, the oil price has gone up and gone down. We have had and still have considerable uncertainty about migration flows, but that is not a new problem. It is very difficult to make a good case that the situation is particularly uncertain at the moment. On the other hand it is a comment you often hear from economic forecasters, so it is probably true.

Q3 Chairman: Does the Pre-Budget Report adequately reflect the current uncertainty, do you think?
Ms Rosewell: I was going to say that there is one additional piece of uncertainty which I think probably has increased in importance since the Budget and that is around the international economy and the state of the US economy in particular. At the time of the Budget it looked like the US economy was slowing. I think that the potential for a much stronger downturn in that economy has probably increased since then, although we are still by no means certain about it. It is that international bit that I would want to draw attention to.

Q4 Chairman: In his response to a question from my colleague Jim Cousins, Charlie Bean said that it is important that "we continue to see a subdued pay growth going forward over next year to avoid, essentially, labour pricing itself out of jobs". The Bank of England has suggested that labour may be pricing itself out of jobs. Do you agree with that and, if so, is there anything the Government can do about it?
Dr Weale: I would say that no, we are not seeing strong upward pressure, that the mechanism for dealing with labour pricing itself out of jobs is the interest rate mechanism that the Bank of England use so, although in the long term, of course, the Government has very successfully pursued policies to improve the labour supply side, in the short term it is a Bank of England issue and not a Government issue.

Q5 Chairman: Anyone else on that one?
Professor Miles: I think the Government's role here is to try to foster productivity growth and there is a whole agenda about education, plus many of the special reports that came out at the time of the Budget, to try and increase labour productivity in the UK. This is one of the ways of stopping labour pricing itself out of jobs. The evidence on the success of that still remains perhaps a little bit patchy. I do not think there is overwhelming evidence that labour productivity growth has increased very much in the UK unfortunately.

Q6 Angela Eagle: What do you think is going on in the labour market because we have had an increase in unemployment but also an increase in overall levels of employment? Can you comment on how you think that is contributing or not to the stability that we have seen in the economy?
Ms Rosewell: One of the difficulties is that we do not really know how big the labour force is. It is obviously particularly an issue in London where many of the migrants, first any rate, appear; they may move on to other places afterwards. One of the things that I recently discovered in trying to delve into this is the limited amount of information on which our estimates of migration are based, and indeed the self-assessment that is required. "Are you planning to stay more than a year?", is what we ask people, and on that basis we estimate what the migration numbers are. It seems to me on this basis that assessing the size of the labour force has become increasingly problematic, as indeed the Bank have recognised, and therefore understanding either what is happening to productivity, employment or unemployment is quite difficult. It would not be therefore any surprise that if you have got much larger numbers of new people entering the labour force you might simultaneously get rising employment and rising unemployment, depending on the particular locality that you are looking at.

Q7 Angela Eagle: Does that have any implications for policy? Should we be trying to get a better handle on the size of the labour market? Clearly, Government policy has been to increase the size of the labour market, including getting people of working age who have been economically inactive back to work, and there are still programmes that are designed to do that, particularly Pathways to Work, to get those that are inactive on incapacity benefit.
Ms Rosewell: The implication of the conclusion that there are more people entering the labour market than we thought, but that these are not necessarily people who are on benefit, is that it actually makes those programmes probably more difficult to deliver because there are more other people chasing the positions at any individual point in time. It is not a fixed sum, obviously, but at any point in time there will be a given number of vacancies and more people chasing them than was probably thought. Particularly, again, in the London economy, which I monitor most closely, we know that, for example, participating in part-time work, the availability of part-time work is quite limited in London. That is partly because it is not worth commuting to such positions but it is also because there is an awful lot of competition for the sorts of jobs which in the rest of the country are done part-time.

Q8 Angela Eagle: Does anyone get a sense of what is going on in other parts of the country? Obviously, London is important but there are other policy implications from what is going on in the labour market in other regions.
Professor Miles: In terms of just how migration fits into this story, my impression from the statistics is that, whereas a few years ago a very large proportion of the flow of net inward migration came to the south east and stayed in the south east, it is spreading out much more widely across the country now.

Q9 Angela Eagle: But the whole unemployment issue is not only migration, is it? Martin, you wanted to say something.
Dr Weale: I wanted to say that if you want to measure migration and therefore the labour force much better, you really would have to have a landing card system at airports and ports, and without that we are really stuck with the sort of very poor survey that we have.

Q10 Angela Eagle: I think in fact the Governor was pointing something similar out when he came before us the other week. In terms of productivity then, it seems to be rising, as does business investment.
Dr Weale: You would expect business investment to be rising. What happened over the last couple of years was that we had something like 500,000 unexpected people added to the labour force and, of course, if those are to work productively you need capital for them to work with and that is provided by investment, so we are seeing a lagged response to an unexpected surge in the labour force. In terms of productivity, of course, the Pre-Budget Report talks about how rapid increases in employment have typically been associated with falling productivity. That is true on some occasions but on other occasions, if you go back to the 1950s and 1960s, growth in employment was associated with growth in productivity and no one quite understood what that mechanism was, but perhaps we are seeing something a bit more like that process.

Q11 Angela Eagle: Does that have any implications for the stability of the cycle or any policy implications? Is there anything that you see in the way these trends are working that is worrying you in terms of the Treasury's predictions and assessments?
Dr Weale: It does make it very hard, of course, to assess the trend growth rate of the economy and the current position in the cycle. The Government is assuming that immigration continues at a fairly high rate, not as high as we had in 2004 but I think at the rate observed in 2005. Now, of course, there is a question whether that will happen because you might think that the people from the recent Member State who wanted to go and work abroad have mostly gone to work abroad now. As far as I understand it, we are not going to have the same open border to Romania and Bulgaria, so it is perfectly possible that immigration will be slower than it has been recently and therefore the Treasury will not realise quite the trend growth that they have been hoping for.

Q12 Mr Love: Ever since I have come on to this Committee we have been going through whether business investment is going to improve into the future. What is your, as the group of experts, view on

that at the present time? We will start with Dr Weale. What is your view on business investment looking forward?

Dr Weale: My view is that it will do fairly well and maybe for the reason I have given, that so far we have not seen the sort of increase in the capital stock that you would expect, given the increase in the labour force that we have had, so the prospect does look fairly good. However, at the same time I think it is worth pointing out that the overall share of business investment in the economy is rather low at the moment. The Treasury likes to measure it in constant prices, which I regard as misleading. If you look at what people actually spend on business investment, although it has picked up it is not terribly high and, given the profitability of business, I suppose I still find it disappointing.

Q13 Mr Love: If I am a little sceptical it is because forecasters, and indeed ministers, have come before us in the past and said that the prospects and the forecasts look good for the future and it has not quite arrived. Does anybody have a slightly different view or a slightly more pessimistic view?

Ms Rosewell: I suppose it depends what you mean by "good" in the sense that are we looking at the prospect for the sort of investment boom that we have seen in previous decades and I think the answer is no. Is investment, however, falling? It is doing better than it has been doing and looks like it will at least continue on a positive path but I would view it as fairly disappointing levels of investment. The only *caveat* to that is that you could argue that much of what really is investment does not count as investment in the books, as it were, because it is not investment in plant and machinery; it is investment in intellectual property, it is investment in software and various things which do not count as such, at least in the national accounts. To some extent that must be right, that we have moved the mix of investment towards such sorts of asset. Nonetheless, I would still say that the level of investment is disappointing and likely to remain so.

Q14 Mr Love: If we do not know why it has not increased as the forecasts have suggested, how do we know that it will not decline rather than improve and what are the risks of a decline in business investment rather than a continued modest increase?

Professor Miles: Yes, there are risks and you are right: we do not understand that well. Investment has picked up a fair bit, I should say, though. We have got three-quarters of this year's numbers in and it looks like fixed investment is about 6% higher than a year ago and that is probably what the Treasury were forecasting at the beginning of the year, so it has not panned out substantially different from what the Treasury themselves were thinking a little while ago. Their own forecasts are fairly conservative in a sense. They have got about 5% growth next year and 3% growth for the couple of years after that, so the Treasury's own predictions are not exactly pessimistic but certainly conservative in an environment where profitability is very high. You would expect more investment; I think the Treasury share your uncertainty about what is going on here.

Q15 Mr Love: Can I turn to net trade? When I asked the Governor of the Bank of England last week whether, with the dollar at 1.95 to the pound, it is likely that trade with the United States is going to be even more difficult, he suggested that the solution was intra-European trade. What is your view, Dr Weale?

Dr Weale: Certainly trade with the United States will be harder but, as the Governor of the Bank of England said, that is only 15% of total UK trade. Nevertheless, one area where I do disagree with the Treasury forecast is on the net trade assumption that they show exports and imports growing broadly in line although they have above trend growth for the economy, and when you look at what has happened to sterling and the fact that they have domestic demand growing fairly rapidly, I would be very surprised if imports grow no faster than exports, so I would look to net trade deducting from output next year instead of making the zero contribution that they show.

Q16 Mr Love: Does anybody vary from that markedly? No? Taking those assumptions, if we then assume that business investment, if it increases, perhaps is not going to increase that much, and if net trade, as you suggest, Dr Weale, may actually be negative rather than positive, is this shift away from consumption into those other aspects of demand going to happen? Are we being too optimistic on the overall level of demand in the economy going forward?

Dr Weale: Obviously, the forecast can turn out better or worse than the central numbers presented here. My own view is slightly more pessimistic for next year, not enormously more pessimistic but slightly more so. I am expecting something like 2.5% rather than the 3% growth that the Treasury is showing. It could turn out to be worse than 2.5% if the United States gets into a real mess and world trade does not grow very rapidly and at the same time business investment does not take off, so yes, the margins round any forecast are fairly substantial and I think probably more so than the Treasury's quarter point either way range indicates. I am inclined to be on the slightly more pessimistic side.

Ms Rosewell: I think there is a slightly different way of thinking about that though, which is, if you like, a rebalancing which occurs not because net trade or investment does particularly well but because the consumer turns out to be rather more pessimistic, and that is just as likely in my view. We are seeing at the moment, for example, another Christmas which is looking a bit shaky as far as the retailers are concerned. That, of course, may change. They can be volatile people, these consumers. If you think back a year ago we were quite nervous about the consumer for 2006 and the 2005 Christmas was looking bad and then it all seemed to sort itself out

during the year, but I think that nervousness of the consumer is still a particular issue and we could well see 2007 looking weak.

Q17 Mr Love: My last question, and Dr Weale mentioned it in his last response is, what happens if the American economy dips into recession? People have talked almost as optimistically about the euro economy replacing that as they have talked about business investment increasing. Should we really be confident that other parts of the world economy will replace America if it does tail off into recession?
Professor Miles: The rest of Europe is something like three times more important to the UK in terms of trade , so it would not take much of an increase in growth in the rest of Europe to offset even quite a significant slowdown in the US. I am fairly optimistic on all that and I do not think one should believe that what happens in the US is the real driver of what happens in Europe in general and in the UK in particular.

Q18 Mr Gauke: Mr Chote, can I ask about the trend growth rate returning to 2.75%? As I read the PBR essentially it is saying that the revision is purely due to the fact that net inward migration to working age population is greater than it was thought at the time of the Budget. Is that the correct interpretation of what—
Mr Chote: I think there is also some demographics, but that is the main one, yes, that they refer to.

Q19 Mr Gauke: And given the concerns and, Dr Weale, you have already mentioned your concerns about the future and whether that is going to continue, what sort of level of immigration are we talking about year-on-year in order to justify this assumption? Is there anyone who knows the answer?
Professor Miles: I think the answer is very roughly speaking that it is higher than had been forecast back to the time of the Budget by about 0.2 of 1% of the labour force each year and that is somewhere in the region of 60,000 people.

Q20 Mr Gauke: So that is the difference, the 60,000 people?
Ms Rosewell: Yes.
Professor Miles: My rough, back-of-the-envelope calculation would say that this set of forecasts now assumes that net immigration for the foreseeable future is of the order of 60,000 a year higher than they had been expecting in the forecast back in March.
Ms Rosewell: Which is about 250,000 people net. If memory serves, that is about 450,000–500,000 in and 200,000 roughly out, and I do not know how it is balanced out for every year but I think that is roughly the current position.

Q21 Mr Gauke: Can I ask if anybody wants to jump into this one?
Mr Chote: This document on trend growth says estimates showing net inward migration of 185,000 in 2005, so I think, as Martin was saying, it is based on an assumption that that continues. That is probably the number they are looking at.

Q22 Mr Gauke: Dr Weale, you have already mentioned your concerns. This seems to be going contrary to the Home Office's policy on Bulgaria and Romania and trying to control numbers. How uncertain do you feel this is and does this throw into question the Treasury's overall assumption about trend growth?
Ms Rosewell: Trend growth could not be higher. If we are underestimating these numbers and we are underestimating the extent to which there can be a continued inflow of people who both can and do work, then we will be underestimating the amount of trend growth. We may be overestimating productivity, however, if we have been underestimating the number of people in the past. We have been saying there is more productivity because we have got the output but not the people, so there are some swings and roundabouts in all of this. If you look at the long term performance of the economy, the 2.5% looks pretty solid. 2.75% over the forthcoming cycle looks to me to be optimism.

Q23 Mr Gauke: Are there any other views on the 2.75%?
Dr Weale: Could I just make the point that if that is indeed the trend rate delivered by immigration then one ought to be thinking about the extra public spending that will be needed given the immigration, and that seems to be discussed nowhere in the Pre-Budget Report.

Q24 Mr Gauke: I was going to come on to that. I know you mention it in your submission to us, Mr Chote.
Mr Chote: Indeed. The assumptions are still based on the same real growth in spending despite the higher trend growth rate, so if you have 1.9% a year real growth in spending over the CSR period and now push the same rate forward into the following year. If, as Martin says, you have got more people coming in, presumably that spending is being spread over more people.

Q25 Mr Gauke: And presumably creates demands on public services and so on, so therefore if we do stick to the—
Mr Chote: It depends where the constraint moves.

Q26 Mr Fallon: Mr Chote, the Chancellor changed again the end date for the cycle and then said he would meet it with eight billion to spare. What would be the effect if he had not changed it? Would he have missed the Golden Rule?
Mr Chote: It would have been very tight. He was originally saying that the cycle would proceed through to 2008–09. If you look at the impact of, as it were, the nasty surprises that have come along since the time of the Budget, inflation being slightly higher than expected with an impact on, for

example, the costs of social security benefits lower, a lower North Sea oil revenue and other revenue changes, that lot taken together would have probably removed the £16 billion cushion that he was talking about over the cycle at the time of the Budget. However, on top of that he would also have given himself back a bit of cushion by the increase in air passenger duty and other taxes, so he would still probably have been forecasting that he would meet it on a 2008–09 finish.

Q27 Mr Fallon: But it would have been very close?
Mr Chote: It would have been very close.

Q28 Mr Fallon: Martin Weale, you say in your note to us that the cycle did end almost certainly in 2003.
Dr Weale: Sorry, 2003–04; it depends exactly how you do it. If you look at the chart on page 198, that shows the output gap and although the period in 2004–05, in which the economy was above trend on these data, is not very large, nevertheless it is plainly there, and were it not for the inconvenience of having what had been one cycle suddenly split into two, I think most people would be saying that the cycle ended in 2003 or the start of 2004 and now we are in a second cycle which is likely to draw to its close next year, and a three-year cycle is slightly rapid but it is much closer to the normal sort of business cycle than the protracted 10-year cycle that the Chancellor is describing.

Q29 Mr Fallon: So if he had not protracted the cycle what is the answer to the same question: by how much would he have missed the Golden Rule?
Dr Weale: I cannot give you the numbers but he would have missed the Golden Rule by large amounts because, as we know, the Budget has been in deficit, I think, in every year since 2003, so it could not possibly be realised now.

Q30 Mr Fallon: This is the third change, I think, to the cycle. Have any of these changes hampered the Chancellor's chances of meeting the Golden Rule?
Dr Weale: No, I think they have all made it easier.
Mr Chote: If I could just add, it is interesting that in a document of this length there is no explicit statement anywhere that says something convenient like, "And all these projections are on the basis that the cycle ends in 2006–07". There is some airy phrase about, "Oh, it is going to end some time early next year", and the only way you can work out what the final fiscal year of the cycle is is by inferring it from various paragraphs. Another question you may wish to ask officials is where whether they stick to the view that the last year of one cycle is also the first year of the next cycle when you are considering the Golden Rule.

Q31 Jim Cousins: There is no consistent pattern on under-shooting tax receipts and the reasons for this appear to be different from year to year. Mr Chote, you have just mentioned North Sea oil corporation tax receipts. Do you think this volatility will continue?
Mr Chote: With regard to the sorts of problems that we would have been citing through many previous sessions such as this from 2001 onwards, the main concern was that the Treasury was over-estimating the speed with which financial sector corporation tax receipts and the earnings of relatively well off people in the financial sector and the income tax payments they make would rebound after the hit that that sector took at the time in of the stock market decline. Our view was when we met this time last year was that much of that damage had been undone by the fact that the Chancellor raised taxes, pencilled in spending cuts and made his underlying corporation tax revenue forecast look more sensible. This, I think, is a different set of bad luck that has come along for him this time, particularly the North Sea oil sector and the inflation effect, so you are right: there has been a continuous run of over-optimism on tax revenues but I think what we have had this time certainly was not something that we would have predicted and it clearly was not something the Chancellor had predicted and is slightly different from the story we have been telling in recent years.

Q32 Jim Cousins: Bad luck—perhaps I could ask you, Bridget Rosewell, about this. Do you see this as being bad luck or do you think there are maybe complexities in the system that are causing a shortfall of revenues?
Ms Rosewell: I think Robert is right, that the particular example this time has got an element of bad luck in it, as it were, but I think that there is generally still a lot of complexity in that system. If you look at the proposals which are in the Pre-Budget Report, which look rather more like a Budget Report, I have to say, in some aspects than a Pre-Budget Report, which I thought was supposed to make proposals rather than announce things, there are a lot of announcements around quite detailed level areas of the corporation tax system in particular, or the business tax system perhaps, rather more accurately, as well as this announcement of a change in the air passenger duty. He is expecting to raise an extra two billion next year, of which a billion is the APT, and the other billion is all about quite complicated changes to a whole raft of corporate and business tax systems, and it seems to me to be completely unknown whether those are actually able to bring in the revenues that he expects. They certainly do not seem to be simplifying it.

Q33 Jim Cousins: Professor Miles, do you think that some of the measures to reduce tax avoidance, and indeed some of the cases that are presently now in front of the European Court to be decided on, for example, the taxation of overseas subsidiaries, will make a meaningful difference to future revenues?
Professor Miles: I think on the overseas subsidiaries thing the numbers are not trivial and I am sure there is concern in the Treasury about how the judgments may go and it may have material impacts on the flow of corporation tax coming in. I think these are things that the Treasury will understandably worry about and are very uncertain.

Q34 Jim Cousins: Dr Weale, Bridget Rosewell has already mentioned nervous consumers. Do you think that this nervousness of consumers could be reflected in an undershooting of tax receipts from things like VAT?
Dr Weale: If nervous consumers do decide to spend appreciably less than we are expecting, then there will be an undershoot of revenue from value added tax and also from the other taxes associated with expenditure. That said, the household sector has, more by luck or more by rising house prices than anything else, acquired quite a lot of wealth over the last 10 years and it is showing a willingness to spend some of that wealth so I believe it has a cushion of wealth which, if you like, protects consumer demand from the sort of nervousness that you are talking about.

Q35 Mr Gauke: Can I ask Mr Chote a question about the next economic cycle and the Golden Rule there? The Chancellor appears to be optimistic about meeting his Golden Rule in respect of that. Can I ask what your view is and where you see the potential risks?
Mr Chote: In terms of working out what the Treasury itself thinks is going to happen, as I say, the first thing it would be nice to be clear about from them is what they believe the first financial year of the next/current economic cycle is. If they were following the example of the PQ that I think that Mr Boateng replied to some while ago, saying that the cycle in terms of the fiscal policy analysis goes from the point at which you include the same financial year both at the beginning and at the end, it would be nice to know whether that was still the case. If it were to be, and the forecasts were to work out as the Treasury expects, you would need the next cycle to be four years long on their basis for the deficits expected in the current fiscal year and the next fiscal year to be outweighed by the deficits surpluses in the two subsequent years. as well, So it depends, crucially, on what you assume to be the length of the next cycle. As the Treasury has basically got output moving back to trend and staying there, that is obviously not giving anybody a very useful guide to how policy might need to adjust, if at all.
Ms Rosewell: I think that is a very important question: what the Treasury view is of the next cycle, because they are saying they are looking at a trend rate of growth. What they actually mean is what the average rate of growth is over the next cycle, so far as I can see from reading the report, and yet their projection shows essentially that you could take the view that on the chart that they have got on the output gap, in fact, the current cycle never ends because we move back to a position of balance and then stay there, in which case, since you are never going above the line, as it were, into a position where you have squeezed the output gap, you never get to a position where that cycle has ended. Therefore, since the amount of judgment which is required to show where a cycle is actually going to begin or end under these circumstances is very great, then better clarity on what judgments are actually being made is really important and we just do not get it from this report.
Mr Chote: Or much better, of course, would be to abandon the idea of trying to meet the Golden Rule over a fixed cycle but to say where do you want to be over a sensible time horizon of three or five years and to approach it in a forward-looking way as the Bank of England does.

Q36 Mr Gauke: As both the IFS and I think this Committee have argued in the past. Can I ask about public expenditure? The assumptions—and I think they are assumptions—within the PBR about this seem to suggest that growth in public expenditure is going to be extremely tight. May I ask you, and I do not know if anyone has a particularly strong view on this, as to whether those assumptions are realistic, particularly given the remarks earlier about immigration? As a whole do you think those projections are realistic?
Mr Chote: It depends what quality of public services you are prepared to have as a response We are talking basically about going to 1.9% growth in real public spending as a total and that would compare with 3.3% on average under Labour to date. Obviously, that included a very tight squeeze in the first three years and then, as it were, the six years of plenty that followed that. Obviously, the Chancellor has announced some tight squeezes in some (albeit relatively small) departments already, so I think the key question comes down to what do you believe to be a plausible medium-term growth rate for social security and tax credit expenditure, and then the issue is how do you basically deal with what were the big winners in the years of plenty: health and education? Together they will do less well presumably than they did during the years of plenty but as to which does better than the other and who bears the pain is a political decision, obviously, as much as an economic one.
Ms Rosewell: But can you turn the tap off at all?
Dr Weale: We did, of course, have three years of very tight public spending at the beginning of the Labour Government and I was taken by surprise then that it was actually made to stick. Having been surprised once, I am not going to be surprised again. It is plain that governments can limit growth in public spending if they set their mind to it and the fact that we have had a period of rapid expansion is not an obstacle to that. On the other hand, I do think it would be better to have stable growth rather than feast followed by famine.
Mr Chote: That early period was, of course, helped by falling unemployment and falling debt interest payments which we do not have this time.

Q37 Mr Gauke: As a rule, what have we learned about the state of public finances as a consequence of this PBR that we did not know last week and where would you summarise we are?
Ms Rosewell: I am just wondering what I have learned about the state of public finances. I have learned that, according to the Chancellor, the cycle is about to come to an end but I am not sure that tells

me anything about the state of public finances. I have learned perhaps more than I want to know about a number of small schemes and I find it extremely hard in this PBR to winnow out any wheat from the chaff, so I am not sure I have learned very much.

Professor Miles: I think one has learned that the situation in the eyes of the Treasury is a little bit worse than they had thought. GDP is higher, growth in GDP is stronger than had been forecast, borrowing is slightly higher, the stock of debt is projected to be a little bit nearer the 40% limit. It strikes me as quite a realistic assessment but it is a more pessimistic one than was made at the beginning of this year.

Mr Chote: The underlying position is that borrowing is roughly five billion a year higher along the forecast horizon than we would have thought a week ago. The Treasury has made up roughly half of that by increasing the trend growth assumption and almost the other half of it through the increase in air passenger duty and tax avoidance measures, so the two have roughly cancelled out. The fact that the Chancellor is in a tight position I think is clear both from the fact that he did not offset the rise in green taxation with a cut in other taxation, as he might have found appealing given the political debate, and he has not found any money for child poverty in this Pre-Budget Report, which has been a priority in previous ones.

Dr Weale: What I have learned is that the Treasury has gradually moved in line with everyone else. Before the election in 2005 the Chancellor was saying that the forecasts produced then were deliverable and that there was not a fiscal problem. Everyone else was saying that there was a fiscal problem. He has now moved much of the way towards the position that people like the National Institute were saying a year and a half ago, so what we have learned is that the Treasury is becoming more realistic.

Q38 Mr Todd: If I can turn to another of the Chancellor's rules, the sustainable investment rule, first of all is there anything magic about the 40% that he has chosen?

Ms Rosewell: No.

Mr Chote: No. It is at roughly the level that Labour inherited. There is not much more significance to it than that.

Q39 Mr Todd: The PBR appears to indicate that it will be a little bit tighter to that rule than before. Is there any particular reason for concern there? If you said that the target did not matter very much then presumably the answer to that question is no.

Dr Weale: My view is that fundamentally whether investment projects are a good idea or not depends on the returns they deliver relative to the costs of providing them, including the costs of collecting the taxes to pay for them. Extra taxes, discourage labour but one could reasonably suspect that with a 40% limit we may be losing investment projects that would be well worthwhile.

Q40 Mr Todd: Is there a clear-cut case that you can make for discriminating in investment in that way or do you think that that will just be a mechanism for a political wheeze for arguing that this particular investment does bear future revenue returns and another does not?

Ms Rosewell: I think that there are issues about the slightly arcane way in which projects are compared and contrasted in different areas of government activity, for example, so there is no consistent way of thinking about it and there is no consistent way of, say, comparing a project which pays back in terms of some revenues which are generated and one which might not; some might pay back their debt, others might not pay back their debt and we do not think about it in that way. Instead we have rules for particular departments which are based usually on non-monetary ends and objects, so we do not really have a way of thinking about it which enables you to make those distinctions.

Q41 Mr Todd: Would you encourage a greater development of—

Ms Rosewell: I would, yes.

Dr Weale: Yes.

Mr Chote: Just on a belated related point, could I suggest also that if the Treasury has said, "To meet the sustainable rule with confidence net debt will be maintained below 40% of GDP in each and every year of the current economic cycle", you may again like to ask Treasury officials what that means looking forward.

Q42 Mr Todd: Does that mean he is going to change his rules after that?

Ms Rosewell: Next year.

Mr Chote: Implicitly he could do. Of course, we are now, in some definitions, in the first year of the new current cycle but you might like to check with Treasury officials—

Q43 Jim Cousins: Do you think that is all on-balance sheet debt that you are talking about there?

Mr Chote: That is on the average by definition, but you could have averaging or in every year so you might like to check.

Q44 Mr Todd: Is there a case for saying that public sector borrowing is crowding out private sector borrowing at all? Is there any indication of that?

Professor Miles: You would be pretty hard pushed to make that argument because the cost of capital to the corporate sector is unusually low and real interest rates are exceptionally low. Long-term real interest rates are under 1%; the way that public borrowing would naturally crowd out private investment is by making interest rates high.

Q45 Mr Todd: Can we turn to a subject favoured by others on this Committee, which is what is classified in public sector debt, and particularly PFI projects? There does appear to be a rather inconsistent rule as to what appears in the public balance sheet and what does not, and indeed there are some projects that

appear not to appear either in the private sector or the public sector balance sheet. Do you have some concerns about how that works now?
Dr Weale: I think that any set of accounting rules is bound to be arbitrary because things are either there or they are not there. Proper publication of government contingent liabilities, which I think is happening, is a help but whether some fraction of those, 20% of them, ought to be added on to public liabilities to indicate the risk that they may be called—

Q46 Mr Todd: So just a broad contingent liability ought to be added to take—
Dr Weale: Well, some allowance for it. I can see a case for that. Of course, you then have the issue associated with what are actually much larger numbers, like Civil Service pensions which do not appear as a liability anywhere.

Q47 Mr Todd: We are coming to that in a second. Since the 40% is not any hard rule, all that would happen if we included a number of these elements in it is that someone would say, "We will raise the figure then"?
Ms Rosewell: Add it on both sides, yes.

Q48 Mr Todd: Turning to public sector pensions, do you feel that those are reflected appropriately in the Government's accounts at the moment, the liabilities of future public sector pensions?
Ms Rosewell: It would be nice to see them treated as they are for the private sector, which they are not.

Q49 Mr Todd: Presumably the implication of that would again be that you would simply raise the rule and say, "Okay, we are working within a rather larger margin".
Ms Rosewell: That is entirely possible, but at least it would be more transparent.

Q50 Mr Todd: I was going to turn you to that. Does it have a further value of bringing home the importance of the value of these particular liabilities?
Ms Rosewell: I think that would be quite important.
Dr Weale: I think very much we have a situation where we are not sure whether public sector workers are badly paid or well paid because of the obscurity of the pension arrangements and the costs associated with them.

Q51 Mr Todd: So it is less an economic argument and more a transparency argument?
Dr Weale: It also helps Government planning. One can argue that the fiscal rules should be to keep expected future taxes constant and you have to take account of public sector pensions.

Q52 Mr Todd: But the forecast shows that spending is going to go up from 1.5% of GDP to 1.9% in 2025–26. Does that seem a reasonable projection based on what we know of the changes in public sector pension policy?
Ms Rosewell: I have no information which enables me to make that calculation.
Dr Weale: In terms of the Government's long term fiscal projects I would guess that that is one of the safer numbers.

Q53 Angela Eagle: On that point surely if that change was made and some public sector pensions are funded whilst others are not there is a range of different issues there? If that change were made, that is not compatible with the sustainable investment rule, is it? Would that not imply massive cuts in public expenditure or the abandonment of the rule?
Professor Miles: If you decided to measure the present value of the cost of future public sector pensions and count it as government debt, and you had always done that, you would not have set the number at 40%; it would have been 65% or some higher number.
Mr Chote: It is as large as public sector debt anyway, so we are talking a far larger order of magnitude than PFI commitments would imply there. You would have to just set a completely new target or ceiling.

Q54 Angela Eagle: Do you all think that is a reasonable thing to do here?
Dr Weale: Yes. I do not think you would want to run a large surplus to drive down the overall—
Angela Eagle: You would have to abolish public expenditure.

Q55 Mr Newmark: Given that, and this I think is the point that Bridget was making, private companies are now expected to show what their pensions are and what their pension liabilities are, just because we have this arbitrary figure, as you have said, of 40% of the sustainable investment rule, the fact of the matter is that these pension liabilities are real liabilities and if you do include them, public sector pension liabilities plus PFI, it looks as though it is 100% or 105% of GDP, and I am just curious as to what your thoughts are with having a figure of 105% of GDP rather than 40%, as a figure.
Professor Miles: But against it you have got the enormous asset which is the ability to raise taxes from future populations, so personally I would not get terribly excited if you decided to include the present value or cost.
Mr Newmark: You should get excited. If you have an expanding public sector those liabilities are there for future generations to pay. Surely you should care about whether your children or grandchildren are facing increasing public sector pension liabilities. You are right, in a theoretical sense it does not matter because future generations will have to pay.

Q56 Chairman: So get excited! Brooks, on you go.
Dr Weale: Could I just say in response to that, what I think is particularly important is accounting for the cost of extra public sector pensions as it is incurred so, if you like, they would just be starting from where we are now, they would be notionally funded and if they were notionally funded then in the current budget balance we would see the cost of the pensions

as well as the cost of paying the workers. That seems to me much more important than what we do with the balance sheet number.
Ms Rosewell: And that one could have a debate about those matters.
Mr Chote: You could do that formally or informally, but one the point of worth saying is that the Treasury is publishing projections of what it thinks it will cost to pay these on an ongoing basis, rising from 1.5% of GDP now roughly to 2% as a steady state. That is telling you the adjustment future generations will have to make and then the issue is how quickly do we do it.

Q57 Mr Newmark: One other question. The point of PFI is to transfer risk but with a number of projects it does not look like that risk is being transferred. One of the arguments for keeping it off-balance sheet traditionally is that you are transferring risk from the public sector to the private sector. Would anybody care to comment on the fact that there are a number of PFI projects that are not transferring risk?
Dr Weale: It seems to me inevitable that as PFI was set up there were learning processes among civil servants, and I think you typically—

Q58 Mr Newmark: What happened to the Chancellor, is he learning?
Dr Weale: You typically find in all countries that have tried this sort of thing that there are cases where the private sector has taken the public sector for a ride.

Q59 Mr Newmark: Given the costs of capital in the private sector versus the public sector, it seems that it is costing the taxpayer more money to effectively pay up for not transferring risks on these projects.
Dr Weale: I would not be amazed if that had happened but, again, Britain would not be the only country where that has happened if it is the case.
Ms Rosewell: You have to be slightly careful because I think there is a difference between income risk and capital risk. The contracts that go wrong are essentially where the capital, the balance sheet of the private company is not big enough to handle those risks and inevitably all that comes back on government. Risks always go back to the larger balance sheet. If you talk to the oil and gas industry you will see exactly the same thing. They have understood that and they manage their contracts on that basis so that income risk is passed to the contractor and not the capital risk because generally their balance sheets will not bear that. I do not think we understood that with PFI, hence the balance sheet risk is coming back to government where it probably properly belonged in the first place, but we did not do well enough at transferring some of the income risk.
Chairman: Can I thank you very much for that. We will move on to session two.

Witnesses: **Mr Robert Chote,** Institute for Fiscal Studies, **Professor Colin Talbot,** Manchester Business School, **Mr John Whiting,** PricewaterhouseCoopers, and **Dr Martin Weale,** National Institute of Economic & Social Research, gave evidence.

Q60 Chairman: Welcome to you. John, can you identify yourselves for the shorthand writer, please?
Mr Whiting: John Whiting, PricewaterhouseCoopers and Chartered Institute of Taxation.
Professor Talbot: Colin Talbot, Manchester Business School.
Mr Chote: Robert Chote, Institute for Fiscal Studies.
Dr Weale: Martin Weale, National Institute of Economic & Social Research.

Q61 Chairman: Stern, Eddington, Barker, Leitch, Lyons and Gowers, a plethora of reports; what is the function of these reports? Does it open up the discussion on public policy options for the Government or does it delay difficult decisions? Who wants to start on that? What about you, Colin?
Professor Talbot: I think probably the first question to ask would be what is the purpose of Pre-Budget Reports. I hate to sound like a broken record but it seems to have become, I was going to say mini-Budget but judging by the volume of documentation we have had this time round it is more like a maxi-Budget. We are now in a situation where we will have three announcements of public spending plans in the next seven months: the Pre-Budget Report, the Budget and the Comprehensive Spending Review next July. That, coupled with all of these policy reviews attached to the PBR, presumably more coming out with the Budget and even more coming out with the Comprehensive Spending Review, does certainly muddy the waters a little bit to put it mildly.

Q62 Chairman: Does anybody else have any comments?
Mr Whiting: One comment from the tax point of view. They can be very useful in surveying what is possible but then the issue is often what happens after that, are they carried through or are they just left to gather dust?

Q63 Chairman: What is your experience? Have they been carried through in the past?
Mr Whiting: I think you can only say they are mixed.

Q64 Chairman: Tell me one that has been carried through and one that has not.
Mr Whiting: As one that is currently being carried through one might point to the Planning Gain Supplement and the discussions there, which have been quite constructive. It is a wide-ranging review

and it has been narrowed down. Where it gets to rather depends what happens over the next year or two.

Q65 Mr Todd: It is certainly good news for consultants in this particular field, is it not?
Mr Whiting: I could not possibly comment!

Q66 Mr Todd: The review of the Gershon savings. Earlier this year the NAO gave what in their terms was a fairly critical analysis in which it suggested that without proper baselines and with relatively little evidence it was hard to verify the savings that have been made to date. Are we a little nearer to hard knowledge in this hard?
Professor Talbot: I would say no. In fact, we seem to have an interesting law operating here, which is the higher the claimed savings the less information is published about the detail of where these savings have actually come from. It seems to me that the Government must have fairly simple savings by department, given that they are targeted by department, and in turn broken down by the six work streams that were announced in the Gershon Review. All we have had so far in terms of analysis of that information is four examples in the PBR itself and three bits of data given by Mr Timms in a parliamentary answer about the break down, but only on three out of the six issues on work streams within the efficiency review, so we are more or less in the dark about where this 13.3 billion has come from.
Dr Weale: Could I just add that since we do not, and I think in some areas never will, have good measures of public sector output inevitably we are not going to do terribly well at trying to measure public sector efficiency.

Q67 Mr Todd: I was going to turn to that. It will be difficult to know whether one is comparing a like-for-like service delivery, for example. What we may be seeing is reduced expenditure but actually a reduced level of services. Certainly that has been argued by some Civil Service unions. Is that reasonable to say?
Professor Talbot: I do not think we can say a great deal either way at the moment. The only bits of information we have got are, as I said, Mr Timms gave a parliamentary answer in which he said of the 13.3 billion which is currently being claimed, 5.5 billion must come from procurement, 2.4 billion from productive time and 1.5 billion from policy funding and regulation work stream. The other three around corporate services, transactions and the other category, which is 11% of the total, there is no information about. If you look at those figures carefully, in terms of the target for savings from procurement, for example, according to that we are running at about 70% of the target having been met. On the productive work time area we are running at about 47% of the target having been met. On policy funding and regulation we are running at 41% of the target having been met. I would be really interested to hear why that is the case, what has happened to the other three work streams and a break down by department as to where that money has come from.

Q68 Mr Todd: The ONS has published a consultation paper on the measurement of public service outputs and productivity. Has that assisted in this matter?
Professor Talbot: The largest area of work which both Atkinson and the ONS studies have looked at are the two areas which are most important for particularly the productive time work stream of the efficiency programme, which is health and education. Between them, they are actually responsible, on my calculations, for 88% of the productive work time savings, just from those two departments, but they have been looking at it at a very high level in terms of the overall economy and the contribution of public sector activity to the economy in terms of raising productivity. I do not think it goes down to a detailed enough level to really apply adequately, if you take productive time work stream as an example, to have really good measurement of the quantity and quality of outputs against which we could say those have remained constant or they have gone up as a result of improved working practices and we have saved money as a result of that. As far as I can see we do not have the measurement systems for doing that, and I would agree with Martin on that.

Q69 Mr Todd: We seem to have roughly the same problem on headcount reduction as well. Since Civil Service headcounts, public sector headcounts, go up in some areas anyway, working out a net position accurately is hard to do, is it not?
Dr Weale: The headcount target is quite misplaced, I think. Increasing efficiency means saving money but reducing headcounts and employing consultants to do the same thing is unlikely to be in any sense a saving. Equally, if people are *de trop* losing one person on 100,000 per year it is better than losing two people on 30,000 a year. Headcounts obscure all of that and I think are actually a distraction from efficient running of the public sector.

Q70 Mr Todd: I think the OGC denied that there was a basis for thinking that a load of consultants had arrived in lieu of established posts, but you remain sceptical of that, do you?
Dr Weale: It remains a risk, yes.
Professor Talbot: In the OGC's own guidance to departments they warn against that as a risk, so I do not think that they do not think it is a possibility. I agree with Martin but I would add on the relocation issue, if you remove staff to another part of the country at some considerable cost presumably in terms of compensating staff purchasing new buildings or whatever you have to do in order to relocate them, and their salaries remain the same, because despite the Treasury wanting to have regionalised salaries within the Civil Service we do not yet, the net benefits of that are likely to be negative in the sense that it has cost you money to

relocate people and you have made no efficiency savings at all, so why it is constantly put into the efficiency agenda is beyond me.

Q71 Mr Todd: Presumably one of the arguments was that over the long-term the establishment costs of posts in less expensive parts of the country, disregarding the salaries, just the cost of buildings and other services, would be less, would it not?
Professor Talbot: Possibly.

Q72 Mr Todd: The Government has said that it is on track to meet its target to relocate 20,000 civil servants. Do you see any sign that it is helping recruitment and retention issues because mainly they are transferring them to less heated parts of the labour market?
Professor Talbot: I have not seen any data on that. I would point out my calculation two years ago was that the 20,000 target more or less brought us back to the distribution of civil servants that we had in 1997, it was not achieving any change, it was simply that the growth in the Civil Service had been concentrated in London and the South East.

Q73 Mr Gauke: Can I just ask Mr Chote to begin with on expenditure on education. You have made some sceptical noises about the Chancellor's big announcements in the PBR statement. If we could take them in turn. First of all, the capital expenditure, the £36 billion over four years. You said that is mostly old money, could you elaborate on that?
Mr Chote: Yes. Essentially these amounts for schools had already been announced at the time of the Budget, so the new announcement was effectively the capital spending for colleges and universities and there it was effectively new money amounting to about £0.1 billion in this year's prices. That is roughly 2% a year real terms increase. If you were to look at overall capital expenditure in education the numbers now pencilled in for 2007–08 to 2010–11 would be 4.3% a year real increase compared with 15.9% under the period from 1997–98 to 2007–08, the previous decade, so quite a step down from that. That would divide between schools dropping from 16.3% to 4.9% and other HE and FE from 14.5% to 2%. Certainly you can get a nice big number by adding together the totals over the next four years but in terms of the growth rate you are stepping that down. To a degree one should point out that when Labour came in there was initially a further fall in public sector investment and then an increase. If you are saying you are moving from a very low base, there would be a step adjustment and you would not be expending expecting capital expenditure to increase at the sort of percentage rates you saw during that catch-up.

Q74 Mr Gauke: Just to go back to something you have said. As far as what was announced in the PBR on capital spending, that relates more to colleges than to schools?
Mr Chote: That is right, yes. This is opaque in the way it was presented but it looks like the schools money is the same as it was before and the new announcement is HE and FE.

Q75 Mr Gauke: So the capital spending is no different, the PBR did not make any difference specifically on schools?
Mr Chote: No.

Q76 Mr Gauke: Just on the current spending, the £200 per pupil going directly to the schools, how much of that is new money?
Mr Chote: £20 per head. Budget 2006 had announced £60 and previous announcements and plans have been £120, so that gets you to your figure of £200.

Q77 Mr Gauke: Twenty quid. What is that in percentage terms? What are we talking about here?
Mr Chote: Here, of course, what we do not have yet is the current spending for education for the period of the Spending Review, which will be one of the key announcements that we get next year. If we are looking at this famous aspiration that the Chancellor set up to get towards the £8,000 per head spent in the private sector in 2005–06, which is current and capital, the gap before the Pre-Budget Report was about £2,350 and it has now fallen to £2,330, so obviously if you were to continue to increase at the rate of 20 quid per announcement we could be waiting quite some time.

Q78 Mr Gauke: We would be waiting for about 200 years, would we not, if it was 20 quid?
Mr Chote: More relevantly perhaps, when we met last time after the Budget I think we said that if we were to increase the school spending per head by the rate of the economy we would be talking about 17 years or so, but crucially now this depends on what the Chancellor says on current spending for education when we get to the CSR next year. That will tell us realistically how long it will take to close this gap.

Q79 Mr Gauke: We will be none the wiser until then. There was a report in the *Financial Times*, I think this was relating to education capital, about a 4.1% increase.
Mr Chote: As I say, total education spending looking forward rising 4.3% a year in real terms, down from about 16% the previous decade.

Q80 Angela Eagle: In the last 10 years we have an increase, the Leitch report says, in those with high level skills from 21% to 29% and a fall in those with no or low skills from 22% of the working age population to 13%. The report then comes out with a slew of proposals about how this improvement could be continued. How effective overall do you think that Leitch's proposals will be in terms of turning around this skills gap that he identifies?
Dr Weale: What we found at the National Institute looking at the DfES programme for delivering basic skills was that it seems to raise people's aspirations.

Whether and how that will work with school children instead of adults I am not sure but I think it is something that we have to try. I would expect it eventually to be effective, but it will be a very slow process.

Q81 Angela Eagle: For school children certainly. Clearly there is a range of government policies at a macro-economic level to do that from Sure Start onwards, all the help with parenting and education, et cetera, but Leitch is always about adults.
Dr Weale: Yes. With adults, as I say, the evidence that we found from looking at basic skills was that it improves their aspirations and that is likely gradually to feed through to employment but I think it is going to be a slow process.

Q82 Angela Eagle: This issue of the Train to Gain scheme, which has been piloted, I understand, with 30,000 employers and a quarter of a million employees having benefited from it at pilot stage, seems to be an issue that Leitch decided is one of the main delivery mechanisms for getting employers more engaged in basic skills education. Do you share his optimism about that as a delivery process? None of you have read it, have you!
Mr Chote: I think one issue to bear in mind is that Train to Gain is built on the employer training pilots and certainly some of the assessment that has been done of that so far suggests that there is pretty high deadweight in that. So quite a lot of the money that is spent through that is actually given to companies for training that they would have been doing anyway. One of the concerns has to be how much of this would be additional to what would be happening anyway.

Q83 Angela Eagle: There is clearly an issue even though there has been an improvement in basic skills levels and also an economic need to try to get our workforce to engage at a higher level of skill too. What I am trying to ask you is, if you are not enthusiastic about what Leitch has come up with, what is the way to do this? Surely everybody agrees that we have to try to do it given the globalisation trends.
Dr Weale: For school children what is important is to have a framework in schools where the principle is that every child can be taught basic skills. I think we still have an environment where it is assumed that there will be some children who cannot read by the time they are 11 and even adults who are happy to boast that they are no good at arithmetic. As I say, that will be a very slow process but if you look at other countries and the teaching methods they use, they do seem to be more successful.

Q84 Angela Eagle: Already we have a load of young adults and those already in the workforce, mainly doing low level jobs or unskilled jobs, that do fall behind. The Leitch report shows that in all its starkness. We have to deal with adult training too. It is not something that employers have traditionally been excessively good at. There is clearly an economic need to do it as well as a need about fairness in society. Is what Leitch suggests the way to deliver it, that is what I am trying to get at? It is not only an issue for schools, it is about in-work training.
Mr Chote: One issue you raise on fairness and efficiency as to whether the money that one is spending on adults rather than children is for fairness reasons or efficiency reasons. There are those who would say that the marginal pound you have available would be better spent in terms of the long-term outcomes on younger people rather than older people, and the question to what extent—

Q85 Angela Eagle: Quite a lot of that has already been done. You were mentioning the education statistics earlier for the amount of money expended. I am trying to get at skills in work.
Mr Whiting: One comment from a tax point of view. There is an argument that says encourage the employer to provide the skills training by perhaps giving them an additional deduction in the same manner as the Research and Development Tax Credit and so allow the employer to have a deduction of 125%, or 150% of the actual spend. This recognises that many employers, particularly small ones, pay twice for training in the sense that they pay the cash and of course they lose the time of the employee. Yes, they get the employee back in a better trained state but that sort of pump-priming in the manner that would encourage the employer to look hard at the skills that would pay back in their workforce might pay some dividends, which I think, is in line with some of Leitch's recommendations.

Q86 Mr Love: In his statement last week the Chancellor announced net efficiency savings of 3% and administration budgets to be cut by 5% across the board. Obviously that would have kept his colleagues happy on equality of sacrifice, but is it sense? Is there room for the same levels of efficiency savings and administrative cuts in every department?
Professor Talbot: No, and they did not do that last time either. The Gershon target was 2.5% per year for three years, but it was not 2.5% for every department. The Cabinet Office target in terms of the actual amount of money in relation to its budget that it was supposed to save was 0.4% of its budget per year for three years, whereas DWP's was 5.8% per year for three years. There was a huge degree of variation in the actual targets which were set for departments, even though allegedly this was an across the board 2.5% target. That is the first thing. Clearly there is a lot of variation in what is possible within individual departments. Secondly, I think the 3% figure is quite interesting. If you assume that the public sector is largely much more labour intensive than the rest of the economy, and the labour intensive parts of the economy are the most difficult to achieve efficiency or productivity gains in, then I find it quite odd that we are expecting a 3% gain in efficiency across the public sector—this is not just central government, this is central and local government—a 3% increase when the overall productivity increase in the economy at the moment

is running at about 2.4% according to the PBR. Obviously they are not measuring exactly the same things but it seems to me to be an extraordinary idea that you can achieve that level of efficiency gains in areas which are primarily labour intensive. If I can refer you back to the answer I gave earlier about the discrepancies between the different work streams, it is quite obvious if you look at the figures, the small amount of information that we do have, the fact that on the productive time work stream, which is the one which is focused on individual's work and how they do it, we are only running at about 47% of the target according to the figures which have been released, whereas on procurement, for example, we are running at 70% of the target. It is quite clear that it is much more difficult to achieve efficiency savings in those areas where you are looking at human resources issues essentially.

Q87 Mr Love: Let me take you on. They also announced that the Value for Money Programme will be delivering net cashable savings. Gershon was gross. Is that going to be an improvement? Will that really get their noses to the grindstone?
Professor Talbot: First of all, it would be nice if they did actually measure things net because one of the things the National Audit Office pointed out in their first report was that we do not know from the way the information is being reported about the efficiency gains whether or not they are being reported net or gross, and in most cases they seem to be reported gross which means they are not necessarily real efficiency gains, or not as much as is being reported if you are disregarding the costs of actually implementing them. The fact that they are moving towards supposedly cashable gains is interesting. Because of that I would be interested to see that because the main area of non-cashable gains in Gershon was areas like the productive time activity because they were not forecast to release cash, they were forecast to improve the quantity and quality of output by improving the way in which people worked. Are they saying that those things are no longer going to be done in the new forecast? We do not know, there is not enough detail there to be able to say.

Q88 Mr Love: But it will be tougher if they do not include that?
Professor Talbot: Yes, absolutely. Except that we do not know, because they have not said, is this going to be on the same basis as the Gershon efficiency savings, which is that the savings were retained by departments and local authorities, so those that did make real savings released cash to do things and those that did not did not. To that extent, it is not money that is supposedly flowing back to the Treasury.

Q89 Mr Love: The Chancellor also in his statement set out the proposed levels of public sector capital investment up to 2011–12. Can I ask Mr Chote how that compares with trends in recent years?
Mr Chote: Yes. The quick answer while I find the table is that it is much slower, again coming back to this point that there has been a big step up with adjustment.

Q90 Mr Love: I would say take your time but the Chairman will start to pressure you in a second.
Mr Chote: Averaging capital spending the real increase to come increase is 2.7% a year, the real increase to come, compared with 15.5% under Labour to date. As I say, you have to bear in mind the fact that when Labour came in there was an initial attempt to get capital spending up which did not work out and it actually dropped to a lower level in the first term than previously, but there has been a subsequent much larger increase. It would be unrealistic to expect capital spending to continue to be growing at 15% or so, but 2.7% is the real growth rate over CSR 2007 on those figures.

Q91 Mr Love: The other side of that equation, of course, is asset disposals. They are talking about £30 billion of surplus assets by 2010–11. How does that compare with recent disposals? Is there any reason to believe that they can get up to that level based on the sorts of assets that they are talking about disposing of?
Mr Chote: I do not have that number on me. I think 30 billion has been the number for quite a while, has it not?
Professor Talbot: I am not sure. The basic problem is where are these assets coming from and identifying them. They are setting targets for them. It would be very interesting to see what the assumptions are behind those targets.

Q92 Mr Love: Based on recent experience there is no reason to believe that level of asset disposal could be achieved? We have not disposed of anything like that level of assets over the period of this current Spending Review.
Mr Chote: I do not know over what time period that would be.

Q93 Mr Fallon: Robert Chote, you have drawn attention in the last few days to the increase in the number of people living in households of less than 40% of median earnings. Could you just clarify that particular figure for us and tell us what the proposals are in the PBR to reverse that increase?
Mr Chote: If I could start on the 60% child poverty target. We did some work with the Joseph Rowntree Foundation on what would be needed to get to the child poverty target in 2010–11 and to do that you would need to have gone from roughly about 2.7 million children, approximately 21%, in poverty on the new 2010 target definition in 2004–05 and it would need to drop by a million, that is to 1.7 million or approximately 13% in 2010–11 for the target to be met. We estimated that this would cost around £4.5 billion. If, for example, the Government were to do as JRF suggested, to either put the money into the child element of the Child Tax Credit, which is the most well targeted element, or, if you wish to minimise some of the means testing involved, to split

it between payments on the Child Tax Credit and additional child benefit payments for larger families, which tends to be poorer families, as I say, that would have cost about £4.5 billion. In the absence of spending that money we would expect the level of child poverty to rise from 2.7 million in 2004–05 to 2.8 million or thereabouts in 2010–11. The Chancellor has not found very much extra money in the PBR to contribute towards that. There have been extra child benefit payments promised from 2009 onwards for—

Q94 Mr Fallon: If I could just stop you there. It is not the expenditure I want, I am coming to that, I just want to know the numbers. What has been the increase in the number of people living in households of less than 40% median earnings?
Mr Chote: I do not have the 40% figure. It depends on which measure of income you use—before or after housing costs. John Hutton has used one measure where he stood up and gave a PQ answer in the House, which you may be referring to, in which he said there had been no increase, which is true on one of the two measures and using 1997–98 as a base. There is an increase of an amount, and I cannot remember of what amount, if you use either 1996–97 as a base or you use the excluding housing costs or including other housing costs measure.

Q95 Mr Fallon: You are using that latter measure for your 60% calculation.
Mr Chote: The one that is relevant now for the target is before housing costs 60% and with the OECD method for adjusting for family size, all of which is different from the measures that we have used for the target to date.

Q96 Mr Fallon: Okay. If you turn to B80 tucked away at the back it says that they have revised upwards projected expenditure on Child and Working Tax Credits by about half a billion, as a result of a number of factors, "including lower earnings growth among low-income households". Why have the earnings of those in low-income households grown less than the Government expected?
Dr Weale: I would say one factor we would need to or want to consider is immigration. The recent surge of immigrants has typically been disproportionately taking low-skilled jobs which does not mean that the migrants themselves are low-skilled but that has had an impact on depressing wage growth in that part of the labour market.
Mr Chote: That sounds quite plausible, yes.

Q97 Mr Fallon: Does that not suggest, therefore, that tax credits might not be the most effective mechanism for relieving child poverty?
Mr Chote: They are the most targeted measure. If you want to get to the target by 2010–11, if you were to do it not by tax credits but by child benefit, for example, then that is much more expensive because it is that much less well targeted, but even the targeted measures are imperfect partly because of take-up and, as you say, you do not know from one year to the next what the trend in pre-tax and benefit earnings is going to be at different points in the income distribution. For example, if median earnings are growing particularly quickly then the hurdle to get over gets that much higher.

Q98 Jim Cousins: My questions are mostly for Mr Whiting. I did ask in the earlier session about the European Court of Justice decisions. The Government has announced some first strike/counter strike responses to that. Do you think the Government is going to be successful in containing tax losses from these European Court of Justice decisions?
Mr Whiting: Obviously much depends on precisely the terms of the judgments, some of which are expected tomorrow and there will be more to come. There has been a bit of a trend recently for the judgments coming down from the European Court to be, one might say, equivocal in terms of exactly where the line should be drawn. In the sort of estimates that were initially made as to the costs maybe not so much is at stake, but clearly there is a lot of money at stake with these decisions. You then put it in terms of will the Government be successful in containing them. That is a very difficult question because if the European Court says that the UK tax system is wrong under European law then it is rather difficult for the Government to say, "But we will not pay the money back" because people have been paying taxes under mistake of law and should, therefore, be repaid. The action that is necessary is to have a good and proper dialogue as to how to make sure the system is robust going forward and there are signs of that dialogue starting to happen.

Q99 Jim Cousins: On the specific point on the containment of retrospection, the Government has indicated that it wants to take a legal power to contain that to six years.
Mr Whiting: Yes.

Q100 Jim Cousins: If there was unlimited retrospection rather than only retrospection of six years, what money difference is there? What revenue difference is there? Are we here talking billions or hundreds of millions, or perhaps not very much at all?
Mr Whiting: I do not have a proper estimate, I am not sure if my economic colleagues can help me. The general estimate is that there are certainly billions at stake but that is a gross figure, as it were, and it is not expected that the biggest estimates will come to pass. The Government in trying to restrict the amounts that are at stake has, for example, a PBR measure of putting a cap as to how far back you can go. It is a moot point as to whether that is valid under European law because obviously this comes up against the issue that if the law is found to be wrong then shutting the door after the horse has bolted is not really valid under law. It is a very difficult situation.

Q101 Jim Cousins: Can I ask you about another thing. The attention of the Committee has been brought to the managed service company issue and the Institute of Chartered Accountants has made some points about this. How many workers are we talking about who might be covered by the management service company regime rather than the conventional employment regime?
Mr Whiting: You might also put a third category in there of conventional employment, conventional personal service company, which might or might not be under the famous IR35, and then the management service company, the ones that are definitely trying to sidestep the IR35 rule or whatever. I have seen various estimates, certainly estimates of 100,000 or more employees or individuals under this regime. It is very difficult to get an exact figure because very often these populations by nature are transient and rapidly changing, which is why the Revenue have found it difficult to tackle them in the past.

Q102 Jim Cousins: Is it likely that the workers we are talking about would be much more likely to be found, say, in this part of the country?
Mr Whiting: From what I know of it I do not think there is any particular geographical area, it can affect all areas. I have heard it mentioned in terms of the oil industry, the IT sector, right through to contract cleaners, teachers, health service workers, so you could say it is almost anywhere and everywhere that this mechanism has been used.

Q103 Jim Cousins: I am grateful to you for that. Turning to another area of tax avoidance, the so-called "carousel" frauds, do you think the measures the Government is taking to contain the potential of VAT losses there are effective or do you think more is required?
Mr Whiting: The basic mechanism of the reverse charge system, which the derogation has been applied to Europe to bring in, is a good way forward but I do not think I or any of my colleagues would say that is guaranteed to solve it. If it stops certain areas, particularly if it is targeted at certain types of goods, then the risk is that it moves on to another type of goods to be subject to fraud. It is one where the nature of VAT in some ways leaves it open to fraud, the basic missing trader idea, and it is one that the tax authorities are going to have to be continually vigilant on.

Q104 Jim Cousins: As I understand it, that particular derogation, the reverse charge regime, has been blocked.
Mr Whiting: I believe so by certain other countries who want a more comprehensive solution. It is not for me to speak of the UK attitude but I think the argument is that we need to block what we know about whilst considering the longer, wider range. I understand the French and certain other countries have said "Well, we have to block everything in one go".

Q105 Jim Cousins: Again if I could ask you, the tax avoidance disclosure regime, about which there is a great deal of—
Mr Whiting:—debate?

Q106 Jim Cousins: I was going to say "hot air" but that is disrespectful to a great deal of parliamentary controversy about the introduction of that. Do you think that has been significant, do you think it has been effective?
Mr Whiting: I think it has been. I think it has been successful in the sense that it does give the tax authorities two things. It gives them advance intelligence of particular schemes and also shows something of who is devising and using them. They are better equipped with intelligence and you can see in this PBR and recent statements actual action being taken. As a scheme it seems to be working tolerably well and thanks to some quite good consultation we have a system which is not too burdensome on the advisers and taxpayers who have to comply with it.

Q107 Jim Cousins: I am grateful to you. I am conscious of the fact I am directing my questions at you, I do not want to prevent any of your colleagues from saying something they wish to.
Dr Weale: Could I just say that on the question of carousel fraud it seems to me that there ought to be a review of the case for moving towards a point of sale tax as the old purchase tax was and away from the value-added tax because a point of sale tax looks to me to be much safer in these circumstances. Of course it is a European Community issue and not simply an issue for the British Government.

Q108 Chairman: I think the Commissioner mentioned a while ago that the estimated fraud is going to be something between 40 and 60 billion so it is a Community issue. It seems a bit crazy that we are sitting back on this issue whilst it is costing our own exchequer £2–3 billion a year, is it not?
Mr Chote: There is the irony, Chairman, that one of the reasons the UK has been particularly vulnerable to this is because it is relatively quick to set up a company here and the tax authorities are relatively swift at refunding VAT. Our modest regulatory burdens and rapid and responsive tax authorities may be contributing to the problem.

Q109 Jim Cousins: You can come again!
Mr Chote: I will not reply.

Q110 Chairman: Maybe John could help me on this because of that comment about the authorities being quick to refund VAT. Anecdotal comments made to me by City people would suggest that the relationship between HMRC and companies is not as good as it should be and there is an aggressive approach by HMRC. Are you picking up those views? Do you think when David Varney has been appointed to serve this transformation that will help the situation?

Mr Whiting: There are a few threads in there. The VAT point of course tends to affect the very smallest companies, the speed of registration and repayment. There has been certainly a feeling that there has been a more aggressive tone coming from HMRC in recent years, that it has been applying its powers with a slightly heavier hand. That said, I think you would say that during the last 6 to 12 months that has reversed somewhat and the tone, for example, of the Varney Report is very positive in recognising that HMRC, advisers and businesses very much have to work together to make the tax system work.

Q111 Chairman: Okay. Robert, would it be naughty for us to say to the Chancellor you want this liberalisation process to stop?
Mr Chote: Yes!

Q112 Chairman: On environmental taxes, just one question on that, the Office for National Statistics states that the proportion of total tax revenues made up from environmental taxes has fallen almost every year since 1999, from a peak of 9.8% down to 7.7% in 2005, so it is the lowest figure for a decade. In terms of the Budget, does it seem as if environmental taxes that the Chancellor has imposed will go any way or far towards addressing the trend? What would be the single most effective tax instrument for that, either a change to an existing instrument or an entirely new instrument that the Chancellor could utilise?
Dr Weale: I think it probably would be a road fuel duty because that is a very large source of tax. It is one whose importance declined as oil prices went up. We know the escalator ended and to reintroduce the escalator would be a means of offsetting the change that has taken place in the last few years.
Mr Chote: As Martin says, road fuel duty and the VAT on fuel duty is by far the largest and the most important green tax and it has explained why there has been a fall in the share of GDP raised. It is basically all down to the decision to have only one nominal increase since 2003 until the latest one we have now. Our estimate is that the APD change and no longer giving away money on fuel duty will just increase the share of GDP from green taxes by 0.1%.

Q113 Chairman: Road fuel duty, that is minimal impact that particular increase, is it not?
Mr Chote: Yes, in this case, that is right. Effectively that is what explains why it has fallen from its peak since 1999; it is basically the movement in fuel duty, real fuel duty falling in size.
Mr Newmark: A brief question: part of the motive I am assuming for the Chancellor increasing air passenger duty for example should be to change behaviour. Do you think it is really just simply a tax raising exercise or is it genuinely to change behaviour?

Q114 Chairman: You must remember we asked him to do it last year!
Dr Weale: I think the answer is that all taxes—

Q115 Mr Newmark: Not by that small amount.
Dr Weale:—all taxes have some change on people's behaviour. Small tax changes or changes which are small compared with the overall cost of what they are buying, you would expect to have only a small change and I think that is probably what we are seeing, particularly if you look at the fuel duty as the cost of a trip rather than just the cost of the air fare.
Mr Whiting: I think I would go along with that, that it is very much at the level where it is just an additional tax rather than really going at changing behaviour. Just coming back to the Chairman's point, if you look at what business would like out of the environmental taxes, I think what I would say is they would like a clear framework as to where these taxes are going. Are they to change behaviour? Are they to raise taxes? Let us have a proper framework and let us go there because that would allow business to plan and respond in the way that is wanted.[1]

Q116 Chairman: As a Committee we are going to look at that issue in the light of the Stern Report.
Professor Talbot: Just a point about the process issues that I raised at the beginning which I think is useful here. To take a step back from the discussion you have just been having, and think for a moment about the situation that we are in, which is that the Chancellor insists on making partial announcements about tax and partial announcements about spending in the Pre-Budget Report and then there is a full-scale debate about environment policy and whether or not the tax balance is right in relation to environment policy, when he clearly is not going to announce all the decisions about all of the taxes affecting environment policy in a Pre-Budget Report. We get into this ludicrous situation where we are having a debate about a major policy area, which it is important to have a debate about, on the basis of half announcements, partial announcements, something being announced and other things not being announced rather than doing it in the context of either the full Budget or the full Comprehensive Spending Review.

Q117 Chairman: Do you think maybe what is going to happen is in the next 12 months the Chancellor could be willing, if we asked him, for this to be his last Pre-Budget Report?
Professor Talbot: It is possible.
Dr Weale: On the issue of environmental taxation, it is suggested that carbon trading is in some sense an alternative and at one level it is an alternative but I think what has been missed from the debate is that from the point of view of the consumer we will have to pay more for our petrol because there will be a carbon charge on it. From the point of view of the final consumer I think there will not be very much difference between carbon trading and environmentally-focused taxation. The suggestion that one is easier to achieve than the other I think is incorrect.

[1] Ev 75

Mr Chote: Colleagues maybe able to help on this anyway. Listening to the speech and reading the text within the PBR I had assumed that this increase in APD was a one-off doubling and that was the end of the story. I note that in footnote 4 of table 1.2 on page 10 it says "The costing of the APD measure assumes revalorisation annually from the 1 April 2008". I am not clear whether that means that APD is now going to rise in line with inflation, whether that is the Government's policy, or not. You might like to ask them.
Mr Whiting: That is how I read it.
Mr Chote: That of course was not in the speech. It is not referred to other than in that footnote so you might like to ask officials for their interpretation of that.

Q118 Chairman: Any other points?
Professor Talbot: Just one small point you might want to ask the officials when you have got them in which is that there are announcements about the changes to the public service agreements and the introduction of these new delivery agreements which are going to underpin them. It might be interesting to ask about that but given that we have now got five departments—DWP, Revenue & Customs, Treasury itself, Cabinet Office and the Department for Constitutional Affairs—which have already agreed their settlements for the spending review period, you might like to ask them whether or not they have got public service agreements with all of those departments and delivery agreements. I know what the answer is, it is no. You have a very interesting contracting process going on here where we agree what we are going to pay for things, apparently, before we discuss with the departments what they are going to deliver in return for the money that they are getting, which I thought was supposed to be the opposite way round according to the Chancellor's statements on how PSAs were supposed to operate.
Chairman: We will certainly ask that question of them.

Q119 Jim Cousins: You put a question into my head, Professor Talbot, when you mentioned it much earlier, you made reference to regionally flexible pay and of course this is about to be introduced into the Department for Constitutional Affairs which is a slightly odd place to start, it seems to me. Do you think that regionally flexible pay could achieve considerable expenditure savings?
Professor Talbot: Fairly obviously yes in the sense that outside of London where you have got London weighting if you start to have regional pay determined by regional labour markets—which has always been the Holy Grail of the Treasury, they have been pursuing this for the last 20 years—to my knowledge, you would obviously have some areas of the country where pay would be considerably lower than it would be in London and the South East, excluding London weighting. Yes, potentially you could do that, and I do not at all find it strange that they have gone for the Department for Constitutional Affairs in the first instance. I am not aware that the trade unions in the Department for Constitutional Affairs are a mighty force to be reckoned with. I can think of other departments where it would be rather more of a challenge.

Q120 Jim Cousins: Mr Weale, what do you think about that? Do you think you could achieve a lot of savings if you targeted bits of the public sector where the unions are weak which is what Professor Talbot suggests?
Dr Weale: I think even in areas where unions are weak it is difficult to deliver pay cuts. The way it would be likely to deliver savings would be in the long run. Salaries for nurses will rise faster in London than they will do in areas where the labour market is very different but that is going to be a long-run process, it is not going to deliver much in two or three years.
Chairman: Okay. It has been very interesting. We have a few questions for the Chancellor on Wednesday and his officials. Thank you very much for your time. It has been very helpful.

Tuesday 12 December 2006

Members present:

John McFall, in the Chair

Mr Colin Breed
Jim Cousins
Angela Eagle
Mr Michael Fallon
Mr David Gauke
Mr Andrew Love
Kerry McCarthy
Mr George Mudie
Mr Brooks Newmark
Mr Mark Todd

Witnesses: **Mr Jon Cunliffe,** Managing Director, International and Finance, **Mr Dave Ramsden,** Director, Macroeconomic and Fiscal Policy (covering trend growth, migration and the economic forecasts); **Mr Mark Neale,** Managing Director, Budget, Tax and Welfare (covering tax issues, MTIC, financial inclusion and capability), **Mr John Kingman,** Managing Director, Public Service and Growth (covering productivity, reviews and Stern), and **Ms Mridul Brivati,** Joint Director, Public Spending, HM Treasury, gave evidence.

Q121 Chairman: Mr Cunliffe, good morning to you and your colleagues, and perhaps you could introduce them.
Mr Cunliffe: Yes, on my left is John Kingman, who is the Managing Director of Public Services and the new Public Services and Growth Directorate. I am Jon Cunliffe, the Managing Director of the International Finance Directorate of the Treasury. On my right is Dave Ramsden, who is our Director of Macroeconomics. Next to him is Mark Neale, the Managing Director for the Budget, Tax and Welfare Directorate and next to him is Mridul Brivati, who is the Director for Public Spending.

Q122 Chairman: Welcome. On the issue of uncertainty around the economic outlook, in the Inflation Report in November this year, the Governor in his opening statement spoke about uncertainty and in his evidence to our Committee on the Inflation Report on Thursday 30 November he said, "I think we are genuinely uncertain as to how price-setting in the economy will respond to large movements in certain costs, such as energy prices". What are the main risks both from the upside and the downside?
Mr Cunliffe: To the global economy and the UK?

Q123 Chairman: Just uncertainty around the economic outlook.
Mr Cunliffe: The main global risks for us are around inflation which, I think, is the one the Governor has mentioned, around the US economy and whether the housing market downturn will broaden into a more widespread slowdown of the US economy, around protectionism and the Doha Round and the impact that will have, around oil and energy prices, which are still a risk, but perhaps less so than at Budget time, and around global imbalances because that risk is always there. I think, as far as the UK side is concerned, there is a risk that the effective labour force is larger than we think and, therefore, there is more slack in the economy and more room for growth, and on the demand side I think there are risk around the housing market, the extent to which the recent increase in the housing market will lead to an increase in consumption and the extent to which there is a link between the housing market and household consumption. There is a risk around savings and whether households will want to save more. There is an upside risk around business investment, with profits strong and corporate financing relatively cheap, whether we could see more business investment than we forecast. Then I think there is a risk to exports both ways, the US risk would be a downturn in global growth and world markets, but, on the other hand, for the eurozone, where most of our exports go, it has grown more strongly and I think there is an upside risk there.

Q124 Chairman: In relation to migration, the figures are cloudy, at best, are they not? The Governor of the Bank of England, when he was talking about the migration from Poland to here, mentioned that in 2003 there were 516,000 flights between the UK and Poland, but over the next two years it went to 1.8 million, but International Passenger Survey forms were handed out at Heathrow, Gatwick and Manchester, so that missed most of the people who were coming into the country because it was elsewhere. Is there anything that you are going to do to get a better handle on it?
Mr Cunliffe: Yes, the Governor made a number of points about migration statistics, first, that the International Passenger Survey, as he said, was originally designed to look at tourism and is now having to pick up answers on migration. There are also points about how you bring together the information we have from the Workers Registration Scheme, and for the issue of National Insurance numbers with the information that is in the International Survey. The ONS have a programme of work to try and improve migration statistics. They have set up an inter-departmental workforce working group to try and bring this together and I think they plan to issue their report before Christmas, and there is also, within the ONS itself, a number of projects trying to improve the quality of migration data.

Q125 Chairman: In answer to a question in a session on the Inflation Report, Charlie Bean of the Bank of England suggested that labour may be pricing itself

out of jobs. Have you any evidence that that is the case and can this explain some of the recent rise in unemployment?

Mr Cunliffe: I do not think we have any evidence for that. As far as migration is concerned, we have no evidence that migration has affected directly pay rates. Certainly average earnings have been low for this stage in the cycle, growth in average earnings has been low, and that might be an effect from migration, but it might also be an effect from globalisation because, I think, right across the economy workers can see that there is much greater global competition than there used to be. I think we have certainly not picked up anything definite to suggest that workers are pricing themselves out of business. I know that one of the points that Charlie Bean has made in the past is that the increase in energy prices will in the end have to be absorbed through pay and maybe not all of that has happened yet and, therefore, there will have to be slower real growth in earnings going forward than there has been to make that happen, so that may have been his point, but certainly we have picked up no direct effects.

Q126 Mr Fallon: This cannot quite be right, can it, Mr Cunliffe, because in your own report, page 242, you say you are having to spend £$\frac{1}{2}$ billion more on tax credits because of lower earnings growth amongst low income households. Dr Weale yesterday attributed that almost directly to immigration from Eastern and Central Europe.

Mr Cunliffe: Well, it is certainly right that we are having to spend more on tax credits on low income families than we forecast and it is also true that for this stage in the cycle average earnings seems low. Whether that is directly related to migration or not is another point.

Q127 Angela Eagle: Sticking with the labour market, we have seen an upturn in unemployment, but we have also seen continuing growth in the number of jobs. What do you think is happening in the labour market? You did just mention that perhaps the effective labour market is larger than might have been thought, so how is this playing through in your policy recommendations and thoughts?

Mr Cunliffe: On the first question, we think what has happened in the labour market in the last year has been a very big increase in the labour supply of about 450,000. We think half of that has come from an increase in the population above 16 and some of that is migration, but some of that is actually natural population growth, but half of that has come from a reduction in inactivity. These are people of working age who are—

Q128 Angela Eagle: Is this the Pathways to Work issues on the supply side?

Mr Cunliffe: It is partly that. It is three things. It is Pathways to Work and people who have been on long-term sickness and incapacity coming back into the workforce and it is a continuation of a trend that is bringing more women into the workforce who were staying at home. The other effect, and this comes back to how we interpret the labour market, has been from students. The number of students, which who are people going out of the workforce while they study, has been rising quite strongly for the last few years. We saw a very large increase in students, larger than trend, in 2005 and a smaller increase in 2006 and what may well have happened, with tuition fees coming in, is a number of people have brought forward the start of their studies. Averaged over those two years, the increase is about in line with trend. If that is the case and next year it goes back to the trend, then we will find that there will be more students and, if you like, the level of inactivity, because there will be more people studying, will go up. Our forecast is that claimant unemployment has already flattened off, I think, by at least 15–16,000 over the last six months and we expect that to continue and probably reverse and unemployment on the other, side, the labour force survey measure, we expect to turn around as the demand in the economy picks up.

Q129 Angela Eagle: Those structural changes you have described would probably have positive effects on the economy, would they not, because actually it is people coming off inactivity where the Government are paying them for being active, going into work and paying and, like with migrants, they are working and contributing?

Mr Cunliffe: The reduction in inactivity, the increase in the participation rate increases the productive capacity of the economy. The same happens with migration because it adds to the labour force and of course the increase in students is an investment for the future which should also result in a more productive workforce.

Q130 Angela Eagle: In terms of the regional effects, have you analysed with the rises in employment whether they are disproportionately impacting in particular areas and what is your insight into that?

Mr Cunliffe: I do not know of any particularly pronounced regional spread.

Mr Ramsden: We have not done a regional forecasting exercise for this PBR and that is consistent, that we stick to forecasting at the macro level. However, for the latest data that we have, that has shown that over the last year employment has increased in most regions.

Q131 Angela Eagle: Might it be possible that the next structural change will be older people staying on in the workforce rather than retiring and have you thought about what effect that might have on structural change?

Mr Cunliffe: We have seen over the last four or five years quite a strong trend of people who have retired coming back into the workforce or staying on after retirement age and that was quite a big factor last year in the increase in the labour supply. You would expect, particularly as life expectancy increases and healthy life expectancy increases, to see more people coming into the working population and indeed that is what we are seeing.

Q132 Angela Eagle: In terms of the impact that the structural changes in the labour market are having in other areas, what is your analysis of what effect this is having on productivity, for example?
Mr Cunliffe: The expectation from migration, I think, is that they would add to productivity because, on the information we have got, migrants tend to be better qualified, there are higher proportions, in the sectors they are going to with university degrees and qualifications, so over time you would expect that to increase productivity. The productivity numbers we have at present show that productivity has come back now quite strongly since the last on-trend performance in the cycle to, I think, about 2.4%, but we have not tried to analyse recent productivity performance against the changing structure of the labour market. Overall, you would expect a more educated labour force to be more productive.

Q133 Angela Eagle: Finally, on the minimum wage, there is a rise in the enforcement spending on that and also an increase in the minimum wage itself. Is that impacting in any way on your analysis in terms of costs?
Mr Cunliffe: Well, in the macroeconomic forecast we do not try and incorporate the effect of announced policies, so the greater enforcement of the minimum wage which has now been announced has not been put into the numbers. You would expect again over time that, if that happens, it could increase the attractiveness of going back to work for a number of people who are outside the labour market and that would have an impact, but we have not put a number in the forecast for that.

Q134 Mr Breed: Could we turn now to consumer spending which of course has been rather volatile. What, therefore, are the main risks to your forecasts for household consumption, do you think?
Mr Cunliffe: I start with the forecast which is pretty much unchanged from Budget to now which is that it grows at about 2% this year and about 2.25–2.75% going forward which is slower than the growth rate of the economy and it has recovered from the low in 2005. The view on the past is that the low in 2005 was caused by two things: one, a reduction in disposable income growth really going back to 2003–04, the partly due to higher interest rates when we had the five interest rate increases in those years; and then in around about the middle of 2005 households began to feel the impact on disposable income of higher energy prices. Going forward, we think those increases have come out of the system and actually—

Q135 Mr Breed: What, energy is going to come down?
Mr Cunliffe: Well, in inflationary terms, energy prices will drop, the rate of inflation will drop. Energy prices have come down, but, even if they stay stable, the rate of inflation drops if energy prices stay stable, and we do not think energy prices are going to continue to increase, although, as I said at the beginning, that is one of the risks to the global forecasts, so we see consumption growing just below the rate of the economy. As to the risks to of consumption, there are a number. As I said, there is an upside risk that consumption could take off or grow a bit more strongly because the housing market has been stronger in 2006 certainly than we forecast and, I think, anybody else forecast. There, you have to make some assumptions about whether household consumption in the UK is linked to the housing market and to what extent there is a link. In the past, there has been a link, but there have also been periods like the recent increase in house prices earlier this century where the link did not seem to be very strong at all. So there is quite a lot of uncertainty as to whether these two things are directly linked or whether they are linked to some other factors and it is only if those other factors grow that consumption will grow. There is a potential downside risk to consumption on savings. The savings ratio has gone up over the last year. As we explained in the PBR, that is partly because employers' contributions to employees' pension schemes have gone up and that is counted as saving. In surveys, households seem to be saying that their saving intentions are greater than their actual saving is.

Q136 Mr Breed: If it works.
Mr Cunliffe: That may just be human nature, but it may be that they have not taken into account the higher saving that is being made on their behalf by their employers and, if they did decide to increase their savings, clearly that would reduce their consumption going forward. So those are really the main risks around the consumption forecast.

Q137 Mr Breed: So house prices generally, do they have an effect, do you believe, after all the sort of experience you have had of volatility there? Are they actually having an effect on consumption then?
Mr Cunliffe: I do not think anybody knows the answer to that. My personal view is that they have had effects in the past and the effects came through the so-called "wealth channel", that, as people's wealth grew, they felt they were more able to spend, and maybe some came through the liquidity channel, that they had more collateral to put down and to borrow. However, I think that relationship is not as strong as it used to be and I think as well that house prices are driven by individuals' expectations about employment and expectations of future income, so more fundamental reasons. I think it is also driven by the costs of purchasing a house and it is not just the purchase price of the house, but it is the interest—

Q138 Mr Breed: The stamp duty.
Mr Cunliffe: Well, there is the stamp duty, but it is mainly the interest cost on the mortgage and there is some evidence that, although the Bank of England has not reduced the bank rate, because more mortgages are now being financed on two- or three-year fixed terms and because over the last year the two-year part of the yield curve for international reasons was very low, the financing of house purchases became low and that is what stimulated

the market. I would not want to make the prediction as to how strong the link with consumption is going forward. It is difficult. As I say, my personal view is that it is not as strong as it was and certainly, although house prices have come back, we have not seen consumption come back.

Q139 Mr Breed: Not yet.
Mr Cunliffe: Not yet, no.

Q140 Mr Breed: So although there is some modest evidence that people are under a bit more pressure with people missing their mortgage payments, a little bit more sort of pressure with a few more insolvencies, some modest rise in repossessions and such, how concerned are you that we are at the beginning of what might be something a bit more serious?
Mr Cunliffe: I do not see in the indicators of mortgage repossessions and in the survey results on household finances anything like the same sort of distress signals that you saw in the early 1990s. The Bank of England's Quarterly Bulletin and Inflation Report has some information on this. It suggests that a number of households are having problems, although, from the Bank's survey, the problems look to be in the unsecured and the consumer credit area rather than in the secured housing area, so I do not see evidence of problems there. When you look at income gearing, the ratio of the mortgage repayments to income, that seems for the UK historically to be at relatively safe levels. I cannot predict the housing market, so I cannot tell you what is going to happen, but certainly in those indicators you do not see the sorts of distress we have seen at other times when the market has fallen quite sharply.

Q141 Mr Breed: Although the indications from the banks', not the Bank of England, the ordinary banks' figures lately are a bit mixed where some of their bad debt figures are a bit higher than we might expect and the others seem to have been much better and such, does the Treasury have any view on the macroeconomic effects on the different levels of tightening of bank criteria, which might actually happen, the banks might actually tighten up some of their criteria for lending? Is that going to have any macroeconomic effects?
Mr Cunliffe: First of all, I think they have tightened up some of their lending criteria, particularly on the unsecured side rather than on the secured, and I think that will affect a number of people. The question is: is that number large enough to have a macro effect. That is really the same question as: are we seeing in the distressed figures, people who are experiencing difficulty. That is a very real problem for a number of people, but are we seeing a macro effect? I do not think so, but my colleague might want to say something on this more generally.
Mr Ramsden: We keep a close eye on the survey evidence that Jon and you have been referring to. We have had this very latest survey from the Bank of England which presents a pretty balanced picture of the issues that households are facing. We have to obviously take account of the fact that it is a survey, so the extent to which it is representative, it is an established survey and the Bank's assessment was that, compared with last year, I think overall, and you have mentioned some areas where there may be a small increase in the issues for households, but I would not say they are statistically significant compared with last year. We do, at the macro level, pay very close attention to this. Obviously consumption is by far the most significant part of expenditure, so we have to look very closely at what is happening on the side of household finances, but whilst we factor it into our risk assessment, I think the consumption forecast that we have at the macro level is a measured one and there are upside and downside risks to it. The key upside risk, I would highlight, subject to the points Jon has made, is on house prices where the latest data which came out yesterday on some of the measures is showing double-digit inflation increases. Now, that is well in excess of what we were forecasting, but we were standing out amongst a lot of forecasters for saying that we thought there would be a soft landing in house prices and, even though house prices are in double-digit rates, they are still moderated from where they were and we expect them to continue to come down to grow more in line with income, but we are not expecting the kind of real house price falls that some forecasters were projecting; we have not seen any evidence of that.

Q142 Mr Breed: Finally, on the individual voluntary agreements, are they working out as you broadly had planned or are you very concerned at the number of people who seem to be resorting to them for one reason or another?
Mr Cunliffe: They were designed, I think, to make it easier for households to cope with debt problems and to be able to adjust their debt and to smooth out the adjustment rather than to have to go into a very sharp adjustment on insolvency. I think the fact that they are being taken up shows that they are meeting that need. There are a lot of stories about how they are marketed and how they are being sold, I think, which the FSA and others are looking at, but the general principle that we try and find a way for households to make a smooth adjustment for those who have debt problems, I think, is being—

Q143 Mr Breed: So you do not know whether or not they have not been over-marketed?
Mr Cunliffe: I do not think so, no.

Q144 Mr Todd: Can we turn to the issue of external trade. How confident are you, bearing in mind the data uncertainties there are following the MTIC trader fraud, of trade data?
Mr Neale: We are pretty confident that ONS is in a position to adjust the import figures, and it is mainly the import figures which are affected here, as a result of what we know about MTIC fraud. ONS works closely with Her Majesty's Revenue and Customs who pass on to ONS their estimates of hidden imports.

Q145 Mr Todd: So the answer is you are fairly confident that the ONS are on top of it, but you would not be too certain, bearing in mind our lack of knowledge of the scale of the fraud in question?
Mr Neale: Fairly confident.

Q146 Mr Todd: You make a forecast that import growth will be slightly less than export growth in the period in question. On what basis do you make that judgment?
Mr Cunliffe: It comes back to the macro side. I think we made that judgment on the basis of the consumption forecast and the strength of consumption relative to the strength of the economy and we make the export forecast also on the basis of surveys for next year going forward which are very strong actually as to order books.

Q147 Mr Todd: Turning to the impacts of the US economy, you have presumably factored that into the possible risks that the economy faces. How does this affect your forecast for the period?
Mr Cunliffe: The US economy is important to the global economy and there are some big risks out there around global imbalances and the like which we have talked about, but as for the specific trade channel to the UK, the US is a much smaller trade partner for us than the EU. We have put in—

Q148 Mr Todd: Which of course has a multiplier effect within the world economy as a whole.
Mr Cunliffe: Yes, and there are other channels through capital markets and the like, but on the trade channel itself, we have got a slowing of the US economy for next year compared to where we were at Budget time. The US had a very strong first quarter in 2006, so the likelihood is that they will achieve 3% growth in 2006. Even though the second quarter was a bit weaker and the third quarter was quite a bit weaker, I think they will still be around 3% there. Going forward, for 2007, most of the commentators have knocked them down by about 0.5% and we are not very different from that, and the IMF has done that, the consensus has done that. That is really to do with the drop in residential investment which they have seen going forward, possibly some effects on consumption linked to housing, the point for the US that we were just discussing. Furthermore, for the UK, there have been some sorts of soft manufacturing survey data and of for the US in November. On the other hand, some of the consumption data which have just come forward have been strong and the last labour market figures that came out on Friday for the US were stronger than people were expecting, so our forecast is for the US to slow in 2007, but not really for it to go into a full—

Q149 Mr Todd: But you have built into your forecasts some fairly confident export forecasts which must be tough to achieve with the dollar at the rate that it is.
Mr Cunliffe: Well, the export forecasts, I think, are affected more by the forecasts for the eurozone. We have got the eurozone growing faster this year than we expected, dropping back to about 2%, as I recall, next year and 2.25% thereafter and that is a much bigger determinant.

Q150 Mr Todd: So you are expecting some rebalancing of exports between the US and the eurozone within your forecast?
Mr Cunliffe: Yes, and I am expecting the very sharp decline in exports to the euro area that we saw in the first three or four years of this century to correct somewhat.

Q151 Mr Todd: The decline of the dollar might suggest some unwinding of global imbalances. Do you think it does?
Mr Cunliffe: I thought the Chairman was going to ask me that question. He always asks me about global imbalances. I think the decline in the dollar that we have seen, and, remember, it has gone down in the last four years by about 25%, is part of the unwinding of global imbalances. The question on global imbalances is not so much whether they will unwind, because I think most economists think they will, but how and whether they unwind in an orderly way. Actually the dollar depreciation that we have seen over the past four years has been pretty orderly. The very recent one that we saw at the end of November was not as big as the dollar depreciation against the euro certainly we saw in the spring, but as it has been quite an orderly process.

Q152 Mr Todd: Presumably this would be assisted by an appreciation of some other currencies which are under-valued?
Mr Cunliffe: It has appreciated against the Renmimbi yuan a little bit and it has appreciated against the yen, but clearly a more global rebalancing of the exchange rates must be part of the overall global rebalancing story. The question is: will it happen over a long period in an orderly way or could it be disorderly?

Q153 Mr Todd: You have been criticised by some for being too sanguine about the future path of inflation with some of the uncertainties identified with the Bank of England. How would you respond to that?
Mr Cunliffe: I do not think our implicit inflation forecast is at all different from the Bank's.

Q154 Mr Todd: No, I did not say that. I said they had identified certain uncertainties.
Mr Cunliffe: The uncertainties we see are pretty much the same as the ones the Bank see. On the supply side, it could be that there is more slack in the economy and the economy has got the potential to grow faster without inflation.

Q155 Mr Todd: Could it be argued that the Chancellor raising taxes in this PBR may have some impact on inflationary transience in the future which may need to be taken into account by the Bank in their future interest rate policy since it removes some expenditure from the economy?

Mr Cunliffe: There is clearly an arithmetical effect on the inflation rate of increasing the fuel duty. Whether that will affect long-term inflation trends, I do not think so, and actually the fuel duty increases have been sort of pencilled in for the last year as part of the normal operating, so no, I do not think that will have an effect on inflation transience.

Q156 Mr Gauke: Can I ask about the trend growth assumption which has gone up from 2.5% to 2.75%. Am I correct in thinking that the reason for the increase is because of a reassessment of the net inward migration of working age population? Is that a correct interpretation?
Mr Cunliffe: We have revised our population growth forecast, but I should say that the trend growth assumption for this year of and the past stays the same at 2.75. What we have done is that we were going to reduce it from 2.75 to 2.5 because of the effect of the retirement of post-baby boom female workers and that now, we think, is offset by the increase in the population of about 0.2% and that comes mainly from an assessment of current migration trends, yes.

Q157 Mr Gauke: What sort of numbers are we talking about?
Mr Cunliffe: The GAD, Government Actuary Department, forecast, although it is actually now done by the Office of National Statistics, the forecast that they had in their 2005 report was for net migration to come down from its peak, and I think it was 235,000 or 240,000 in 2004, to a figure of somewhere between 145,000 and 205,000. We are within that range. It is not an exact figure because what we have done, it is an assumption of population growth of 0.2, but it will be equivalent to a figure of 185–190,000. But it averages out over the period.

Q158 Mr Gauke: Every year for the foreseeable future?
Mr Cunliffe: I would say for the next few years. The trend rate, until we change it. If you look at the long-term report, you can see that once you get three or four years out, it is very different and you have to forecast very differently.

Q159 Mr Gauke: Also, as I understand it, you are not assuming a substantial increase from Romania and Bulgaria post accession?
Mr Cunliffe: No, that figure seems to have had no increased from the A2—

Q160 Mr Gauke: And, for shorthand, if I say "185,000", there or thereabouts, are we talking about EU or non-EU migration? What is the balance?
Mr Ramsden: As we set out in the supporting document that we published alongside the PBR and it is also set out in the NAO audit of our cautious trend growth assumption, we have done an analysis looking at trends in the Commonwealth, including new Commonwealth, in the rest of the world which included A8 up to 2004 when they joined the EU. We have included migration out of Britain and we have included migration inwards from the EU15 and it is fair to say that in the data the strongest trend is actually from Commonwealth countries. Indeed, if you look at the disaggregated ONS data, the average net inflow of migrants from the new Commonwealth countries was 110,000 a year in 2004 and 2005, so we have taken account, and that trend was established back in the 1990s, but our analysis, and other people's because external forecasters have done this as well, has tried to look not just at the very recent figures for A8, which are difficult obviously to project, but these underlying trends, so those all feed into our migration projection.

Q161 Mr Gauke: The return to 2.75 for trend growth obviously has an impact on revenue and that is very clear, but the point which was made to us by Martin Weale yesterday, and indeed in his written submission, is that there does not appear to be any evidence that the impact on public expenditure of this population growth is included. Is there anywhere within the document or within your projections for public expenditure that you have explicitly taken into account the increase in population?
Mr Cunliffe: There is not an explicit reference to expenditure, nor is there any explicit reference to revenue. What happens in the trend growth assumption is that the economy grows as a whole faster and everything else adjusts within the model to that. We have never forecast it, but I think actually Martin Weale did look at forecast it.

Q162 Mr Gauke: If you are having a growing population in a year, the economy is going to grow, but the demands on public expenditure will also grow. I know, for example, that police forces are spending a lot more on interpreters now than they were three or four years ago, to give you just one small example and there are many. Is that factored into your public expenditure projections?
Mr Cunliffe: I would make three points. First, I think the studies which have been done, and the National Institute did one, suggest that immigrants contribute more fiscally than they consume, and that is why it is interesting it was Martin Weale because I thought he did that work. The Home Office has also not done that. So you would expect there to be a benefit. Secondly, we have not put into the revenue projections or the expenditure projections the ways in which immigrants might particularly increase one aggregate or the another aggregate. What we have done is increase the trend growth of the economy. That runs through the model generally. Where the economic model generates fiscal costs and where it generates receipts, that is followed through. Within departments' current expenditure plans will be whatever plans they have to deal with the costs of migration, so that will already be within departmental plans. When we get to the CSR, it will be within their plans going forward., but I think you have to distinguish between that from the economic model which looks at the economy as a whole and

then the aggregate numbers are fed into the various fiscal forecasting models and they project fiscal costs and receipts accordingly.

Q163 Mr Gauke: Moving on to now to the golden rule, and of course the reversion of the trend growth assumption is that the economic cycle comes to an end earlier than it was otherwise going to do, we received evidence from Martin Weale yesterday on this issue of the economic cycle, arguing the fact that the economic cycle came to an end in 2003–04 and the new cycle started then. Did you give any consideration to applying the economic cycle in that way?
Mr Cunliffe: First, can I say that the change in the trend growth rate makes no difference. It has nothing to do with the dating of the economic cycle.

Q164 Mr Gauke: It was the growth, yes, thank you.
Mr Cunliffe: What has changed our view of the economic cycle was the ONS revisions in July of this year and the faster growth that we have had than we were forecasting. It is those two things. The ONS revisions also changed the middle a little bit, the pattern of growth. Our view in 2003–04 is that the economy did not move decisively through trend. When the Chancellor came to the Committee in, I think, July 2005, we published a Treasury document on how we decide when the cycle starts and ends and we made clear that what you would want to see is either a decisive move through trend, to what you would normally see, or, conceivably, the economy comes back to trend and stays on the trend level for a long time. But actually 2003–04 did not look to us like a decisive move through trend, particularly when you looked at the other indicators, inflation, earnings and some of the capacity indicators we used to confirm it.

Q165 Mr Gauke: How much of that is a judgment call or is it very obvious? Are you applying a degree of judgment, and I am not necessarily saying it is a wrong judgment, but it is quite a difficult call to make?
Mr Cunliffe: You cannot observe the economic cycle directly and you cannot observe the trend rate of the economy directly, therefore, there are judgments in all of this. What you try and do is make judgments openly based on a sort of transparent methodology and allow yourself to be judged against the judgments you have made, which is what we do. But there is an element of judgment in deciding where the cycle is and there is an element of judgment in deciding around determining the trend rate.

Q166 Mr Gauke: Looking forward to the next economic cycle, we were specifically asked yesterday by the experts to ask you as to when the new cycle will begin and will 2006–07 count as part of the new cycle, as I think has been the case in the past, that the end year, if you like, counts in both the old and the new cycles?
Mr Cunliffe: I am very happy to answer that, but I should make clear that what we are talking about is our forecast and the actual dating of the cycle has been, and will be, a backwards-looking exercise. You base the dating of the cycle on the economic data. You forecast on what data you have, but then you look to see, and you certainly wait for the end of the year in question. You look at the economic data and then you date it. That is how we have done it in the past and that is how we are doing it.

Q167 Mr Gauke: So it is a forecast, not a conclusion?
Mr Cunliffe: Our forecast is early in 2007, which I would expect to be in the fiscal year 2006–07, but we will not have, bearing in mind what happened last year and particularly the revisions from the ONS in July, the final data on that, the first of the first is the yearly view of it, until the ONS blue book in the summer.

Q168 Mr Gauke: So you will not know for sure until July when—
Mr Cunliffe: No, we will not know.

Q169 Mr Gauke: But whenever it does end, whichever year it is, will that year count for both the old cycle and the new cycle?
Mr Cunliffe: That is what we have done in the past.

Q170 Mr Gauke: Is that what you are going to do in the future?
Mr Cunliffe: I do not know what we are going to do in the future.

Q171 Mr Love: You have revised down your growth forecasts for 2008. Can you go into the reasons why you have decided that.
Mr Cunliffe: It is very much to do with the point we have just been discussing on the economic cycle and the ONS revisions. Effectively, what the ONS released in July of this year was a picture in which past growth had been 0.25% higher, I think, in 2003, 2004 and 2005 and that we have had economic growth of about 0.5% more in 2006. If you take that together, it means the level of GDP is closer to its trend level. There has been 1.25% more GDP growth in the past or to date and, therefore, the level is closer to its trend level and it is the difference between the level of GDP at present, not the growth rate, but the level at present and its trend level which gives you the output gap, so basically the output gap got smaller because of the ONS revisions, and I think when I came before the Committee at the Budget I said that that might happen. With the output gap smaller, there is less room for future growth because our forecasting model, as set out in the Pre-Budget Report, assumes the economy comes back to trend over two or three years, so, if it is closer to trend now, it has less growth to make up to come back to trend and effectively growth is higher this year than in the past forecast and it is 0.25% lower in 2008 as a result.

Q172 Mr Love: You have not taken into account any assumptions about business investment, international trade, anything of that nature.
Mr Cunliffe: Their forecasting up to 2008 is different from forecasting the next year ahead. For the next year ahead you can forecast by looking at

manufacturers' surveys, service industry surveys, intentions, and that gives you some idea of, if you like, the momentum in exports, in business investment and in consumption, but, when you are looking more than two years ahead, it is very difficult to project. We anchor our forecasts two years ahead by a view of where the economy's trend level of output is, is it above or below trend, and then the view that the economy will return to that trend level over two or three years. So the 2008 change is really to do with those medium-term issues rather than anything we can see now at the end of 2006 which might then be impacting business investment. We have increased business investment in 2007 and I think the 2008 forecast is very similar to the Budget.

Q173 Mr Love: Let me just press you finally in relation to questions which were asked earlier on about what is happening to the US economy. The Governor, when he came, said to us, "Oh, don't worry, it is only 20% of our trade and Europe is over 50% of our trade", but taking the assumption, and I think you commented on it, about the stronger link that appears to exist in the United States between house price movements and consumption and the multiplier effect internationally that the recession, if I can call it that, although that is too strong a word, the downturn in overall demand in the United States might have on the euro area as well as on the United Kingdom, tell me what you think the likely risk of that is for the future export performance of the United Kingdom economy.
Mr Cunliffe: First, if I said that the US had a stronger link between consumption and housing, then I should not have done.

Q174 Mr Love: No, that is an example. I was obviously trying to lead you!
Mr Cunliffe: It certainly has a stronger link between housing and residential investment because what happens in the US is that, when the housing market expands, there is a lot more room to build new houses, whereas in the UK, as you can see from the Kate Barker work, the supply response in the housing industry is nowhere near as strong. What has slowed down the US GDP at present is not consumption slowing quickly because the house prices are not growing as fast, but what has slowed down the US GDP is residential investment. People are not building houses and housing construction has gone down. I do not know what the link is yet and I do not know what the link in the UK is and I would not want to say what the link in the US is. If the US economy were to develop a much more broadly based slowdown and instead of slowing down to growth rates, I would go with the mid-2s next year, and I think you said went into recession or whatever, would that have an impact? It would have an impact on our trade. It would have an impact on the eurozone, although the eurozone's exports to the UK, as Jean-Claude Paul Trichet has said on a number of occasions, are larger than their exports to the US, so we are a more important trade partner for the eurozone than the US. The channel, I think, might come much more through general confidence effects, through the Stock Market and the like, but we do not see that. We see that as a risk, but we do not see it as the majority sort of probability that that might happen. And certainly the evidence is not there so far.

Q175 Mr Newmark: I have two or three technical questions, I am not sure whether they should be for Dave or for Jon, but the first is: how likely is it that the ONS will reclassify more debt, which was previously off balance sheet, as on balance sheet? The reason why I ask this question is because I know the ONS added £1.25 billion of PFI debt in August in 2005 and then £5 billion in February 2006 and then a further £4.95 billion in September 2006.
Mr Ramsden: Perhaps I might start on that and Mridul might want to come in on the detail. We have taken account of those revisions as they have been made, including, as you have highlighted, the recent revision in September to bring in finance leasing and that has been one of the key factors that has led to our net debt forecast being very slightly higher for the forecast period, but that reflects the upwards revision in the data. The ONS is operationally independent for these purposes, so it is for them to decide as and when, in line with international classifications, to bring these classification issues when they crystallise in the public finances data.
Ms Brivati: I am not sure I have much to add to that. To the extent that the ONS is an independent body and it determines that specific items are off balance sheet, they do not figure for the purposes of net debt and impact on the Sustainable Investment Rule.

Q176 Mr Newmark: Is not the purpose of doing stuff off balance sheet the transfer of risk and, if you can transfer risk, you move stuff off balance sheet, but is there not a pattern beginning to build up which shows that some of these public sector projects which have moved off balance sheet, when there is a problem, they ultimately come back to bite the Government in the arse which is why more and more debt, which was previously off balance sheet, seems to be dripping each year on to the balance sheet? Is that not a problem or an issue?
Ms Brivati: Well, the decisions as to whether a particular project is on or off balance sheet are made on a case-by-case basis and there are very many of those cases, so I am not sure that I could give you chapter and verse on any of them really, but I do not think I would agree that there is a pattern. I am not sure what evidence there is for that so far. Certainly there are cases—

Q177 Mr Newmark: Well, the evidence is that each year more and more stuff, which was originally off balance sheet, is coming on balance sheet, but, if it gets to a point where a significant reclassification previously off balance sheet suddenly reaches sort of a tipping point and breaks the sustainable investment rule ceiling of 40%, would you have to then change the ceiling or not?
Ms Brivati: That is a hypothetical question about the sustainable investment rule which Jon might like to answer, but in terms of how we actually operate

under the sustainable investment rule, we deal with the rules as they are and with the numbers as they are which ONS determine for us.
Mr Cunliffe: There is not much to add to that. The rule is clear.

Q178 Mr Newmark: It is all great government speak, but let me ask my second question. What is your estimate of the present value of the Government's public sector pension liabilities and, when you answer that question, can you tell me what discount rate you are using?
Ms Brivati: The number I have for that is £530 billion. I am not sure what the discount rate for that is, whether it is the green book discount rate. Yes, the discount rate for that would be the one that is in the green book.
Mr Newmark: It is higher than a risk-free rate, but that is okay.

Q179 Mr Love: It is the standard rate.
Ms Brivati: Yes, the standard rate, thank you.

Q180 Mr Newmark: I am just curious, and we touched on this yesterday, have the recent figures on the number and the pay of public sector workers ultimately affected this figure, ie, as the public sector expands, the public sector pension liabilities ultimately will increase?
Ms Brivati: Well, we have published alongside our PBR documentation our long-term fiscal report and we give our latest estimate about what the long-term impact of our current liabilities and stance on pensions and pay is, and that shows it rising to 2% of GDP over the next 50 years which we deem to be affordable and sustainable, so we have taken it into account over the long term.

Q181 Mr Newmark: My third question is to do with the timing issue of this whole air passenger duty thing.[1] I noticed that air passenger duty is actually going up in February rather than April which is unusual, is it not, because usually things begin at the financial year and I am wondering why it is happening, how many holidays will be affected, and what revenues will be raised?
Mr Neale: There is no iron law about when tax changes come into effect. We have chosen to implement this particular change to air passenger duty from 1 February.

Q182 Mr Newmark: Is there a reason for that? Do skiing holidays for middle-class people have anything to do with it or anything?
Mr Neale: It is a matter of judgment based on the information we have about the proportion of flights that are pre-booked at any particular time and the Government's policy and revenue objectives.

Q183 Mr Newmark: They are pre-booked, so you should have an idea then of (a) how many passengers are affected and (b) how much revenue will actually be raised between that figure of February, which is an unusual date to begin this, versus the beginning of the financial year.
Mr Neale: The information we have is that roughly 30% of air passengers have booked more than two months in advance, so that would give you an indication of the number of passenger flights affected, but it is quite important to emphasise that air passenger duty is not a levy on individual passengers, it is a tax on airlines which airlines on the whole tend to collect by collecting from individuals.

Q184 Mr Newmark: But it is still ultimately affecting people who are flying, so you should have an idea of how much you are going to raise.
Mr Neale: Well, it will be for airlines to decide how they pass it on.

Q185 Mr Newmark: You are in the numbers business, so you must have done an analysis. In your decision to decide suddenly to raise it in February versus April, I assume you recognise that there are going to be people who will be travelling quite a lot over that mid-winter period.
Mr Neale: Yes, the point I am making is how that is passed on to passengers is a matter for the airline.

Q186 Mr Newmark: That is not the question I am asking. I have asked you a specific question on the timing. It is unusual timing; usually it begins in April, not February, and you must have done an analysis of roughly how many people are going to be affected and how much more money you are going to raise with that.
Mr Neale: I have given you an indication of the proportion of passengers who are likely to have booked more than two months in advance. We think the revenue raised in respect of those passengers rate will be about £50 to £100 million—

Q187 Mr Newmark: So you are not going to give me any figures?
Mr Neale: We reckon the rates will be between £50 and £100 million.
Mr Newmark: Thank you very much.

Q188 Mr Fallon: Can you just explain to me, Mr Neale, what the Parliamentary and statutory authority will be for collecting APD at the new higher rate from 1 February in advance of the Budget and the Ways and Means Resolution?
Mr Neale: It is a perfectly standard procedure. The Finance Bill will contain the provisions to implement the tax and it will begin on 1 February. It is quite standard practice for a Finance Bill to contain provisions that actually come into effect earlier.

Q189 Mr Fallon: But in the previous financial year?
Mr Neale: Yes, it is not unusual.

Q190 Jim Cousins: The figure has been given to us of a public sector pension liability of £530 billion. I just wonder what we know about the distribution of those liabilities across the public sector workforce,

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because it is plain that people with long periods of service at a higher rate of pay will make up those liabilities to a much greater extent than those on low pay with short periods of service. Indeed, there may well be public sector workers who are not even members of the public sector pension scheme. I wonder what we know about the distribution of those liabilities across the workforce.
Ms Brivati: I will try to tell you what we do know about the distribution of pension liabilities. The way in which we take account of the management of the public finances and the need to manage public finances against future pension liabilities is to look at the future net cash payments that are required from the schemes that exist, and all departments publish the net cash payments in their departmental reports. That will give you one indication of the distribution there.

Q191 Jim Cousins: That does not tell us anything about the public sector workforce and who are the main beneficiaries of future prospective pension payments. Plainly, workers on low pay with short periods of service will not benefit to the same extent as workers on high pay with long period of service. I just wondered what we knew about the distribution of those liabilities across the workforce in those terms.
Ms Brivati: I am not sure if that is a question about the distribution of the liabilities rather than a question about the distribution of the benefits of public service pensions. I do not think I have any data on that.

Q192 Jim Cousins: Do you collect that sort of data?
Ms Brivati: I do not know. I can look into it and get back to you.[2]

Q193 Chairman: Can I ask Mr Neale, are there any other instances in the past where your rates of tax or duty as opposed to technical tax avoidance measures have come into force soon after the Pre-Budget Report and been given retrospective Parliamentary authority after the Budget?
Mr Neale: It is quite common for us—

Q194 Chairman: Are there any instances?
Mr Neale: I will have to come back to you on specific instances, but it is quite common for us to announce an anti-avoidance measure having effect from the time of the announcement, and then—

Q195 Chairman: That anti-avoidance measure is different. I have asked for something different from technical tax avoidance measures; I am asking for instances in the past when new rates of tax or duty have come into force. I wonder, Mr Cunliffe, if you could write to us this evening so that, before the Chancellor's appearance tomorrow, we can have that information?

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Mr Cunliffe: We will do our best.

Q196 Chairman: You say you will do your best. Will you do it?
Mr Cunliffe: If we are able to write to you of course we will.

Q197 Chairman: I am looking for instances here. If there are no instances then you write to us and tell us there are no instances; if there are instances and examples you write and give us them. It is dead simple.
Mr Cunliffe: I accept that, yes.

Q198 Mr Fallon: Could we now turn, Mr Cunliffe, to the forecasting errors which you have made over the last year. The Budget 06 was nine months ago, but if we turn to Table B12 we will see that already, in nine months, you overestimated tax receipts by nearly £5 billion: £200 million National Insurance; £700 million in Corporation Tax, £500 million in VAT and £2.8 billion in North Sea oil revenues. How did you get it so wrong?
Mr Ramsden: Just to clarify from Table B12, you are referring to our forecast for 2007–08?

Q199 Mr Fallon: I am referring to the difference in what you forecast nine months ago and what you published on Thursday. These are forecasting errors for 2007–08 of nearly £5 billion. How did you get it so wrong?
Mr Ramsden: Actually, if you take out North Sea revenues the forecast error is significantly smaller. Remember, we are talking about a period that at Budget 2006 was not due to start for a year. If it would help the Committee, I can explain what happened on North Sea revenues. As we detailed in the Budget document at some length, at the time of the Budget we were forecasting a significant increase in North Sea revenues in 2007–08 consistent with the trend of the last two years. Since the Budget 2006 forecasts were finalised, and over the last few months, we have had a lot of new information all of which has actually contributed to bringing down our forecast. In terms of the impacts they have had, we have had a significant fall in the data for oil production. There is an underlying long-term declining trend in oil production which averages, over the projection period, about 3% a year, but it has actually, in 2006, been significantly in excess of that. We have had to fully factor those lower production estimates in. Second, this Committee has discussed with us before what we are assuming about capital investment in the North Sea, and what has happened is that capital investment has come in much higher than we were forecasting and, also, operating expenditure in the North Sea has come in higher, reflecting the tightness of the market for, basically, the kit that operators use and the labour needed; it has been much more costly. That is important because both capital expenditure and operating expenditure are 100% deductible against tax. The final thing that has happened is that although, as we account in the document, the oil price has risen in Dollar terms, because of the

movements in the Sterling/Dollar exchange rate the Sterling oil price, which is what drives UK tax revenues, has been weaker. So that has had a big impact in the baseline year in 2006–07. So those three factors together—lower production, higher investment and what has happened on Sterling prices—has led to that £2.8 billion change in our forecast. I might just say that for 2005–06, at Budget 2005, we were forecasting that North Sea revenues were going to be about £7.5 billion; they turned out to be nearly £10 billion. All that is meant to illustrate is that at the moment, with everything that is happening in world oil markets and, also, with changes that we have been making to the North Sea regime, it is quite difficult to forecast the North Sea.

Q200 Mr Fallon: You set this out at great length and there is a box explaining it at great length, so it confirms my belief that the longer the explanation the more serious the error. You are supposed to be good at forecasting this stuff. You said North Sea oil revenues would be £13.5 billion and, in fact, they are going to be £10 billion—that is a 21% error in just nine months. Why did you not forecast all these things would happen?
Mr Ramsden: We did our best.

Q201 Mr Fallon: You did your best? A 21% error?
Mr Ramsden: At the macro level what we were trying to do at Budget 2006 was take account of the fact that there were significant increases in oil prices which were leading to significant increases in investment, and our assessment was it would lead to less of a fall in production. That investment would feed through into production. Indeed, our forecast still showed that happening in the medium term, but it has not happened in the short term. It is a forecasting error and we are extremely transparent in accounting for it.
Mr Cunliffe: If I can just make a couple of general points, the difference in that year between Budget and PBR, taken overall, is 0.12 billion on the plus side. If I can make another point, it is that, as we have reported to this Committee before, I wish we could forecast 18 months out with complete accuracy. We cannot. No other forecaster in the world can. Our fiscal forecasting record compares quite well with other forecasters—better than the Americans and better than most Europeans—and our economic forecasting record compares quite well. When you are asking the question that you have had an unprecedented rise in the oil price and you are trying to work out what effect that will have on one part of the global oil picture, you can make assumptions and you can have models but whether 18 months out you can predict that with accuracy I would very much doubt. I would very much doubt that we could find a similar example in UK or other history where that sort of thing is forecast with 100% accuracy. It is sensible to look at our overall forecasting record on public sector net borrowing, but if you want to look at the forecasting record for individual components of that, I think you then need to look at it against other forecasters.

Q202 Mr Fallon: This is a very big component and you are supposed to be making cautious forecasts. Let us turn to inflation. In March you said it would be 2.65% in September and it turned out to be 3.6% in September. That has added another £1.5 billion a year to your pension and social security bill. How did you get that wrong?
Mr Cunliffe: I think our forecast for inflation in March was very similar to the Bank of England's forecast and very similar to other commentators' forecasts. I am afraid the point about forecasts is that they do not give you 100% accuracy. When one is dealing with a very large price shock on oil and trying to work out how it will go through to the economy and the extent to which it will come through to inflation, that it a very big puzzle for the Bank of England, and it is a puzzle for us as well.

Q203 Mr Fallon: If you had not got all this wrong by £5 billion a year you would not have had to put up taxes by £2 billion from April. So all our constituents are having to pay for these errors.

Mr Cunliffe: The taxes were forecast. They were in the equation. We had the same revenue forecast going forward but, unfortunately, you have to base your forecasts on the past, and when you are dealing with areas of large uncertainty, such as how does the world respond to a big oil shock, you cannot take the uncertainty away.

Q204 Mr Fallon: So I am right: last Wednesday you had to increase taxes next year by £2 billion a year because of forecasting errors of £5 billion.
Mr Cunliffe: No, I do not think that is right at all.

Q205 Mr Fallon: Why are taxes going up by £2 billion a year?
Mr Cunliffe: I think last Wednesday the PBR set out the fiscal position for the next three years, which includes some tax increases and it includes some revenues with shortfalls, but I think to assume that there is a direct causal relationship between the two is not right.

Q206 Mr Todd: Can we turn to the Gershon Review and progress on it. First, if I quote the Chief Secretary from five days ago, he said: "It is important that we provide full information on the programme because the more transparency there is the better the chances of success". Is that information that is contained on 140–141 the sum total of the disclosure about this subject that we are going to be entitled to?
Ms Brivati: If I may try to answer that, there is some information in the PBR document about progress in the Gershon programme. This gives the latest achievement on Gershon, which is that we have, so far, reached £13.3 billion of efficiency gains against our £21.5 billion target. It is not the sole total of information that will be available because departments will publish in their departmental reports individual departmental achievements and contributions to that target.

Q207 Mr Todd: Bearing in mind the difficulty of both getting a consistent picture across a wide range of departments with slightly different ways of delivering this and the need to impose some methodological consistency anyway on how these things are measured, would it not be rather better to have a coherent government picture of delivery in this rather than relying on individual departments to say it in their own specific words?
Ms Brivati: The reason we rely on departments to report their own progress against targets is that those targets are departmental targets and the Secretaries of State for those departments have accepted those.

Q208 Mr Todd: This programme was announced in a huge fanfare and then subject to large-scale political competition at an overall corporate level in government. I think it is not unreasonable to expect some consistent overview other than the overviews already brought about by the NAO and, to some extent, by Public Accounts.
Ms Brivati: Departments remain accountable for their targets, and that is an important point in terms of ensuring delivery of the targets. We do aggregate the numbers to report overall progress and that is why we are reporting it in the PBR. As you say, there are methodological issues which we continue to explore with the NAO about how best—

Q209 Mr Todd: So the answer to my question is we wait until the NAO produce their next report on how you are getting on?
Ms Brivati: No, that is not the answer I am giving you. I think the answer I want to give you is that there is more information in the public domain about the methodological issues and how we approach those, which is publicly available on the OGC website, for example. We hope that that illuminates the issues about how progress and efficiency is measured.—

Q210 Mr Todd: Let us take the little bit that we have been given in this exercise. Of the reported savings of £13.3 billion, the Chief Secretary gave information on 7 December that total savings of £8.4 billion were attributable to three work streams but did not give us any information on the remaining work streams and how those broke down. Can you give us some information on that?
Ms Brivati: I do not think I have that breakdown with me.

Q211 Mr Todd: Local authorities are expected to meet their Gershon efficiency target a year ahead of target. What incentives are there to achieve that?
Ms Brivati: What incentives are there on local authorities to achieve it?

Q212 Mr Todd: Yes.
Ms Brivati: Local authorities operate under the same sorts of incentives as other public sector bodies.

Q213 Mr Todd: Are we going to await the same reporting framework for them as for individual departments, so we will hear from all the individual local authorities how they have been getting on?
Ms Brivati: It has been our practice to subsume the local authority efficiency achievement in departmental progress.

Q214 Mr Todd: How is that going to be achieved, with all the local authorities around the country achieving these savings in their own different ways without any coherent audit framework across them?
Ms Brivati: I do not think I would agree with you that there is not a coherent audit framework for that. The way in which efficiency gains are measured by the OGC, which reflects the advice we have had from NAO, takes that difficulty into account the difficulty—and it is a difficult matter to attribute local authority efficiency progress to department totals—but that is the way we have done it over the course of the programme so far.

Q215 Mr Todd: There is a risk, of course, which the NAO have identified, that this programme will actually deliver lower quality services. Indeed, there have been comments that that has actually happened. To what extent is that taken into account in the way in which you examine the success or otherwise of this programme?
Ms Brivati: It is taken into account. We have been conscious from the outset that that is a risk in terms of pursuing and delivering efficiency savings.

Q216 Mr Todd: Is it a risk that has been delivered in reality?
Ms Brivati: The answer to that must be no, because the precautions we have taken have been to include measures of service quality as part of the assessment that is made when the OGC are assessing whether an efficiency saving has been made. So in order to know whether an efficiency saving has been made rather than a service cut been delivered, that will be clear.

Q217 Mr Todd: Bearing in mind the straitened circumstances of the Department of Health budget at the moment, does the saving of £3 billion in the last 18 months suggest that this programme is being achieved without pain?
Ms Brivati: The circumstances of the Department of Health budget and the reasons for what is going on in the NHS are many and different—

Q218 Mr Todd: There is no contributory factor from the Gershon review in this process?
Ms Brivati: I would hesitate to make a direct link between the two.

Q219 Mr Todd: There seems to be a slight contradiction over the relocation of civil service posts. The Chancellor said that—a very precise figure—10,179 posts had been announced for relocation, but your own document gives a rather rounder figure of 10,500 having actually been relocated. Which is true?

Ms Brivati: The figure I have is that 10,574 posts have been relocated out of the South East.

Q220 Mr Todd: So he has both given a lower figure but, also, suggested that these have not actually been relocated but have merely been announced for relocation. Bearing in mind that relocation was partly, presumably, about delivering savings in establishment costs in lower-cost locations, has there been any evidence that that has actually happened? Or that it has been easier to recruit or retain people who have been relocated to those locations?
Ms Brivati: The purposes of the relocation programme are many. As you say, it is partly to benefit from lower-cost locations, it is partly to do with enjoying the benefit of different labour market conditions in other parts of the country and partly to do with the possible benefit to local economies of locating significant government operations out of London. I do not have any information to hand about the benefits realisation on that.

Q221 Mr Todd: Just finally, the headcount reductions area has been a chancy one right from the start. Have we got a clear picture of exactly how many headcount has been reduced in this programme?
Ms Brivati: I think we have. There have been gross workforce reductions of 54,963 posts since the start of the programme against a target of 84,100—

Q222 Mr Todd: That is the gross picture?
Ms Brivati: Yes, that is a gross picture. Those are the terms in which the target was expressed when it was announced at the end of SR04.

Q223 Angela Eagle: On the issue of delivery of high-quality public services, there are some eye-wateringly tight efficient targets announced here, are there not: the usual 3% per year in baseline savings for central and local government? Do you anticipate that it is just going to be 3% forever? Is the Treasury view that it is possible to achieve 3% efficiency savings every year in public administration forever, because that has been the assumption for the last few years and continues for the next three? There is also a 5% reduction in real terms in administration budgets across departments. That is a very demanding target. How do you see it being done without any pain in terms of service delivery?
Ms Brivati: The efficiency ambition in the SR04 period was for 2.5% and, as you say, in the CSR07 period it will be for 3%. I cannot speak about forever because our planning horizon only extends over the CSR period. You also mentioned the 5% administration budget limit. It is a stretching target, but the reason why we believe it is achievable and necessary is that the Government wishes to continue prioritising resources for frontline services.

Q224 Angela Eagle: I understand the argument and support the argument of prioritising frontline services, but have these figures just been plucked out of the air as a sort of: "That will be okay; we will do that this year", or has there been some research work to see whether they are achievable?
Ms Brivati: The figures on efficiency, for example, have been thoroughly researched. In the context of our preparation for the CSR, departments have been conducting zero-based reviews of large and significant areas of their spend, and the progress that departments have made on that, the discussions we have had with them, the data and the evidence that they have gone over in order to work towards these ZBRs has informed the development of these targets.

Q225 Angela Eagle: Why are they the same across all departments then? It is a bit like the bank charges are the same across all banks. Why is the 3% target the same across all departments and the 5% target the same across all departments if you have been researching with each department? It looks like a figure plucked out of the air to me.
Ms Brivati: As I say, these numbers are based on highly researched zero-based reviews and we believe that this is the right number for the CSR period.

Q226 Jim Cousins: In answer to an earlier question you said that one of the benefits of relocation (and I wrote it down) was "to enjoy the benefits of different labour market locations".
Ms Brivati: Different labour market conditions.

Q227 Jim Cousins: "Conditions". Thank you. Does that mean simply that you pay people less in Rochdale and the Rhondda?
Ms Brivati: I have got no idea what we pay people in—

Q228 Jim Cousins: What did you mean by that remark?
Ms Brivati: What I mean is that like any employer the Government would need to deliver good value for money in the way it spends money.

Q229 Jim Cousins: That remark meant that you were going to pay them less after you have moved them.
Ms Brivati: No.

Q230 Jim Cousins: You pay the post-holders less after you have moved them.
Ms Brivati: No, that remark meant that, like any employer, the Government needs to get value for money out of its pay bill and take account of where it can do that.
Mr Cunliffe: You can often solve recruitment and retention difficulties or get a better motivated and skilled workforce by relocating as well. Department decisions are not just about cost; it is also about the sort of workforce that is available.

Q231 Jim Cousins: Is it the case that the Public Sector Pay Committee is committed to the introduction of regionally variable pay?

Ms Brivati: It has been government policy to seek local variation in pay, and that has been policy for some time.

Q232 Jim Cousins: So you are going to pay people less because they happen to live not in London but in the regions?
Ms Brivati: It has been government policy to seek local variation in pay that reflects local labour market conditions and the requirements of different public sector employers in those areas.
Mr Cunliffe: We already pay people less because they do not live in London and the South East, because we recognise the higher cost—

Q233 Jim Cousins: You pay London Weighting because they live in London.
Mr Cunliffe: People outside London may feel—

Q234 Jim Cousins: Paying people London Weighting because they live in London is entirely a different project from breaking up national pay bargaining. So you pay people less because they live in the regions. That is an entirely different project.
Mr Cunliffe: You pay people in line with the labour market. You pay what is necessary to recruit, retain and motivate.

Q235 Mr Gauke: Public expenditure plans going forward. The IFS has stated that your forecasts imply that growth in the Government's total managed expenditure would be 1.9% between 2008 and 2012. Do you agree with that assessment?
Mr Cunliffe: We have set out what the planning assumptions are, I think, in here, and therefore 2%, 1.9% and 1.9% for the CSR years.

Q236 Mr Gauke: Broadly, you do not disagree with the IFS view?
Mr Cunliffe: I think the IFS is just reading what is in the document.

Q237 Mr Gauke: But it is not under dispute? I was not particularly expecting you to dispute it. That is correct?
Mr Cunliffe: Yes.

Q238 Mr Gauke: Within that, presumably, there will be variations within departments, and that is what the CSR will determine. If I can just focus for a moment on education spending, the Chancellor has an aspiration, which he announced at the last Budget, to get total spending on education per pupil up to the levels within the independent sector of 2005–06—ie approximately £8,000. Do we know yet at what point that aspiration is going to be met?
Mr Cunliffe: I will ask Mridul to come in on the aspiration, but just on the spending assumption, it is set out on page 223 of the PBR. I did not catch exactly what the IFS said, but the assumptions are set out there.
Ms Brivati: You asked about the Chancellor's aspiration set out for funding. There is no date on that; when the Chancellor announced that at the Budget he made clear it was a long-term ambition.

Q239 Mr Gauke: Has the announcement in the Budget of extra spending, which the Chancellor made, taken us substantially closer to meeting that aspiration?
Ms Brivati: Taking together the announcement in the Budget and in this PBR—

Q240 Mr Gauke: Looking specifically at the announcement in the PBR.
Ms Brivati: We have now made progress on the capital side with the announcement on capital spending in the PBR.

Q241 Mr Gauke: How much of the capital spending announcement in the PBR relates to schools and how much to colleges and universities? The evidence we received from the IFS yesterday was suggesting that it essentially related to colleges and universities and not schools.
Ms Brivati: The total amount of spending relates to both schools and colleges and universities.

Q242 Mr Gauke: But the additional amounts.
Ms Brivati: The additional money is £250 million for FE colleges.

Q243 Mr Gauke: So the additional capital expenditure announced by the Chancellor in the PBR relates to FE colleges, not schools?
Ms Brivati: The announcement in the PBR related to schools and colleges and was a capital settlement for the Department for Education and Skills.

Q244 Mr Gauke: Is it possible to break down the announcement in the PBR? How much of that money is going to schools for capital expenditure?
Ms Brivati: I have that number but not readily, if you would let me come back to it.[3]

Q245 Mr Gauke: I would be grateful. Would you be able to give it to us this morning?
Ms Brivati: Yes.

Q246 Mr Gauke: I would be grateful for that. On current spending on schools, what is the new money there that the Chancellor announced in the PBR?
Ms Brivati: Let me search my brief and find that for you.

Q247 Mr Gauke: One final question: the Chancellor's aspiration relates to independent schools. He has also talked about the capital spending figures for independent schools. On what basis does the Treasury determine what the figures are for independent schools? There has been some press comment, certainly, that independent schools are at a loss to know where the Treasury is getting the numbers from. I would be grateful to know.
Ms Brivati: We use a variety of data sources, including from the collective body which represents independent schools—whose name escapes me for the moment.

[3] Ev 81

Q248 Mr Gauke: Anything else? You say a variety of data sources.
Ms Brivati: Data provided to us by the Department for Education and Skills, for example.

Q249 Mr Mudie: Staying on education, can I take you to page 147. You refer to a long-term programme of refurbishment and replacement of secondary schools, you say over 15 years. You refer to the secondary schools as "over 15 years", but in the preceding paragraph, for primary schools, you say "over around 15 years". Why the hell "over around" for primary, and what does "over around" mean in accountancy terms? Why do you not just put the additional word "maybe over around" and it would make it even clearer?
Mr Cunliffe: We are gratified the documents are read that closely, but do we know the answer?

Q250 Mr Mudie: It was in last year's Budget book as well—"over around". It would be useful if you had a look at that. We will accept "maybe" in future but "over around" seems hedging your bets, in a way Mr Fallon would certainly not accept in order to prevent forecasting errors. However, aspirations in targets, etc, etc When did the 15 years start for each? We do not want a Golden Rule here, where we discover it starts next year or it started—when did it start?
Ms Brivati: I think the *Building Schools for the Future* programme began in the SR04 period or, possibly, SR02 period.

Q251 Mr Mudie: Which would give me a starting date of when?
Ms Brivati: Of 2004–05. Let me check that. I would not want to give you—

Q252 Mr Mudie: Is that for secondary?
Ms Brivati: That is for both of them.

Q253 Mr Mudie: I will give you the context in which I ask this question. The Chancellor brought forward the Millennium Goals and we were going to give education to every Third World child, etc After a few years this Committee actually pinned the Chancellor down to accept that at the current rate of progress it would take 120 years for some of the goals to be achieved. What are we doing with these schools? For example, how many secondary schools do we have? Do we know? Do you know how many primary schools we have?
Mr Cunliffe: We have that information but I do not have it with me, no.

Q254 Mr Mudie: We are anxious to know. We have got a 15-year programme to refurbish or rebuild. How many have we done at what individual cost? I am coming on to child poverty figures: are we below or above? Do we know? Do you know?
Mr Cunliffe: I do not have the—

Q255 Mr Mudie: Why not? Are you not in charge of the Budget? If you put a 15-year programme on but we do not know how many schools, I presume you do not know the average cost of the refurbishment or rebuild. After two or three years with this programme in being we do not know where we are relative to the target.
Ms Brivati: It is known it is just that we do not know.
Mr Cunliffe: We can certainly write to you—
Mr Mudie: Some aspiration.

Q256 Mr Todd: Somebody knows.
Ms Brivati: They are in the Department for Education and Skills, who are in charge of this programme.

Q257 Mr Mudie: Another aspiration. How much have we spent on academies and is that part of the same programme, part of the same budget? They are costing £25 million each. How many have we done? Are we on target? Are the figures in this Budget book, ensuring that the target of 200 academies is met, on target? How do we know?
Mr Cunliffe: I make a general point that these programmes are for the Department for Education to carry through.

Q258 Mr Mudie: I am sure they are but they cost money and you give them the money.
Mr Cunliffe: Yes, that is true; we give money right across government for a range of targets that are reported on by individual departments. We will certainly come back to you.

Q259 Mr Mudie: Jon, what do those words mean, they are a matter for the department? First of all, they are matter for you because you are paying for them.
Mr Cunliffe: The carrying out of the programme and implementation is for the department.

Q260 Mr Mudie: Yes, but if they are below or above the programme target it is extremely important for you to know, is it not?
Mr Cunliffe: At certain times we do know, we just do not have the figures—

Q261 Mr Mudie: These figure here, in the financial years that we are fairly firm about, do they mean all the targets are being met in terms of the programme of rebuilding primary and secondary schools plus the academies?
Mr Cunliffe: The safest way to do this is for us to come back to you.

Q262 Mr Mudie: So you do not know.
Mr Cunliffe: I do not have those figures.

Q263 Mr Mudie: Do these figures in the overall Budget totals have built in the further aspiration the Prime Minister made in the last two weeks to build another 200 academies? In other words, another £5 billion expenditure. Was that just an aspiration, just a speech, just part of a legacy, or is it in the Budget book?
Ms Brivati: Let me try to tell you what we do know about expenditure both on *Building Schools for the Future* and on academies. The point about what has been achieved so far is that we do not have

information with us but it is known and knowable. The point about the future is that future expenditure on both *Building Schools for the Future* and academies will take place over the CSR period, for which allocations have not yet been made. So these are programmes and aspirations that will have to be met within the spending envelope for the CSR.

Q264 Mr Mudie: I understand that, and I think we would welcome the figures, but if we put in a book that there is a 15-year programme we ought to know where on earth we are with the programme, how much the programme is going to cost and the individual costs. If we are to scrutinise public expenditure you are not helping us do it with Budget information like this. If the Prime Minister says: "I am just going to give a speech and commit ourselves to another £5 billion" I would like to know where it is in the Budget book. I will move on to less controversial information—child poverty. You missed your targets—surprise, surprise—on child poverty. You were supposed to get a quarter of them, you have only got 17% of them. What is in the Budget book that demonstrates you have learnt your lesson and that you are going to meet the next target?
Mr Neale: Just to put the child poverty figures in context, we, in fact, reduced child poverty by 700,000 between 1998 and 2004—

Q265 Mr Mudie: Mark, I wish you would not do that.
Mr Neale: We have got reversed a circular trend in the other direction—

Q266 Mr Mudie: That is a politician's answer. We will get that from the Chancellor tomorrow. That is a politician's answer. The other side of the coin is that because we missed the target, a target that was set by the Government, 400,000 children are still in poverty. You can explain it away by "700,000 are not" but 400,000 are that should not be because we missed the target. Mistakes happen, but what do we learn from it? What is in the PBR that will ensure we pick up this and also get to the next target?
Mr Neale: The Government published a strategy for tackling child poverty in 2002 and that has a number of legs to it. One leg is round increasing participation in the labour market, and there are a number of announcements in the PBR that bear on that, including continuing with the Work Credit for lone parents in those areas where that is being tried out. Another leg of the strategy is around income transfers through Child Tax Credit, and the PBR confirms that the child element of the Child Tax Credit will be worth £80 more from April, reflecting the rise in line with earnings that the Chancellor announced in the Budget. The third leg is to do with tackling opportunities for children, and the Comprehensive Spending Review is looking at the programmes that bear on that.

Q267 Mr Mudie: You are quite confident in the Treasury that you have costed all these, you have worked them out and that they will deliver the targets?
Mr Neale: The Government remains committed to the 2010 target—

Q268 Mr Mudie: I know they remain committed to a target. I asked you, first of all, what is in the PBR to ensure that we do meet this very, very important target. You have spelled things out and Government Ministers always spell things out—they are never lost for words—but will they do the job? Are you saying to this Committee that the Treasury are quite clear that these steps will be sufficient to meet the target?
Mr Neale: I do not think we would ever say that the measures in any single PBR or Budget on their own will deliver a target, but there is a clear strategy for delivering that target. We will take stock of progress over time because progress is affected by movements in earnings and there will be measures in future PBRs and Budgets.

Q269 Mr Mudie: How confident are you that tax credits are the most effective mechanism for dealing with child poverty? To be specific, what modelling have you done to satisfy yourselves that increasing tax credits is more effective than, say, increasing child benefit or personal tax allowances?
Mr Neale: They are one mechanism among a number. We certainly have modelled the impact of increases in child benefit and in tax credits, and raising the child element of tax credits is a more cost-effective way of raising the incomes of low income families than increases in child benefit.

Q270 Mr Mudie: So you have actually done some modelling?
Mr Neale: There is a great deal of modelling that bears on this, yes.

Q271 Mr Mudie: You have done modelling along the lines of and in the context of my question, comparing tax credits to child benefit? Have you done that?
Mr Neale: We certainly have.

Q272 Mr Mudie: Specifically?
Mr Neale: Specifically.

Q273 Mr Mudie: Can you provide us as a Committee with the information?
Mr Neale: We can provide you with a note on the relative cost-effectiveness of increases in child benefit versus increases in tax credits, yes.[4]

Q274 Mr Mudie: If that answers and says yes to what I asked, I am happy. Does it? He used different words to me and when a civil servant uses different words to me, I wonder if he is promising me something different to what I asked.

[4] Ev 83

Mr Neale: I am promising you what you asked.

Q275 Mr Mudie: Good. In our Report on the 2006 Budget we recommended that you analysed the characteristics and income distributions of households facing marginal tax rates in the region of 60% to 70% and to the extent these tax rates discourage people from entering the workforce, et cetera. We also recommended that you published your findings at the time of the PBR. Where are you with our two recommendations? First of all, did you do the analysis?
Mr Neale: Yes, we have a great deal of standing analysis of the impact of marginal deduction rates.

Q276 Mr Mudie: I know you do a lot of analysis but this was a specific recommendation from us on a specific piece of evidence. Did you do the analysis as I have spelled out; yes or no?
Mr Neale: I will have to check with my colleagues whether we have done the precise piece of analysis for which you asked and we will let you know the answer to that question.[5]

Q277 Mr Mudie: Of course this really pushes you to say that you did not do it but if you did not do it, we would like to know why. Secondly, if you did, we asked you to publish it at the time of this PPR and we would like to know why you did not do that.
Mr Neale: What we have published is a table on page 98 of the PBR document which sets out the impact of the Government's reforms on marginal deduction rates.

Q278 Mr Mudie: Okay. Bombing on to tax credits, you were going to introduce a computer system that would change the system where people are having to pay money back.
Mr Neale: Yes.

Q279 Mr Mudie: You were going to have automatic limits on the rates of recovery and it was going to take effect in November. There is a statement made by the Paymaster General which if you read it carelessly suggests it is going to happen in April next year.
Mr Neale: That is what the Paymaster General has asked HMRC to achieve.

Q280 Mr Mudie: In her statement she actually says "introducing fully automatic limits remains a key priority" but then says "and from April 2007 I have instructed HMRC to introduce an IT solution to ensure that claimants will benefit from reduced rates of recovery without them having to ask for this service." That wording when you look at it closely does not exactly say it will happen in 2007. If she is asking them to do and she spells it out, why is she just not saying that this will happen in April 2007? Is she asking the Revenue people to actually have that as an objective but in the meantime do something else from April 2007?

Mr Neale: The Paymaster General is asking HMRC to try to ensure that by April there is an IT solution that ensures that these rebated recoveries are in place and, yes, there is an interim solution meanwhile. HMRC from January will be identifying members of the public who might need this service and be offering it to them, but not using the IT.

Q281 Mr Mudie: Okay. The Paymaster General said that a small proportion of claimants may experience disruption in their payments following the processing of changes in their circumstances. Which claimants are affected and why?
Mr Neale: I am afraid I cannot answer that.

Q282 Mr Mudie: Has the Government considered cancelling all demands for repayments until these automatic limits are put in place?
Mr Neale: I do not think it would be appropriate to cancel all demands for repayment because not all households will be facing hardship and difficulty. I am afraid I cannot answer your first question; we can let you have a note on that.[6]

Q283 Mr Mudie: There is this business of the migration of the families on income support or jobseeker's allowance. Tax credits have been running for four years. They are supposed to be migrated across. When will they be migrated across?
Mr Neale: They will be migrated across as soon as the IT is robust enough to permit that to happen without risk or any interruption to their income.

Q284 Mr Mudie: This has been promised and promised or threatened and threatened. In other words you are still not able to give us a date, time and place?
Mr Neale: I cannot give you a date. The most important thing is that these people do not suffer an interruption to their income and we are not willing to take risks until we are sure the IT will work.

Q285 Mr Mudie: Adam Sharples, Director General, Work, Welfare and Equality—one of your protégés I think, I remember he graced these tables—is at DWP now and on 6 February he said he had a timetable with HMRC. The plan was to migrate the remaining families between July of this year 2006 and April of next year 2000. Which part of the Government is accurate? He says he has a timetable with you; you say you do not have a timetable.
Mr Neale: The Paymaster General is accurate because that is the timetable that we have elected to change in the light of what we now know about the IT and its robustness.

Q286 Mr Mudie: Let us be clear. Adam Sharples is right, he is singing off the same hymn sheet as you, so by April of next year they will be migrated?
Mr Neale: No, the timetable has been changed because we cannot be confident—

[5] Ev 83–84

[6] Ev 83

Q287 Mr Mudie: Since February this year?
Mr Neale: Yes since February because we cannot be confident that the IT is robust enough to permit that transfer to take place without interrupting people's income.

Q288 Mr Mudie: Why is the extension of child benefit to mothers-to-be set for April 2009 instead of implemented? Is it finance or is it IT?
Mr Neale: I do not know whether there is an IT issue there. We will let you have a note on that.[7]
Mr Mudie: Thank you, Chairman.

Q289 Jim Cousins: George, you are still Deputy Chief Whip material! Alternatively secured pensions: how much extra tax revenue are you going to raise by introducing the punitive regime for alternatively secured pensions that was set out in the Pre-Budget Report?
Mr Neale: I cannot tell you off the top of my head what the revenue implication of that is but what it is not is a punitive regime. The Government introduced alternatively secured pensions for a specific purpose, namely to provide an alternative way of guaranteeing an income for people who have a principled objection to pooling mortality risk. It was not designed to enable tax reliefs to be used to build up capital sums for people to pass on when they die.

Q290 Jim Cousins: Of course it is very difficult sometimes to see what the design framework of some of the Government's proposals is. You tell me that alternatively secured pensions were apparently introduced to meet the needs of one particular, rather small religious group. Did it not occur to anyone, Mr Neale, in government that they would also meet the needs of people who had serious terminal or chronic illness and might find the annuity regime very restrictive for them and might find the alternatively secured pension regime a much fairer and more attractive one? Did that not occur to anyone in government?
Mr Neale: I do not think, if I may say so, that alternatively secured pensions have primarily been marketed to people with severe illnesses. They have been marketed—

Q291 Jim Cousins: Do you think the Government should introduce tax regimes that are specific to members of small religious groups and not realise that they also meet the needs of people who have terminal and chronic serious illness? Did that not occur to anyone?
Mr Neale: The Government's intention in introducing alternatively secured pensions was quite clear. It was to provide a facility for certain religious groups who do have a principled objection to pooling mortality risk. The reason the Government has taken the action they have is because they have been marketed primarily to wealthy people as a way of using tax relief to build up large capital sums to pass on on their death.

Q292 Jim Cousins: Do you not recognise, Mr Neale, that they have been marketed as you put it—and I hope you are not suggesting that the Treasury has any ideological dislike of marketing—but they have been taken up by people who have serious illness, chronic illness, terminal illness and for whom the existing annuity regime was deeply discriminatory for them? Do you not realise that that has happened?
Mr Neale: Alternatively secured pensions are still there; they have not been removed. What the Government has announced in these measures are certain steps to prevent the use of tax relief to build up large capital sums to pass on on death. The Association of British Insurers has welcomed the fact that we have retained alternatively secured pensions in that facility.

Q293 Jim Cousins: Mr Neale, I quite understand the Treasury's desire to micro-engineer people's behaviour and to pass judgment upon it. I think it is an extremely unfortunate tendency but one that I recognise is now widespread. Can I ask you simply to say what extra revenue this punitive regime that has now been linked to alternatively secured pensions is going to produce? Surely you must know that?
Mr Neale: I think the revenue impact is fairly small but we will let you have a note on the revenue impact of the measures we have taken on alternatively secured pensions.[8]

Q294 Jim Cousins: What about missing trader fraud; can you give an estimate of how much it is costing you and how much it is going to go on costing you?
Mr Neale: The PBR document sets out our latest estimates based on HMRC advice for 2005–06. It says that the revenue at risk, that is to say the level of attempted fraud, accounted for about £3.75 to £4.75 billion and the actual revenue lost was between £2 and £3 billion.

Q295 Jim Cousins: And you have no present useful plans to do anything about that, do you?
Mr Neale: HMRC has a comprehensive strategy for tackling MTIC fraud with a number of different elements to it. First of all, HMRC has an operational strategy, which is proving very successful, which consists of blocking repayments to businesses that are suspected to be implicated in MTIC fraud; blocking registrations of businesses that are suspected of being implicated; and tagging goods as they cross our borders to ensure that they cannot be used in a carousel and come round time and time again. That is the operational strategy. There is a comprehensive strategy of international law enforcement co-operation and we will be hosting a conference of our major European Union partners on MTIC fraud early next year. We signed earlier this month a bilateral agreement with the UAE to address MTIC fraud. Finally, there is a legislative leg which involves us getting a derogation from the European Union.

[7] Ev 83

[8] Ev 81

Q296 Jim Cousins: Mr Neale, all of that is reassuring. We now know the airlines are going to claw back some of the air passenger duty with the extra flights that are going to be taken as people implement these wonderful international strategies. Could you tell me how much revenue is going to be saved?
Mr Neale: I think the PBR does contain some numbers on that, at least the Budget document contains some numbers on that which we have not changed. Those numbers are associated with HMRC's operational strategy and with the obtaining of the derogation from the European Union bearing on those goods most commonly used in MTIC fraud.

Q297 Jim Cousins: Mr Cunliffe, can you tell me whether there has been any discussion inside the Treasury of the rate of corporation tax that will be variable in different parts of the United Kingdom tax jurisdiction?
Mr Cunliffe: I know of no such discussions.
Mr Neale: There is no such discussion, no.

Q298 Jim Cousins: Thank you, Mr Neale. There is not even a strategy for it?
Mr Neale: There is no such discussion.

Q299 Angela Eagle: The Stern Report recently heaped praise on the EU Emissions Trading Scheme as a very innovative way of beginning to put in place some of the market-based structures that we need to move from a high to a low carbon economy, and yet when we look at the way it is operating, only four out of the 25 Member States actually issued permits that were at or below their current emissions levels, which has meant that in reality in its first year of operation there is a huge transfer of about 1.5 billion from UK business to Europe in having to buy up carbon emissions. What can be done to reverse this because we are being penalised for doing the right thing and the rest of Europe, including some very big producers like Germany, is not exactly rushing to make this system bite?
Mr Kingman: We entirely agree that there have been very significant teething problems with the development of the ETS and the Stern Review is also clear about that. I think we draw very significant comfort from the Commission's recent announcements on the national allocations where every country other than the UK had their provisional allocations rejected and the Commission is proposing to tighten up their allocations. That is absolutely vital to the working of the scheme.

Q300 Angela Eagle: This will not happen until 2008, will it? My understanding is that it is for the next round.
Mr Kingman: That is correct.

Q301 Angela Eagle: And therefore we are stuck with this issue at the moment.
Mr Kingman: That is correct but I think the analysis of the Stern Review, which has to be right, is that the EU ETS is in a sense the only game in town in terms of an international trading system that helps us establish a price for carbon and actually gets the dynamics that Nick described in his report.

Q302 Angela Eagle: At the moment the price for carbon permits is fluctuating widely. In a couple of weeks it has come down from €30 to €8. That is not driving technology change in the UK. It is just making it cheaper to purchase a load of possibly German permits, just to use one example, so that people can carry on as before exceeding emissions.
Mr Kingman: It has been volatile and it has also not been sufficiently tight, but there is no fundamental design reason about the scheme why that is necessarily so. What is needed is to get the allocation of permits right, and we are confident, as a result of the announcements made recently, that the Commission is getting a grip on this.

Q303 Angela Eagle: This is a market mechanism to try to price carbon. What also needs to happen, surely, is mechanisms which drive technological change for cleaner energy production. The Budget has some minor measures in that respect. Are you thinking of tax changes to try to drive investment in cleaner energy production technology?
Mr Kingman: We always look at tax changes that might help us meet our objectives. I think we are pushing on with a number of things in relation to innovation and environmentally friendly technologies, notably the creation of the Environmental Technologies Institute.

Q304 Mr Love: The Barker Review of Land Use Planning: have you made any estimates of the likely improvements in productivity and competitiveness that will arise if it is implemented?
Mr Kingman: No, we have not. I do not think it is possible—and Kate did try as part of her review—to try and isolate the impact of the planning regime on productivity. That is very difficult for all sorts of reasons. It is very clear, and it is clear from the analysis that others have done, the IMF and so on, that the planning regime is a relevant issue in the UK and that we need to get this right.

Q305 Mr Love: That is true because your website states quite clearly that the UK Trade and Investment Organisation says how important it is for companies looking to invest in the UK and the OECD makes a comment on it. If it is that important why has no estimate been made? It seems kind of strange. To put it mildly, it is probably going to be a quite a controversial change that we are making so surely we should have some justification at national level of how important this is?
Mr Kingman: I think there is ample justification in both the interim Barker Review and the final Review itself of why this matters. Isolating the precise impact on national productivity is simply an analytically undoable exercise.

Q306 Mr Love: You have already stated that 70% of the take from any introduction of the Planning Gain Supplement will be hypothecated to local use but it

does not specify that that should be local authorities. Can we take it that that it will go to the local authority?
Mr Neale: A substantial proportion will go to local authorities, yes, I think we have said 70%.

Q307 Mr Love: At least 70% and that will be to the local authority; it will not be for regional or national projects that happen to happen in their local area?
Mr Neale: That is for the local authority specifically to invest in the infrastructure needed to support new development.

Q308 Mr Love: Do you expect the yield from the Planning Gain Supplement to be greater than that currently estimated by the property industry, the £3 billion, that is raised from section 106?
Mr Neale: Yes we do.

Q309 Mr Love: Significantly greater?
Mr Neale: It obviously depends on the precise rate at which Planning Gain Supplement is set but we do expect it to be greater.

Q310 Mr Love: There has been quite a lot of talk about whether there should be a charge for vacant or derelict brownfield sites as an incentive to get them to bring those sites back into use and also some talk about providing tax incentives to encourage the development of brownfield land. Can you tell us what your thinking is in relation to that?
Mr Neale: We are consulting on the development of PGS at the moment. We published two consultation papers with the PBR, but our view at the moment is that the value of brownfield land is already reflected in the price paid for it.

Q311 Mr Love: Do you expect changes that you make will be neutral or will there be an increase in taxation? How do you expect that to pan out?
Mr Neale: Sorry, what is your question?

Q312 Mr Love: The suggestion is that there may be additional taxation to try and bring land back on. There has also been some talk about reliefs to get land back into use. Is it overall going to be the combination of taxation and reliefs or will it be neutral?
Mr Neale: We do not expect that PGS will adversely affect the incentive to develop land because it will be a very modest proportion of the uplift created by the grant of planning permission so there will still be substantial incentive to bring land, both brownfield and greenfield, to development.

Q313 Chairman: Mridul, you promised answers to education spending projections.
Ms Brivati: I did and I knew there was a reason I could not add them up in my head. I am not satisfied with the numbers I have and rather than give you false numbers I would prefer to go back and send you a note, if I may.

Q314 Mr Gauke: If we could have before tomorrow morning.
Ms Brivati: That should be perfectly possible.
Chairman: In answer to questions from George, Michael, myself, amongst others, you will be sending us information tonight so that we are prepared for tomorrow, is that okay? Can I thank you for your evidence session this morning and I look forward so seeing you again tomorrow.

Wednesday 13 December 2006

Members present:

John McFall, in the Chair

Mr Colin Breed
Jim Cousins
Angela Eagle
Mr Michael Fallon
Mr David Gauke
Mr Andrew Love
Kerry McCarthy
Mr George Mudie
Mr Brooks Newmark
John Thurso

Witnesses: **Rt Hon Gordon Brown,** a Member of the House, Chancellor of the Exchequer, **Mr Jon Cunliffe,** Managing Director, International Finance, **Mr Dave Ramsden,** Director, Macroeconomic and Fiscal Policy, **Mr Mark Neale,** Managing Director, Budget, Tax and Welfare, **Ms Mridul Brivati,** Joint Director, Public Spending, and **Mr Michael Ellam,** Director of Policy and Planning, HM Treasury, gave evidence.

Q315 Chairman: Chancellor, good morning to you and your colleagues and welcome to this inquiry into the Pre-Budget Report. Can you introduce your colleagues please.
Mr Brown: Yes, good morning. I have with me Jon Cunliffe, who is the Managing Director for International Finance, Dave Ramsden, who is the Director of Macroeconomic Policy, Mridul Brivati, who is a Director of Public Spending, Mark Neale, who is the Managing Director of Budget, Tax and Welfare, and Michael Ellam, who is the Director of Policy and Planning in the Treasury.

Q316 Chairman: You said you have a short statement to make.
Mr Brown: Well, I thought the Committee might be interested in being made aware of advances we have made in a particular area. Missing trader fraud, sometimes called "carousel fraud", has been the biggest single attack on the taxation systems of the European Union, including its effects on Britain where £4 billion of VAT payments have been targeted by criminal groups. Securing a derogation from European Union VAT law to enable what is called a "reverse charge" has been a vital part of the Government's strategy against carousel fraud. The reverse charge would enable VAT to be charged for those particular items where fraud has been more prevalent, mobile phones and computer chips, at the point of sale to the consumer rather than at different points in the supply chain. This now would remove the mechanism by which the fraudster steals VAT in the supply chain. I am, therefore, pleased to tell the Committee that last night an agreement was reached on the derogation we have sought with France and, with the support now of other Member States, I am confident that the derogation will be adopted. For the purposes of the public finances and in line with the Code for Fiscal Stability, the impact of the reverse charge has been cautiously estimated with a yield of an additional £500 million in 2007–08, although the true impact will obviously depend on the levels of fraud in future years. However, the reverse charge will move the mechanism for stealing VAT from around 90% of goods currently traded in carousel fraud. I can also say that yesterday officers of HMRC were deployed across four countries, executed 50 search warrants across the UK and arrested 15 people in a major operation against carousel fraud, so we are determined to ensure that this missing trader fraud, which has been the most major attack on our tax system in recent years, is dealt with, and I am pleased that the measure that we have sought in the European Union is now going to be acted on immediately.

Q317 Chairman: Thank you, Chancellor. You mentioned the Code for Fiscal Stability. That obliges the Treasury to publish a PBR each year outlining, so far as is reasonably practicable, any significant policy proposals under consideration for the Budget. Is your statement really a "pre"-Budget document with matters for consultation as opposed to the first instalment of next year's Budget?
Mr Brown: No, it is a pre-Budget document and I think this year in particular emphasises why it is a discussion prior to the Budget. We have published probably more significant long-term reviews about what we need to do as a country than at any point in the last 10 years. We are really looking ahead to how an economy like ours faces up to the global economic challenge. It is a completely different world from 10 years ago. We now have China responsible for the majority of computer sales in the world, we have China responsible for 60% of digital electronics and half the growth in the world is now in India and China. We have to respond to this new world as an economy and that is why we have these reports on skills, on transport and infrastructure, on planning and we also have the reports on science through Sir David Cooksey and obviously on intellectual property by Andrew Gowers, so we are preparing the way for the Budget in that particular respect. These reports are now out for consultation and we expect to hear people's views on them. Some of the proposals are more controversial than others, but I think this is exactly in the spirit of what you would expect a pre-Budget report to be.

Q318 Chairman: Talking about the long-term challenges, Pascal Lamy, the Head of the World Trade Organisation, has stated that the Doha Round "now faces collapse". What are the critical developments that need to take place in order to ensure that the Doha Round resumes and has a successful outcome and what alternative avenues

could the Government explore, in conjunction with other countries, to promote trade should the Doha Round collapse?

Mr Brown: Well, I would congratulate this Committee on taking an interest in the international institutions and what can actually be done to ensure that what is to the benefit of Britain, but also the world, and that is a free trade world, is achieved. We look around the world and we see the growth of protectionism, whether it is in America or in Europe or in any other continent, but, in my view, this is a huge danger to the world trading system and also to the long-term growth of the world economy. Trade has been growing twice as fast as growth in recent years and, if trade were to be stalled as a result of the failure to reach agreement, then I believe we would all suffer in both our growth rates and in our prosperity. I still am of the view that progress can be made. It is obviously difficult and it is probably more difficult because of some of the events of the last few weeks, but I have talked to Pascal Lamy himself recently and I have also had talks in the last week with the Treasury Secretary of the United States, Mr Hank Paulson, and we are determined jointly to do what we can to progress negotiations. It is clear to me, as I have said before, that both Europe and America will need to move on agricultural subsidies and on agricultural tariffs, America on agricultural subsidies with Europe on agricultural tariffs. I have set forward before in some detail some of the things that I think could be done. If that were to happen, I believe there would be a response from Brazil which has indicated that it would respond for the ways that it has and India for the ways that it has and, on that basis, I think we are looking for some progress either with the joint initiative from America and Europe or with simultaneous or consecutive actions by these two continents. I think we have got a window still of opportunity here and, even though on the surface it seems disappointing, I think everybody knows that a lot of discussion is taking place about how the talks could be revived; they are indeed very important to the growth of the world economy in future years.

Q319 Mr Fallon: Chancellor, could you confirm that this is the third time you have had to change the length, or the end, of the cycle to avoid breaking your fiscal rules?

Mr Brown: No, there is confirmation about the end of the cycle in the Pre-Budget Report. The end of the cycle can only be judged after we have the full provision available to us and, therefore, there has been no policy change on the part of the Treasury at all. There is a forecast and estimate, but no decision and you cannot make that decision until all the evidence is available to you.

Q320 Mr Fallon: In your Pre-Budget Report, you said there is an assumption that it will end in early 2007. Are you aware that Martin Weale of the National Institute told this Committee on Monday that in fact most people would be saying that "the cycle ended in 2003 and we are in a second cycle, much closer to the normal sort of business cycle than the protracted 10-year cycle that the Chancellor is describing". When I asked him what would have happened if we had kept to the normal cycle in terms of missing the Golden Rule, he said, "He", that is you, "would have missed the Golden Rule by large amounts".

Mr Brown: If the cycle had ended in 2003, we would have met the Golden Rule, but the cycle did not end in 2003 and I do not think this Committee, which reviewed all these things in 2003, 2004, 2005 and 2006 now, has ever in any of its reports suggested that the cycle ended in 2003. It is up to this Committee and other people to look at what they think the evidence is, but we assume that the cycle could end in 2007, but we are not making any statement that it has ended and you can only judge that once you have got all the information available to you. Therefore, I neither accept your first proposition that we have changed our position, nor do I accept your second proposition that the cycle ended in 2003. For this, there has been no statement by your Committee to any effect like that.

Q321 Mr Fallon: What we have said is that the start and end dates of the cycle should be independently audited. You do invite the Auditor General to check your trend growth assumption. Why will you not have the start and end of the cycle independently and honestly audited?

Mr Brown: I think you are wrong here again, Mr Fallon, and I will just correct you. We have said that the NAO would audit the end of the cycle.

Q322 Mr Fallon: But that is after it. You are now saying already that it is going to end in early 2007.

Mr Brown: You cannot audit something until you have a pretty clear view that something has happened. There is no point in auditing it every few months.

Q323 Mr Fallon: But do you not undermine the credibility of your own framework? You are like Alex Ferguson and you are not just moving the goalposts, but you are allowed to shorten the pitch, judge the offside rule and so on. You are your own judge and jury.

Mr Brown: I think Alex Ferguson would take exception to that statement that somehow to shorten the pitch, remove the goalposts and everything else was in the interests of Manchester United. I do not think that is the reason that Manchester United are top of the league, I think it is because they are playing well and I would suspect that people would agree that our economy is doing well also. The fact is that the test is whether the economy decisively moves through trend. We do not believe that that has happened. I do not think this Committee has ever suggested that that has happened. I think most of the independent commentators would agree with us in this matter and the NAO, just to correct you, will be able to audit the end of the cycle.

Q324 Mr Fallon: Let us turn to public finances. By how much in billions are you increasing taxes next year as a result of the PBR?
Mr Brown: I actually believe, if you look at the figures for the tax-take in GDP, the tax-take is lower next year than we predicted in previous years that it would be, so, if you look at the tax-take, the tax-take in 2006–07 will be 37.3. I think in all our previous Budgets we were predicting it would be higher, so the tax-take is lower than what was previously forecast.

Q325 Mr Fallon: In terms of the Pre-Budget Report, you actually have to increase taxes by £2 billion, £1 billion from air passenger duty and £1 billion from business taxes and tax-avoidance. That is the correct position, is it not?
Mr Brown: I do not think you are right there actually because, first of all, there is an APD tax change from February and that is worth about £1 billion over a year, but the second set of measures are to do with avoidance and they are not business tax rises. They are to deal with avoidance and I am very happy to go through each one of them with you and explain why we have had to deal with the problem of avoidance in the economy and why generally we have support from the business community for doing this. I think you should hesitate to call these "business tax rises"; these are measures to deal with avoidance which I hope there would be all-party support for.

Q326 Mr Fallon: But you are increasing tax through air passenger duty, you are increasing your borrowing, you have been cutting PE investment and this is really because you got your forecasting wrong, did you not, of North Sea oil receipts and you badly forecast the September inflation rate which has meant that there has been an outlined increase in public spending?
Mr Brown: Not at all. What has actually happened in the North Sea is that the production levels in the North Sea have been different partly because of rehabilitation of the oil rigs themselves and partly because of the rate of depletion in the North Sea and I do not think that you can accuse the Treasury of mismanagement in this area. This is simply an updating of what is actually happening in the North Sea, but generally I think people are impressed by the fact that the Treasury is not only on course to meet its fiscal rules, but the deficit comes down annually and, despite, I think, the forecasts of you and others over the last year, we have welcomed the 3% which is set by the European Union.

Q327 Mr Fallon: But your own forecast was that you would receive over £13 billion in receipts from North Sea oil and now you are adjusting that to just over £10 billion, £2.8 billion out, which is a 21% forecasting error.
Mr Brown: Mr Fallon, I think we have been round this course long enough to know that, if production falls in the North Sea, that is not the fault of the Treasury.

Q328 Mr Fallon: But you are the forecaster.
Mr Brown: My goodness! The other reason of course that receipts are different is because of the change in the dollar to pound exchange rate and again you do not expect us to forecast to a point of total accuracy what the dollar exchange rate is going to be at any one particular point in time. I think you really are barking up the wrong tree if you are trying to attribute to the Treasury incompetence because there has been a change in the production cycle in the North Sea and because also there has been a change in the dollar exchange rate. These are things that I do not think people in their wildest dreams would think were within the control of the Treasury. It just emphasises my point that generally, despite the uncertainties of the world where you had political instability, you had a volatile dollar, you have had the trade talks stalling, you have had a slowdown in America, and all these things are happening over which we have very little control, our public finances are actually on course, our growth is higher than we forecast, despite the gloom that was on your side of this Committee last year about what we would be able to achieve this year, we are actually better than forecast for growth, and I would say that generally the economy is on course to achieve the objectives that we have set. Your point about North Sea oil, I think, merely reinforces that the Treasury has got it as right as the Treasury can get on this matter.

Q329 Mr Fallon: So a 21% error is as right as you could get. How did you get inflation so wrong? In March you said it would be 2.6 in September and it turned out to be 3.6, throwing out your social security increases. How did you get that wrong?
Mr Brown: Our Budget inflation forecast was exactly similar to that of the Bank of England's, so—

Q330 Mr Fallon: Why was it wrong?
Mr Brown: If you want to blame us, I think you have also got to blame the Bank of England.

Q331 Mr Newmark: Come on!
Mr Brown: Well, the point is that both of us have been looking at what is a very serious problem. Under your Government, Mr Fallon, when oil prices trebled or when house prices went up substantially, the economy went into recession and that was the record of your Government. Under our Government, we have managed to have stable growth with relatively low inflation. Now, what we had to look at was what were the second-round effects of an oil price rise and in fact a general commodity price rise because it is not just oil which has risen, it is commodity prices that have risen as well, and I think what has happened over the last year is that there have been some second-round effects, but it has not fed through into rises in wages. I think you will find, when you see the figures published about what is happening to average earnings, they are relatively stable and that is why we are now able to forecast that inflation will be back to target during this first half of next year and we will be at target next year and the year after. Given what

has happened in Europe to inflation, and interest rates have gone up there, and given what has happened in America, and interest rates are higher there than they are in Britain now, I think that we are surmounting what has been an inflationary pressure on the economy better than other economies and you will see the inflation rate going down over the course of the next year.

Q332 Mr Fallon: What has happened in fact is that you are losing control of the public finances and our constituents have to pay higher taxes because of your forecasting errors.
Mr Brown: I have just given you the figures for taxation. Mr Fallon, I would appreciate it, if you want to make these statements, that you research them before you make them. The forecasts for taxation are lower than they were at the time of the General Election in terms of tax-take per head. In terms of business taxes as well, we are lower than in many years under the Conservative Government as a proportion of GDP. I think, if you look at the tax-take in Britain, it is lower than most of the main competitors that we face.

Q333 Mr Fallon: When you leave, your legacy in fact, Chancellor, will be real cuts in some public services, fairly nebulous efficiency savings, ever-rising borrowing and a continuing structural deficit. That is a hospital pass to your successor, is it not?
Mr Brown: Mr Fallon, I think the fact is that we have had 10 years of stable growth, national income per head has moved from being seventh out of seven in the G7 to being second only to America, we have created two and a half million jobs in this economy, inflation is at half the level it was under your Government, interest rates and mortgage rates are at half the level they were under your Government and people are substantially better off over the last 10 years. Now, I am interested not in talking about what happened over the last 10 years, as you are, I am interested actually in talking about what the future is for our country and I believe we can have a low inflation with a stable, high-employment economy where people are prosperous over the next few years if we make the right decisions, such as we raised in the Pre-Budget Report with the many reviews which we have published on which we will make decisions at a later date.

Q334 Mr Fallon: With a new Chancellor. Well, let us turn to one of those issues. Did you double air passenger duty to change behaviour?
Mr Brown: I believe it will leave people with a choice as to what they do and I think people will make these choices. I think one of the things that is very interesting about the aviation industry is that the scope for savings on emissions is becoming clearer every day. I have been talking to the aviation industry itself and, with the amount of aviation fuel which is wasted, I think at this point there is a huge challenge to the industry now to use the resources better and in a more environmentally efficient way.

Q335 Mr Fallon: And how many fewer people will fly?
Mr Brown: I do not think that is the issue that I am raising with you. The issue is that people have a choice, knowing what a truer cost of the environmental effect of flying is.

Q336 Mr Fallon: If you are raising it now by £5, why did you cut it by £5 in 2001 just before the Election?
Mr Brown: Because we had to deal with the European Union Directive that you could not have a different levy for the rest of Europe than you had for Britain, so at that point, if I am right in saying, the levy was £5 for Britain and £10 for the European Union. We cut it by half for the rest of the European Union, but it remained the same for Britain where most of the flights took place, so it was simply as a result of the European Directive that we had to charge people who were flying within Britain and within the European Union the same rate, and that was the reason why we did it.

Q337 John Thurso: Chancellor, you spoke in your introductory statement about the global challenges that we face and climate change must surely be one of the biggest. I would like to ask you generally about your thoughts on the efficacy, or otherwise, of green taxation. According to the Office of National Statistics, a proportion of total tax revenues made up from environmental taxes has fallen every year since 1999 from a peak of 9.8% down to 7.7% in 2005, and the IFS estimates that the decision to increase fuel duty and air passenger duty together will add about 0.1%. Could you not have used the PBR to take more action on raising green taxation?
Mr Brown: Mr Chairman, I think the Member seems to measure the effectiveness of a policy on the environment by how much you raise taxes. That is not how I measure the effectiveness of our policy on the environment; it is how we meet the Kyoto targets and how we cut emissions generally. I would say to the Committee that there are essentially a number of ways in which we can act as a government with the public to make a difference in this area. One of course is the huge advances which have been made in science and innovation in dealing with environmental issues. The second is the use of market mechanisms, such as global carbon trading, which we are promoting. The third is the exercise of personal and social responsibility by individuals and by companies in their own right where we can incentivise, and encourage, people, but these are individual decisions which have got to be made. The fourth is the public investment which we are prepared to make in environmentally efficient ways of doing things, including, for example, insulation, but also a whole range of different things. The fifth is either tax incentives, that is, tax reliefs, or the taxation that you are talking about. I think you have to judge the effectiveness of a policy not by one lever that you are raising, and in fact only part of the tax lever because you are only talking about tax rises, but actually whether you can make advances in science, in market mechanisms, in personal and

social responsibility, by public investment, by tax incentives, of which there were many in the Budget, to reduce the taxation for environmentally efficient fuel as well as tax and stamp duty for the future building of carbon-free homes as well as the taxation you are talking about. I do think the Committee would be making a mistake if it assumed that the test of your effectiveness as an environmental champion is simply whether you raise taxes.

Q338 John Thurso: I concur with much of what you say, Chancellor, and it is quite clear, looking at, for example, the big grain distilleries in the whisky industry, that carbon trading is changing their behaviour and is being effective, but does your answer indicate that you actually do not believe that what is known as "green taxes", environmental taxes, as a percentage of the total take is a useful indicator and that it does not actually change individual behaviour very much?
Mr Brown: I think there are different definitions of what a green tax is. Some of the percentages that you have given me are very different from the percentages that I have here, but I would say to you that the test is: what cumulatively is the effect on emissions? We have had 28% growth in the economy and we have had a 9% cut in the emissions necessary to meet the Kyoto targets. That is a combination of the tax measures that you are talking about, but also of good public investment, people taking more responsibility themselves, the growth of carbon trading which of course will have a bigger effect in future years and the degree of public investment in insulating people's homes and getting a better use of fuel. Now, in future years we proposed in the Pre-Budget Report carbon-free homes. The Secretary for Communities and the Housing Minister are launching today their proposals to encourage, by new Building Regulations, homes to be carbon-free, not simply carbon-neutral, but carbon-fee by 2017. Just as with petrol duty and vehicle licences when we created a new band that was zero, it is taking time, but it is actually having an effect on the production of cars, so too by creating a new tax incentive will it have an effect on people's decisions about homes. I visited yesterday a carbon-free home and in three ways it had been made carbon-free: by solar panels; by proper insulation; and by wood pellets for the boiler. They effectively meant there was no carbon being used in the home, so it is possible to do these things. The tax system can operate as a powerful incentive, but sometimes in this area, because it is applied most to social housing, it may be public investment that can make a difference as well and a lot depends on the extent to which individuals, who, as consumers, have a right to make these choices, react to the incentives and to the measures which are available.

Q339 John Thurso: You would agree, I think, therefore, that the right taxes can have an impact on behaviour. Have you looked at, for example, instead of the Climate Change Levy, a carbon tax?
Mr Brown: We looked at all these things when we introduced the Climate Change Levy and we have looked obviously at what the situation is, moving forward. I have to say to you that, first of all, the Climate Change Levy, which has not been supported by other parties in this House of Commons previously, has been one of the most effective instruments in reducing carbon emissions and I would hope that there would have been more general support for the carbon levy. It has also led, because it is not operating simply by taxation because we repaid it in National Insurance, to hundreds of climate change agreements signed within industries which will achieve greater fuel efficiency, but, because there is a European agreement about the level of carbon emissions now, I just have to say that to move the Climate Change Levy to a carbon levy would actually make no difference to the overall levels of emissions at this stage at all. Therefore, if you have the Climate Change Levy plus carbon trading agreements and you have a ceiling for carbon which is already established until 2012, then to move from the Climate Change Levy to a carbon levy at this stage would not make a difference.

Q340 John Thurso: Another example is aviation. I think we all agree that we want to see the environmental costs of aviation properly paid. The APD charged on passengers is relatively limited. Why not charge something on aircraft which encourages people to have more fuel-efficient aircraft and which would capture all the freight aircraft which currently pay nothing whatsoever?
Mr Brown: This is a big issue which has to be dealt with internationally and, in the absence of an international agreement, you have got to do what you can domestically. What we have decided to do, like many other countries, and I was just talking to the Korean Minister the other day who has just introduced air passenger duties, it does not obviously pay for the full cost to the environment of the effect of flying and it still means that air travel is taxed less than cars by a very substantial amount, but you have to balance off the needs of the consumer and the industry with the need to make advances in the environmental areas that we are talking about. I do think this will spur greater fuel efficiency on the part of the airlines and, as I said earlier, I have had some talks with the airlines about some of the things that they could do actually to reduce the usage of fuel and the waste of fuel that often happens as a result of some of the decisions that are made. Again I just come back to this, that you cannot judge the effectiveness of a policy for reducing emissions simply by one of the instruments that is available to you to use and, whether it is in cars where of course the rise in the price of oil itself has had a more powerful effect over recent years than any tax change, you have to look at the range of measures that is available to you and I think people will come to a balanced view of this environmental agenda.

Q341 Chairman: Chancellor, you mentioned about talking to the aviation industry. They have been talking to me in the last day or two and they are concerned about the APD in terms of the notice period which is required, they say, of 12 months to synchronise the changes in the industry's selling system. BA in particular, they say to me that hundreds of thousands of passengers have already booked, and paid for, travel at the present APD rate for travel that is going to take place after 1 February and they will be unable to collect the payment of the difference between the current and the new APD rate. For them, as a company, they say that is going to cost about £11 million and for the industry it is going to cost £100 million. Is there not a case here for negotiation between the industry and your officials to look at a solution, for example, to implement the 1 February deadline as planned for the bookings made on, or after, 1 February or to get an accommodation between the industry and HMRC that recognises the value of APD already collected with bookings already made at the existing APD rate and for that to be reflected in the monthly APD returns to HMRC?
Mr Brown: When fuel duty changes on cars, it changes immediately. This is a lead-in that takes you through to February and I do think you will be looking at a period of time which allows the airlines to adjust. I may say that, when the airlines charge surcharges for fuel, they charge it on existing tickets as well as new tickets, and holiday operators have often done that as well. I think that the whole issue of the air passenger duty tax has to be seen in the context that this is a departures tax, it is not a bookings tax, it is not a ticket tax. It is a departures tax and actually, if a passenger does not turn up who has paid the departures tax, the airlines get it back, but it is a departures tax.

Q342 Chairman: Chancellor, I understand that, but I am just focusing on the issue of bookings which have already been made for travel after 1 February at the current APD rate. I think there is an opportunity for negotiation between the industry and your officials here.
Mr Brown: Well, there have been discussions with the industry.

Q343 Chairman: Yes, but they have not got very far.
Mr Brown: I do not recognise the figures that you are giving me actually, but there have been discussions between ourselves and the industry and obviously these continue. I think the airlines and the Treasury met earlier this week, but I do repeat to you that the change that they face, when it took place in car duty, it took place at midnight on the same day, whereas they have a run-in period until February, but this is a departures tax, it is not a purchase tax.

Q344 Chairman: I will write to you then, Chancellor, because I think there is a case here for them. Do you expect airlines then to pay that before it is authorised by the House of Commons and, if so, do you have the legal sanction to do that?
Mr Brown: I believe we do.

Q345 Angela Eagle: Chancellor, what do you think are the main strategic choices facing the UK over the next 10 years? You were talking about the future and your PBR statement was heavy with a strategic approach, so do you want to outline the most important ones that you see facing the country?
Mr Brown: The issue for Britain is that people be properly equipped for the challenge of a global economy and for the jobs, that people will not only have the jobs in the future, but they will also have the skills for the jobs. The Committee might be interested to know actually that the employment figures have just been published in the last few minutes and they have just been handed to me. Unemployment is actually down 7,000 and the claimant count is down 5,700. Employment is up 41,000 over the previous three months and it is up 216,000 on the previous years. Vacancies are at 600,000 also in the economy and there are more people in work as a proportion of the population in Britain than in other major economies. I hope that this is some good news for Christmas about the increase in employment in our economy over the last few months, but what we have got to do for future years is make sure that people have the skills that are necessary and that is why the Leitch Report is so important. We have to give people the opportunity as adults to retrain, we have to give young people who are out of work at the moment the opportunities for them to get jobs, we have got to give obviously people at school the discipline and the standards at schools which will enable them to be qualified for the jobs that are available. We will not compete on low-paid, low-cost production if we are competing with wage rates in China that are a 20th of ours. We will be able to compete on the basis of having the highest skills on offer and that means that, just as China and India are producing more graduates every year, we have got to produce more skilled people every year as well, so this is one of the major challenges I see us having to face as an economy in the years to come. We have done very well over the last 10 years because there are two and a half million more jobs, unemployment is substantially down and less than for most of our major competitors and that is confirmed today in these figures, but at the same time we have got to give people the skills that are necessary for the jobs of the future and this is, if you like, the premier challenge that the British economy faces.

Q346 Angela Eagle: The Leitch Report does suggest quite a major shake-up in the way that the system works and it demonstrates that, although there has been a good improvement in those with high-level skills over the past period up from 21% to 29% and a fall in those with low skills down from 22% to 13%, there is still an enormous amount of work to do. Leitch suggests a major shake-up of our training structures, particularly emphasising the role that employers can have in training their existing employees. They have not been fantastically good at

that in the past. Why do you think that the Leitch Report recommendations will make this step change that we need?

Mr Brown: Well, there are considerably more adults with skills in the workforce now than there were 10 years ago and there are more adults who have gained the basic literacy and numeracy qualifications now. We have introduced a programme, Train to Gain, which is the employer national training programme. As I understand it, there are now 90,000 people on this programme which was nothing a few years ago, started with a few pilots and it is now nationwide with 90,000. That will rise to 300,000 by 2010, so you are going to have large numbers of people every year going through it and getting the literacy and numeracy qualifications that they need and I think that is a major improvement, but we have got to do better. We have got to do better at the adult skills level and we have got to do better at getting young people, with apprenticeships and with other college qualifications, the skills that are necessary for the future. Digby Jones has agreed to become an envoy to talk to small, medium and large businesses about their responsibilities in this matter. We will have to persuade individuals that they themselves have got to take responsibility for getting the qualifications that they need for the future and the Government will continue to play its role also in terms of funding a great deal of this training, both apprenticeship training and adult training.

Q347 Angela Eagle: The Leitch Report talks about a very large increase in the number of apprenticeships. Is there any planning on the amount of apprenticeships that that will lead to? It is over a quarter of a million now, but do you have a view of how many more we need and do you have a strategy for ensuring that women get appropriate opportunities in apprenticeships in non-traditional jobs since they are currently, despite the very large increase in apprenticeships, still confined to low-paid, female-type occupations?

Mr Brown: On apprenticeships, I think 10 years ago there were about 75,000 apprenticeships and now there are about 250,000 in England alone. We believe that by 2020 we will need 500,000. I think the interesting thing is, despite the popular understanding of this, half the new apprentices, half the 250,000 today are in manufacturing, technology and construction. There has been a very big rise in the number of apprentices in construction and actually in manufacturing in recent years and we are going to have to continue ensuring, for example, that the construction industry has the properly skilled people. What is good also is that girls and women are undertaking apprenticeships and, although I do not have a breakdown about the balance between men and women for future years, I think you will see a rise in the number of girls taking apprenticeships in future years.

Q348 Angela Eagle: On the choice between tax cuts and further investment, you have taken a pretty clear choice in the PBR that, in order to face the next 10 years, we need more public investment in these strategic areas. There are other choices about tax cuts instead, so why do you think you have made the right choice?

Mr Brown: Because if we do not gear ourselves up as an economy by investing in education for future years, then the world-class standards we need to be able to compete with our neighbours and with China and India will not be available to us. Now, in any Budget the Chancellor will make a decision between tax cuts, spending increases and the levels of borrowing in the economy. It is not simply a choice between tax and spending, it is a choice between tax, spending and stability. In future Budgets, I will make these choices whether to have tax cuts, whether to invest more in public services and what to do in relation to borrowing and the stability of the economy. At this stage in the Pre-Budget Report, I felt it was very important that we sent out a signal that Britain at least, of all the major economies, is going to take seriously the need for the new investment that has to happen in education if we are going to be successful. Therefore, I gave figures for educational investment of £10 billion by 2010–11. Now, compare that with £600 million in 1997. This has been a 14-fold increase, if I am right, or a 15-fold increase in education simply to meet the requirements of a modern era, so any school that is more than 15 years old is likely to qualify under Building Schools for the Future for new investment. That means a very substantial proportion of secondary schools and primary schools will be inside this programme and that means that pupils going to schools in future years will have the best facilities, the computers and the amenities available to them. Building Schools for the Future, which I am properly financing in the biggest programme of educational investment this country has ever seen, will mean that pupils will go to schools with proper facilities, not just for the basic studies, but for personalised learning, for a range of facilities in the curriculum available to them, for good, nutritious meals and for sports facilities in the schools, and that shows our commitment to invest in the schools for the future and I do not think any other country is making the same sort of investment that we are making in education for future years.

Q349 Angela Eagle: Do you worry, Chancellor, about the continuing persistence of pockets of poverty in our communities, particularly in some geographical areas, and what do you think the Government should be doing to try to deal with that?

Mr Brown: Well, I am glad that there is now an all-party interest in tackling poverty, but that means that people will have to face up to the responsibilities that that brings. When we came into power, I think it is true that the payment received for a first child was about £28 a week and that is now £64 a week from April, but the evidence of course is that you would need to do more in future years to help these children out of poverty. Now, one way we can do that is by getting more people into work. We have two and

a half million more people into work, the rate of single parent employment has gone up from 43% to 56/57/58%, it probably is now, single parent unemployment has gone below one million for the first time for years, we are getting incapacity benefit claimants back into work and we are getting many people who have been long-term unemployed back into work. One of the ways we can deal with poverty in the areas that you are talking about is not just to help children themselves through education and through the children's benefits that we provide, but also through getting people into work and that is a very important part of the strategy, moving forward. In the first few years, the New Deal enabled us to get a large number of people back into work. The new group of people that we have got to deal with are often people that need personal mentoring and coaching, they need childcare if they are single parents, they need better training facilities for literacy and everything else and we are going to have to make the New Deal capable of giving people these skills for the future as well as what has been achieved very well by the New Deal in the past.

Q350 Mr Newmark: Chancellor, since it is Christmas, I would like to be in with a couple of positive comments on your Pre-Budget Report speech. I have to declare an interest here, that I am actually also a member of the Science and Technology Select Committee and, as a member, I welcomed your renewed commitment to work with the industry to promote stem cell research and carbon capture as these are both areas in which British expertise and innovation already leads the world. Unfortunately, the rest of your speech reminded me of the new Will Ferrell film, *Stranger Than Fiction,* and I really do want to probe you a little bit more than the heroic attempt of my Chairman here on the air passenger duty. Could you please clarify once again why you decided to move air passenger duty up in February and not at the beginning of the new financial year in April because this is what is usually done? Associated with that, can you tell me how many families will be affected by this and how much additional revenue do you anticipate you will raise?
Mr Brown: The figures for revenue are clear, and we have given the figures. It is just over £1 billion a year for air passenger duty and that would work out, if I am right, at about £80–90 million per month, so that is clear. There has been no sort of normal procedure. Air passenger duty, its rates have been moved only once or twice since it came in. For vehicles generally, as you know, the date of the Budget statement is usually the time at which rates are moved up. In this case, for air passenger duty, there is a three-month period until 1 February 2007 and I am very surprised about this discussion now because, on the day of the Pre-Budget Report, all parties in the House of Commons supported the rise in air passenger duty.

Q351 Mr Newmark: I am asking a question not of whether it should be raised, but it is the timing issue.
Mr Brown: Hold on, you have to put it in its context: all parties in the House of Commons—

Q352 Mr Newmark: But you are answering a different question, Chancellor.
Mr Brown: Some of the parties were asking me to raise air passenger duty by far more. I was criticised—

Q353 Mr Newmark: I am not talking about the amount; I am talking about the timing. Let us deal with the timing issue.
Mr Brown: Fine, so we agree that air passenger duty should be raised. That is the common view of the Committee?

Q354 Mr Newmark: That is a common view.
Mr Brown: Then the question is at what point it should be raised and, as I say, on car duty for petrol, it is raised on the day—

Q355 Mr Newmark: That is because people can hoard, so they go out and they buy petrol. Passenger duty is something different. Families have already bought their tickets, so it is a retrospective tax on those who have bought tickets on top.
Mr Brown: No. I just said there is no general rule that taxes go up on April 1 and I just made that point to you when you introduced—

Q356 Mr Newmark: But is it not really a tax? I would be really curious to know, did you discuss this with your Treasury officials beforehand and what was the decision made?
Mr Brown: Mr Chairman, I discuss everything with my Treasury officials.

Q357 Mr Newmark: But did your officials advise you to put it up in February rather than April?
Mr Brown: We are agreed on the decision that we made.

Q358 Mr Newmark: But I am just curious. Was this a decision which you made, Chancellor, or were you advised to begin it in the new financial year?
Mr Brown: All decisions that are made in the Treasury are made by the Chancellor with advice from officials.

Q359 Mr Newmark: Well, I only say this because I read in today's paper, Chancellor, that you overruled your officials who advised you to begin it at the beginning of the financial year.
Mr Brown: I do not think that is the case. I think you will find that—

Q360 Mr Newmark: You do not think it is or it is the case?
Mr Brown: I think you will find that decisions in the Treasury are made by the Chancellor after taking advice from his officials.

Q361 Mr Newmark: So you overruled them, okay. My next question is to do with living standards. I note that regular pay—
Mr Brown: By the way, you can draw that conclusion from the—

Q362 Mr Newmark: I can draw whatever conclusion I wish!
Mr Brown: Well, that is true, you can draw whatever conclusion you wish, but other people cannot draw that conclusion.

Q363 Mr Newmark: I note that regular pay rose at an annual rate of only 3.5% in the year to September. However, yesterday's inflation data put the RPI in the year to date at 3.9%. Does this not mean that average regular pay and, therefore, real take-home pay actually fell in real terms over the year?
Mr Brown: I think you will find that the figures today that are published for average earnings are 4.1%.

Q364 Mr Newmark: For what? I am talking about comparing the 3.5% versus the 3.9%.
Mr Brown: Yes, but the figures for average earnings are 4.1%. The average earnings, including bonuses, are 4.1% and average earnings, excluding bonuses, are 3.8%.

Q365 Mr Newmark: I am talking about average regular pay. Average regular pay is 3.5% in September versus 3.9%.
Mr Brown: But I am giving you the latest figures and I thought you would be grateful to have them.

Q366 Mr Newmark: Well, those are not the figures that we have here.
Mr Brown: I know, but the figures have been published at 9.30 and I can tell you that the figures for average earnings are 4.1% and 3.8%.

Q367 Mr Newmark: Are those figures including bonuses or excluding bonuses?
Mr Brown: I just read them to you. I said that average earnings, including bonuses, are 4.1% and average earnings, excluding bonuses, are 3.8%.

Q368 Mr Newmark: So average earnings, excluding bonuses, are 3.8?
Mr Brown: Absolutely.

Q369 Mr Newmark: But unfortunately the inflation index is 3.9%. Unfortunately, most people actually, other than your friends in the City, do not get bonuses, so actually in real terms once again living standards and real take-home pay are falling.
Mr Brown: You have got to look at what is happening to the typical consumer budget in this country where the prices of items, like clothes and electronics, have fallen over the last few years. We have had a rise in interest rates which has meant that mortgages are rising—

Q370 Mr Newmark: But, Chancellor, you just said that, excluding bonuses, it is 3.8%, whereas 3.9% is now the inflation rate.
Mr Brown: Sorry, but the CPI inflation rate is, if I am right, 2.7%.

Q371 Mr Newmark: Again you are moving statistics. It is the RPI.
Mr Brown: Sorry, but the official inflation rate in this country is CPI and it is 2.7. The RPI is 3.9, RPIX is 3.4 and RPIY is 3.6.

Q372 Mr Newmark: And 3.9 versus 3.8 is actually showing that real living standards and real take-home pay are falling.
Mr Brown: I just do not accept that you take one index of inflation and—

Q373 Mr Newmark: You are using one index, but I am using an RPI index. An RPI index is far more reflective of what is going on out there with ordinary people who do not get bonuses, so, as I say once again, real take-home pay for ordinary people not getting bonuses is falling.
Mr Brown: I just do not accept this.

Q374 Mr Newmark: Well, you do not have to accept it once again, but that is a fact for ordinary people.
Mr Brown: I just do not accept this because you have got to look at household budgets as a whole and, when you look at the costs of clothing, when you look at the costs of electronics, when you look at the costs of other items in the household budget, and they will affect people differently, the one thing that is clear is—

Q375 Mr Newmark: I am talking about for ordinary people out there giving you the latest stats which you have just said are 3.8 versus 3.9 which shows that real take-home pay is falling.
Mr Brown: I am sorry, but the official inflation rate in this country is 2.7%.

Q376 Mr Newmark: Once again you are changing the stats. I am using an RPI index.
Mr Brown: There was all-party agreement when we changed the measure of inflation to bring it in line with all international standards and it is the CPI. Now, of course for benefits we do these things differently and of course I recognise, if you take housing costs and mortgages which are going up, that there is an issue for people, but, generally speaking, the costs of items, such as electronics, clothes and food, are such that it means that people are generally better off.

Q377 Mr Newmark: I know, but I am using as a measure RPI, which you yourself also used, and it shows to me at least that real take-home pay, excluding bonuses, is falling. Anyway, let me move on to PFI—

Mr Brown: Maybe I should just give you the figure that was in the Pre-Budget Report, that, in real terms, disposable income, that is after inflation, grew in 2006 by 2%, which is—

Q378 Mr Newmark: I am not talking about the past. I am talking about where we are today, a snapshot today. A snapshot today shows that real take-home based on the latest figures is actually falling.
Mr Brown: Well, can I just also give the Committee figures so that we do not confuse people. Disposable income, which is in real terms after taking account of inflation, grew by 2% in 2006 and the forecast is that it will grow by 2.25 to 2.75% in 2007.

Q379 Mr Newmark: That is not what I am talking about, yesterday or tomorrow, I am talking about today. Anyway, let us move on to PFI.
Mr Brown: Hold on, when I talk about 2006, it is actually the year we are living in and, when I talk about 2007, it is the year which is just ahead.

Q380 Mr Newmark: Let us move on to another favourite of yours, Chancellor, PFI. Actually I will not go on to PFI, I will just wrap up with an assessment of your 10 years with some comments from your colleagues.
Mr Brown: This dispassionate, objective Committee continues its work!

Q381 Mr Newmark: The Rt Hon Member for Sheffield Brightside has said of your record, "The tax credit system is in a shambles", the Rt Hon Member for Birmingham Edgbaston has said, "We have had excessive spending, rising taxes and excessive micro-management", the Rt Hon Member for Birkenhead candidly notes that, when Labour came to office, we had one of the strongest pension provisions in Europe and now we probably have one of the weakest, and last, but not least, your friend, the Rt Hon Member for Darlington, admits that the inequality gap is stubbornly and persistently wide and that poverty has become more entrenched on your watch. Chancellor, whose judgment do you trust, theirs or your own?
Mr Brown: The judgment of the facts, that two and a half million more people are in work, that more than a million children—

Q382 Mr Newmark: So you do not trust their judgment?
Mr Brown:a million children have been taken out of poverty, a million pensioners have been taken out of poverty, we have had the longest period of growth under a single government in the history of this country since the industrial revolution and we have moved from being seventh out of seven, and I hope that people will note this, in the G7 when your Government was in power in 1997, we were below Italy, we were below France, we were below Germany, we were below Japan and we were below Canada, to a situation where in the last two years we have been above Germany, above France, above Italy, above Japan and above Canada in terms of income per head. Now, that is progress for this country which I think most ordinary citizens would recognise and they would particularly recognise it when they know that interest rates are not at 15%, as they were under your Government, they are at 5% and they know that inflation is not at 10%, as it was for a long period under your Government, inflation, the CPI, is actually 2.6% and moving towards 2%.
Mr Newmark: So all of your colleagues are wrong and you are right?
Chairman: Chancellor, you probably thought you had more friends before you came in here!

Q383 Jim Cousins: Chancellor, in your Pre-Budget Report statement, you specifically mentioned that, with public sector call centres, you were going to save £400 million which is a cut in costs of 25%. Can you tell the Committee how many jobs lost that might imply and whether that would involve any outsourcing either to the private sector or offshore?
Mr Brown: It is basically co-ordinating the use of government call centres and avoiding any duplication. I think you would agree that that is a good thing to do. As far as the jobs are concerned, we have published our figures for Civil Service job reductions and there are 85,000 job reductions going to take place; 45,000 jobs have gone and another 40,000 jobs are still to go. Obviously, for the years after 2008 we will publish figures later.

Q384 Jim Cousins: Sir David Varney's report tells us that there are 55,000 jobs in public sector call centres, so cutting costs by 25% would seem to, possibly, indicate a cut of 12–15,000 jobs. You cannot confirm that?
Mr Brown: The job reduction figures within the Civil Service are 85,000 by 2008; we have already achieved 45,000, so 40,000 jobs are still to go.

Q385 Jim Cousins: That is correct. In the present public expenditure planning cycle you have referred to the cut of 85,000 jobs—45,000 which have presently been achieved, 40,000 more to be achieved by the end of 2007–08—but in the Pre-Budget Report there are clearly flagged up future public spending cycle indicators for a number of government departments, including the Department for Constitutional Affairs, and quite a high rate of cost-saving in a number of high-employing government departments, like the Department of Work and Pensions and HMRC. What additional level of job cuts do those indicator savings represent?
Mr Brown: There will be more jobs to go. I can assure you that in the next spending round, once we met the Gershon targets, we will have to reduce Civil Service numbers further.

Q386 Jim Cousins: This Committee has already had an indication from the Head of HMRC of an additional 12,500 job cuts on top of the 12,500 that are built into the 85,000 that you have referred to.

That indicates a level of public sector job cuts for the present and future public spending cycle of well over 100,000, does it not?
Mr Brown: I can confirm that 84,500 was the jobs figure for Gershon and that another 12,500 jobs on top of that would be scheduled to go within the Inland Revenue in the next public spending period.

Q387 Jim Cousins: The policy for public sector pay set out in the Pre-Budget Report clearly involves, in the immediate pay round, a cut in real take-home pay, does it not? Paragraphs 631 to 633 of the Pre-Budget Report.
Mr Brown: We have submitted evidence to the pay review bodies suggesting that settlements should be based on the inflation target of 2%. I think that is both fair and right. If we are going to maintain our record as a low-inflation economy then there needs to be discipline in public sector pay settlements. Of course, the individual pay that any teacher, nurse or civil servant would receive depends not only on the settlement itself but on other contractual agreements, including increments for length of service.

Q388 Jim Cousins: In addition to that, you have also set out a public sector pay policy in the Pre-Budget Report which points to a break-up of the national pay bargaining systems and the locking-in of low pay in the English regions to public sector pay, too. That is clearly set out in the Pre-Budget Report in the paragraphs I have referred to.
Mr Brown: We have had this discussion before, but what we want to achieve is more local pay flexibility. The Civil Service remit guidance requires departments to consider local pay as part of the business case they submit to the Treasury every year. All groups covered by the review bodies have an obligation to consider local pay in their terms of reference. Now, I think that is the right thing to do and that will continue to be the policy of the Government; just as you take into account London Weighting you take into account local pay conditions. You are absolutely right, Mr Cousins: first of all, there will be a reduction in Civil Service numbers in the next spending review period, and that will be in thousands, not in hundreds; secondly, public sector pay will have to meet the inflation target and be founded on that, and thirdly we are committed to greater local and regional pay flexibility.

Q389 Jim Cousins: Do you think, Chancellor, that you can achieve the higher levels of public sector productivity that, absolutely correctly, you are trying to achieve against a background of threatening the sack to large numbers of workers, squeezing their take-home pay and breaking up the national pay bargaining system?
Mr Brown: The issue for the public services is getting value for money. There is and will continue to be an increase in the numbers of nurses and doctors and people working in the health service, and in schools through teaching assistants and teachers, and if we can save money through administrative, clerical and what you might call back-office jobs being replaced as a result of new technology and get more resources to the front line, I think every one of your constituents will want to support that rather than criticise that. That is the best way that we can deliver better and high-productivity public services.

Q390 Jim Cousins: The economic base of the city I represent is in the public sector, and I represent a very large number of low-paid, public sector workers. To be honest with you, Chancellor, I am fearful of their reaction to the package of proposals you are setting out.
Mr Brown: Newcastle, as you know as well, is a fast-changing city; it is an education centre with large numbers of people attending university; it is a big research centre, with stem cell research based in Newcastle; it is a big entertainment and leisure centre—and that is not public sector work, that is private sector work—it is a financial and retail centre for the region, and actually known throughout the United Kingdom for that. All these things are contributing to the success of your city, and that is why the growth rate of a city like Newcastle has been very high in recent years and, I believe, focused on all these different sectors that are doing well, will continue to be high, but what we are not going to do is to shirk from the big decisions that are needed to make the public sector more efficient in future years and ready to get resources to the front line, including to nurses and nursing in your hospitals and including to better teaching and better support for teachers within your schools.

Q391 Jim Cousins: However, if the threat of redundancy and the squeeze on pay produces a crisis of confidence and performance in the leadership and management of the public sector, both at a political level and at an official level, is that not going to make it very difficult to achieve the productivity gains you are seeking?
Mr Brown: I have always found that the people you are talking about, the nurses, the teachers and the public sector professionals and, indeed, the ancillary workers—the home helps and carers—know themselves what needs to be done. People know that where technology is changing and other companies and other organisations are replacing, if you like, administrative and clerical jobs and getting more resources to their front line, so too must the public services do this. So we must not shirk from the change that is necessary to secure value for money in our public services and to get resources to the front line, which I think will be welcomed in your constituency, particularly when it is getting resources to policing, nursing and medical services and to education.

Q392 Mr Gauke: Chancellor, can I ask what new capital spending commitments with regard to schools were made in the Pre-Budget Report?

Mr Brown: Considerable. What we announced was public spending for schools right through to 2010–11. We have never announced before both the figures for the overall resources for education and the overall resources for schools. I do not know whether you want me to give you the exact figures, but we gave a figure, for the first time, for 2008–09, 2009–10 and then we gave a figure for the whole of education expenditure for 2008–09, 2009–10 and 2010–11. These were new figures. In addition, of course, I put more money into individual schools' budgets for this year so that, on average, the typical primary and secondary school pupil will have £200 per head. So all these were new announcements that meet our commitments on education in a way that I think can be summed up as the biggest capital investment programme in our schools and education in the history of our country.

Q393 Mr Gauke: Let us take those two areas in turn. First of all, capital spending. According to the evidence given to us by the Institute of Fiscal Studies, there is only £0.1 billion, in 2006–07 terms, in respect of capital investment that had not previously been announced before the Pre-Budget Report.
Mr Brown: That is not correct. The overall effect of the education announcements in 2006–07 are these: about £170 million set aside for education; £120—

Q394 Mr Gauke: What was new?
Mr Brown: That is new.

Q395 Mr Gauke: That is not what the IFS said.
Mr Brown: No. £170 million, on which there were Barnett implications, and I think £120 million or so went to English schools in addition to what had already been promised in the Budget to be a rise for next year. So that was totally in addition. We put more money into the Every Child a Reader programme, which is now going—

Q396 Mr Gauke: Can we stick to capital, just for the moment?
Mr Brown: You can talk about capital but I wanted to sum up all the new announcements. You will give me a chance to mention all of them later.

Q397 Mr Gauke: I am sure I will. Yesterday I asked one of your officials, Ms Brivati, the question of what new capital expenditure was announced in the Pre-Budget Report that related to schools? The reason why I asked that—
Mr Brown: 2006–07 or 2008–09 or 2009–10?

Q398 Mr Gauke: Going ahead, what new announcements were made in respect of capital? The evidence we have had from the IFS is that there is only £0.1 billion, and that, they believe, relates to colleges, not to schools. Do you dispute that figure?
Mr Brown: No, because I made an announcement for money going direct to schools for 2006–07—

Q399 Mr Gauke: Let us stick to capital. The capital spending—
Mr Brown: A lot of that is capital. Do you think it is capital or do you think it is not capital? A lot of it is capital.

Q400 Mr Gauke: According to the IFS only £0.1 billion relates to capital, and that is not going to schools. I asked Ms Brivati for an answer and she was not able to give the figures yesterday. She said she would write to me before the close of play. We have an answer but it does not begin to address the question of what new money announced in the PBR related to capital expenditure. We have the evidence from the IFS; they say there is nothing for schools on capital. They say there is more money for colleges. Do you dispute that?
Mr Brown: Which year are you talking about? What we have done is we have announced 2006–07 expenditure, we have announced new figures for 2007–08, we have announced new figures for 2008–09 and we have announced figures for 2009–10 and 2010–11. Which figures are you talking about—which year—so we can go through each one of these years and clarify it for you?

Q401 Mr Gauke: For the next year I think we are talking about £0.1 billion. Is that right?
Mr Brown: We are talking about expenditure per individual school and then we are talking about additional money for colleges as well. Yes.

Q402 Mr Gauke: So what is the breakdown?
Mr Brown: I said that £170 million had been put into schools and £120 million of that was for English schools[1]. I think you are right[2]; £100 million has been put into further education colleges. So it is additional money.

Q403 Mr Gauke: Let us move on to current spending. You quoted, again, this morning the extra £200 going directly to schools.
Mr Brown: That is what I have just mentioned.

Q404 Mr Gauke: Indeed, the £200. Again, according to the IFS, £120 of that was announced before the last Budget, £60 of it was announced at the last Budget, which leaves only £20 per pupil new money. Is that correct?
Mr Brown: I hope you support the fact that we have actually increased—

Q405 Mr Gauke: Is that correct?
Mr Brown: It is additional money.

Q406 Mr Gauke: The announcement was £20 new money. That is the effect. I take the whole figure as £200, but £180 of it has been announced before. Do you agree?

[1] *Note from Witness:* This refers to current spending, as the answer to Q403 states.

[2] *Note from Witness:* The correct figure is £250 million, not £100 million.

Mr Brown: I do not think it is £20 because there is a different figure for primary schools and secondary schools. So it is £225 per pupil in secondary schools, and £200 for pupils in primary schools. I think, if I am right, there is a bigger rise for primary schools as opposed to secondary schools. It does mean that the typical primary school will be around £50,000 in 2007–08 and the typical secondary school will be £200,000, and I raised it from what I had already announced in the Budget.

Q407 Mr Gauke: Chancellor, the reason why I am asking these questions is because the central political message of your Budget was "more money for schools".
Mr Brown: So it is.

Q408 Mr Gauke: I look at the press beforehand. I do not think they have made all this up. This is from the Press Association: "Mr Brown is expected to announce new cash for refurbishment of thousands of state schools"; we have got the BBC: "The Chancellor is expected to announce big investment in schools and colleges"; the *Financial Times*: "Gordon Brown will put fresh investment for schools at the heart of Wednesday's Pre-Budget Report". The figure we are talking about is £20.
Mr Brown: No, it is not.

Q409 Mr Gauke: That is the new announcement.
Mr Brown: Mr Chairman, we have got to get this in its proper perspective. We have announced money for this year (that is 2007–08—the coming year); we have also announced money for 2008–09, 2009–10 and 2010–11. The total cumulative announcements run into billions, and because by 2010–11 we are spending £10 billion on education and £8 billion on schools, it is right to say that this is the biggest ever capital investment programme. If you want to go back to 2006–07, current expenditure, we have the additional expenditure per pupil, we have the increase in the Every Child a Reader programme, we have the increase in the amount of money going for personal tuition, we have the increase in the London—

Q410 Mr Gauke: Chancellor, this has all been announced before. There is very little new money. This is what *The Sun* said the morning before: "Brown's Class Act. Chancellor's refit for 21,000 schools to cost billions". It is old money.
Mr Brown: It is not old money.

Q411 Mr Gauke: Chancellor, this is spin. This is pure spin. You have announced nearly all of it before. £200, all but £20, has been announced before. The billions on capital have all been announced before. You are the biggest spin merchant north of Shane Warne. You make the Prime Minister look like Ashley Giles. Is there any wonder there is a lack of trust in politicians.

Mr Brown: Mr Chairman, we have just announced the biggest programme of education investment in the history of the country. There is £10.2 billion for education by 2010–11; there is £8 billion for schools; we announced new figures—

Q412 Mr Gauke: Which you have announced before.
Mr Brown: No, it is not true. We have announced new figures for the years 2007–08 (I have just given you them) for current and for capital expenditure. We have announced new figures for 2008–09 and we have announced new figures for 2009–10. Unless you are prepared to deny that the cumulative effect of all the announcements we have made is the biggest educational investment programme in our history—and I would like to know whether the Conservative Party is prepared to support this new investment in schools—I think what you are saying is completely misleading. We have just put billions more into the schools and the colleges as well.

Q413 Mr Gauke: Chancellor, would you accept that the rate of increase of capital expenditure on schools and education as a whole is dropping? From 1997 to 2007 it was going at around 15–16% and from 2007 to 2011 it is going to be round about 4.9% for schools and 4.3% for education as a whole.
Mr Brown: In real terms it is much higher than the inflation rate and is probably going to be the highest of any of the major departments, simply because we have this huge additional programme of investment in schools. The test of this is going to be the number of primary schools that are given new facilities and the number of secondary schools that are given new facilities. I am surprised that Members of this Committee think it is almost a spin to announce that schools in our constituencies—and almost every one of our constituencies benefits from this Building Schools for the Future programme—are not going to get money when they are going to get money. We are going to have refurbishments of schools to give—

Q414 Mr Gauke: It has been announced three or four times. You keep re-announcing it. There is very little new money.
Mr Brown: I am sorry, it has not been announced three or four times, and you have not proved your point because I have just told you that in 2006–07 there is more money; in 2008–09 there is more money; in 2009–10 there is more money and in 2010–11 there is more money. In each of these years I have given new figures to the House of Commons for the amount of investment that is taking place. Okay, the Conservatives are not interested in the amount of investment going into the schools; they are simply interested in what sort of figures and percentages and everything else. The fact of the matter is more investment is going into our schools.

Q415 Mr Gauke: Chancellor, can I look at public expenditure more generally, briefly. According to the projections that we have within the PBR, from

2008–09 to 2011–12 it is forecast to grow at 2% or below in real terms. That is above inflation but below, presumably, the growth rate of GDP. Are you content that as a consequence public spending will be falling as a percentage of GDP?
Mr Brown: You will get the announcement of the final results of the Comprehensive Spending Review when we publish it during the course of next year.

Q416 Mr Gauke: The projections are that public spending will fall as a percentage of GDP.
Mr Brown: These are projections; you will get the final announcements during the course of next year, and all I can say is that these are the projections.

Q417 Mr Gauke: Do you have any objection in principle to public spending over these years falling as a percentage of GDP, as you are assuming?
Mr Brown: I have always said you have to do what is right for the country, and what is right for the country may be, in some years, percentages going up and, in some years, percentages going down, but we are going to do what is right for the country. Final figures will be published when we have completed our review.

Q418 Mr Gauke: If public spending is above the rate of inflation but falling as a percentage of GDP, do you consider that to be a cut?
Mr Brown: I think you will have to wait until you see the final figure—

Q419 Mr Gauke: Theoretically, if public spending is falling as a percentage of GDP is that a cut?
Mr Brown: You have got this wrong, because in every Budget a government must make a decision between the balance between tax and spending and the stability of the economy. As far as the results of our public spending review are concerned, these will be published during the course of the next year. You will just have to be patient and wait and see what the results—

Q420 Mr Gauke: This is not to do with the particular numbers, Chancellor. Imagine you are an economics tutor explaining to a dim undergraduate, and I am the dim undergraduate. If public expenditure is falling as a percentage of GDP, is that a cut in public spending?
Mr Brown: I think you will have to wait until you see the results of the review. Then you may be quite surprised.

Q421 Mr Mudie: Chancellor, I will come back to education but I want to ask you a question under fairness for pensioners. Last week the Social Care Commission reported that 100 out of 150 providers (I presume local authorities) are no longer providing home help care to the elderly, unless under very extreme conditions, which means thousands and thousands of old people are not getting home help. In my constituency the *Evening Post* carried a front page story yesterday of a 94-year-old war hero in a wheelchair who has been assessed as not needing a home help. He gets by with a 78-year-old woman next-door to him, who has osteoarthritis, doing his cleaning. Now, when I raised this with the council they blamed the Government; they say either cuts or they have been encouraged by the Government to cut back on home helps. Can you enlighten us as to this, because it is a totally unacceptable situation? I am regularly meeting elderly ladies in their late-70s who, years ago, would have qualified without question for a home help and are now neglected.
Mr Brown: The assessment of who gets home help is not for the Government; the assessment of who needs home help and who does not need home help is a matter for the professionals who make that assessment. I cannot, Mr Mudie, make a judgment as to whether your constituents should or should not have home helps; that is a matter for the proper authorities. What I do know is that the social care budget and the general budget for social services continues to rise.

Q422 Mr Mudie: So you see no reason why over the years fewer and fewer elderly people are getting home help? The money is there you are saying.
Mr Brown: There are more elderly people in the population, and many of them are very fit indeed. When people need home help that is assessed by the proper authorities. I cannot make a judgment from here—

Q423 Mr Mudie: Of course you cannot.
Mr Brown:about whether people need this home help and are deprived of it or not. What I do know is that the social care budget continues to rise.

Q424 Mr Mudie: So you reckon if an elderly person, 94 and in a wheelchair, with nobody else in the household, is judged as not needing home help, it is not financial reasons; you think the council have the money but they are setting the criteria at a level. Do you accept that level?
Mr Brown: I cannot judge this case. All I know is that I know 90-year-old pensioners who are getting home help in, certainly, my constituency, and I think in other constituencies around the country. I think you will find that these assessments are made on an individual basis. Obviously, the social care budget continues to rise and I hope that people who need home help will get it.

Q425 Mr Mudie: That is a step forward. I asked your officials, I think probably unfairly because it was cold—no warnings—for some figures, but you have now had 24 hours and I am sure the worthy Jon, on your left, has provided you with the figures. He is looking a bit worried, but somebody should have. You put two pledges in the PBR (and we are going back to schools). I think you got an answer to Angela wrong; you said something about "every school over 15 years is eligible." If you look closely it is over 15 years, half of primary schools and half of secondary schools will either be refurbished or rebuilt. The first thing is what is the starting year for that 15-year pledge?

Mr Brown: That has already started.

Q426 Mr Mudie: I know, but we do not know—and we simply ask you—which is the starting year?
Mr Brown: You will find that the two statements are right. One is that the schools—

Q427 Mr Mudie: The two statements are right.
Mr Brown:which are eligible for the refurbishment that is taking place under this programme are mainly schools that are over 15 years old. So schools that have been built in the last 15 years do not need the level of refurbishment that we are talking about. The second point, however, that you are making is that there is wave one already of the Building Schools for the Future programme; it was launched in February 2004 in the SR204 period (that is between 2004 and 2007) and £2 billion a year has been spent on this programme. This programme then moves into higher gear, contrary to what was being suggested by the previous question, and more money is spent each year on the school programme in future years as you move from waves one to three, which covers 38 local authorities, to the next wave of authorities in future years and then you have got the secondary school programme as well as the primary school programme.

Q428 Mr Mudie: I am not sure where that leaves us. The primary school refurbishment/rebuild, 15-year programme, started in 2004; secondary started in 2004. Do we know how many primary schools we have? Do we know how many secondary schools we have? Therefore, if we have both figures we know how many schools should be in the programme. Do we know? We did not yesterday.
Mr Brown: I thought it was something in the order of 31,000 schools.

Q429 Mr Mudie: Do they not brief you beforehand, Chancellor?
Mr Brown: Three thousand one hundred of the 3,500 secondary schools—

Q430 Mr Mudie: Can you slow down because we are trying to get this on the record. How many primary schools and how many secondary schools?
Mr Brown: For secondary schools it is 3,100 of 3,500 secondary schools, and I will give you in a minute the figure for primary schools. Twenty-thousand primary schools exist in the country. I think 90% are covered by this programme.

Q431 Mr Mudie: Let us take secondary, to start with. The officials can catch up with you on primary. It is usually the other way round. That means you are committed in Budget terms to rebuilding or refurbishing 1,500 secondary schools in 15 years.
Mr Brown: I am saying about secondary schools that 3,100 schools come within this programme.

Q432 Mr Mudie: I will settle for that. That means we have 6,000 secondary schools and the programme is to do half of them over 15 years.

Mr Brown: I am saying that the number of schools covered in the secondary programme is 3,100. I may have to correct that.

Q433 Mr Mudie: I will settle for that figure. We have this absolutely difficult job of scrutinising public expenditure, and it does not help when the Treasury will not give us figures on just a simple thing like the number of secondary schools in the country.
Mr Brown: The figure I have here, which is a figure I read out in the House of Commons, is overall around 3,100 of the 3,500 secondary schools in England will benefit from Building Schools for the Future.

Q434 Mr Mudie: I will settle for us being sent a note by your officials about how many schools. That means either 1,500 or 3,000. You have started the programme for three years. How many have you done in the three years? We are tired of these programmes of 10–15 years that do not seem to meet the targets. I am asking, after three years, where are you? Are you on target?
Mr Brown: Waves one to three cover 38 local authorities, which is a quarter of all local authorities, and nearly 400 schools, mainly in the deprived areas of the country, are now under way for the BSF programme.

Q435 Mr Mudie: We are in some difficulty here because we do not know how many schools. Again, I presume, you will not object to providing us with a note of how many schools are in both programmes and what was the estimated cost of that programme?
Mr Brown: Three thousand one hundred are in the full BSF programme. The number of primary schools in the country is 20,000, and I have said that half the primary schools in the country are covered by that.

Q436 Mr Mudie: Chancellor, I would be happy with a note. One of the things I am perturbed about is you have this programme and this budget and then last week, a week before your PBR was published, the Prime Minister doubled the number of academies, thereby upping the programme by £5 billion. Is that in your future public expenditure figures?
Mr Brown: Yes, the figures for secondary schools will include city academies.

Q437 Mr Mudie: Can you tell us, what is the average figure for secondary school rebuild or refurbishment compared with the £25 million for the academies?
Mr Brown: I think £25 million is the cost of one or two of the academies. I do not think—

Q438 Mr Mudie: One was 30, Chancellor.
Mr Brown: I do not think it is necessarily the cost of future academies, but the 3,500 secondary schools include academies, and 3,100 are to be renovated, and that will include academies.

Q439 Mr Mudie: In other words, if we just sum this all up, can we get a note in the next few days from your officials about the number, the costings, the estimated cost and the spending and completions to date broken down by sector? That would be very useful.
Mr Brown: Yes, I think we will get a note from the Department of Education that we will pass to you.

Q440 Mr Mudie: I am very interested in their names, their buildings and their locations, because I would raise with you that my good friend and your good friend, Ken Purchase, told me over breakfast in the tearoom that Wolverhampton has not got one secondary school refurbished or rebuilt because they will not take a decision on the academy. Is this a Cabinet policy—that if you do not take an academy you do not get put in a programme?
Mr Brown: There are 3,100 secondary schools going to come within this programme. It means that in areas where there are academies and areas where there are no academies schools are going to be refurbished. I was in Wolverhampton recently and I saw a huge amount of investment going into Wolverhampton University, so the college facilities there—

Q441 Mr Mudie: That is not a school.
Mr Brown:—are improving.

Q442 Mr Mudie: Chancellor, things have changed from your day. That is not a school. Not one school has been rebuilt or refurbished in Wolverhampton because they will not take a decision on an academy. I find that appalling.
Mr Brown: I would be very surprised if out of the 3,100 secondary schools to be renovated there is not one to be renovated in Wolverhampton. I think that is probably—

Q443 Mr Mudie: It comes on good authority: Kenneth Purchase. I do not want to know from the DfES. I want to know from the DfES details of the schools, if you wish, but I want a financial note. We are the Treasury Committee and we are here to scrutinise public expenditure. Can I have a public expenditure note along the lines suggested? Jon, is that okay?
Mr Brown: We will give you a list of the costs year to year of the schools programme.

Q444 Mr Mudie: No, no. Chancellor, are you refusing what I have asked for? I have asked, and I have spelled it out and it is on the public record. Are you agreeing to give this Committee a note of the programme, the estimated outturn of the programme, the completions to date and the public expenditure to date on that programme, year by year? If you are, fine, but that is what I am asking for.
Mr Brown: We can give you a note that we have from the Department for Education on the individual allocations for the schools, secondary and primary, over the course of the last few years, and we can give you a note of how much money has been spent on it, yes. [3]

Q445 Mr Mudie: What about the starting point? You are the Chancellor.
Mr Brown: The programme was launched in February 2004.

Q446 Mr Mudie: When you agreed a 15-year programme you must have got an estimated cost for it. I am asking for that. I think that is a relevant question for somebody on the Treasury Committee to ask the Treasury officials.
Mr Brown: We have allocated money now right through to 2011.

Q447 Mr Mudie: If you are not going to we will take it up in our deliberations, Chancellor, if that is your last word. I find it unacceptable that you will not provide straightforward financial information to the Committee.
Mr Brown: I am about to give you the figures for the amount of money spent, and I am going to get from the Department for Education the figures for the number of schools renovated, which is what you want.
Mr Mudie: Thank you.

Q448 Mr Breed: Chancellor, in the PBR you reiterated the Government's very laudable goal of eradicating child poverty in a generation. Of course, the commitment to those underlying targets has milestones to achieve that. If the Government is to meet its target of halving the number of children in relative low-income households by 2010–11 then child poverty needs to fall by half as much again in the next six years as it has in the past six years. Do you accept the findings of the IFS and others that an additional £4.5 billion will be needed if you are to actually reach that 2010–11 target?
Mr Brown: No, I do not necessarily accept these findings, because there is a whole series of ways that you can reduce child poverty. The most important way, that I think the Committee would agree on, is to get people back into work. If people are in work, earning a wage and able to contribute to their children's upbringing that is the best way by which you can reduce child poverty. We are determined, obviously, to get more people into work. We have had some success—2.5 million more in work—but there is more to be done. That will be the principal means by which—getting more people into work—we give families higher incomes.

Q449 Mr Breed: In order to achieve the targets, therefore, we are looking at a spectrum of things, of which additional money is only a part. There are no indications within the PBR of what those measures might be in trying to reach that particular goal.

[3] Ev 84–86

Mr Brown: I can tell you that one of them is getting more people back into work. In the last year I think it is true that 90,000 people have come out of inactivity and into work. Some people have come off incapacity benefit, and some people have come off single parent income support and gone into jobs. These are means by which, apparently, those previously on benefits are now receiving income from work. Some of them will also be receiving the working tax credit and they will also be receiving the children's tax credit. So they will be better off in work with a wage and the children's or work tax credit, or both.

Q450 Mr Breed: Do you accept that at the present time we are a bit behind the curve in terms of the quarter and half milestone targets to achieving it?
Mr Brown: Our target is for 2010. We actually met our previous target, which was for the first five years. So we met our previous target and we have got to do what we can to meet the next target but, as I say, there is a range of things that a government can do to meet these targets.

Q451 Mr Breed: You have just mentioned tax credits. Tax credits have been modelled as a very effective way of targeting low-income families. In that case, why did you elect to extend the eligibility for child benefit rather than to extend the tax credits system?
Mr Brown: This is a big issue about nutrition and support for mothers who are about to give birth to children and support for them at the point at which the child is being born. We do give a maternity grant on top of the other benefits to mothers in low-income families at 29 weeks. The £500 that is made available can be paid in stages from 29 weeks. However, I felt that we should look at how we can help all mothers at this particular point in their lives, and this is not simply the poorest mothers, it is all mothers; where there are additional costs there are also additional worries, there are issues about nutrition and about the health of the mother as well as issues about the health of the child. Just as we provide maternity allowances to every mother—and we actually provide, during the first year of the life, child tax credit at a higher level for every mother and, therefore, every child—I felt that we should look at what we could do for that rather critical period. I felt in these circumstances it is right to help all mothers and not just some mothers.

Q452 Mr Breed: When you say "all mothers" that is all mothers of all income groups, including of course all those that would not necessarily be classed as low-income.
Mr Brown: I believe in child benefit. The point I am making is that there are two parts to this policy. One is to recognise that every child in our community deserves support, and that we, society, should recognise the costs that parents have to bear in bringing up their children and in bringing their children into the world. This is a particular part of it, where there are huge costs associated with the last stages of pregnancy and there are huge difficulties if people are not properly getting nutritious food and everything else. Then there is a second aspect of this: how we can deal with low-income families in our country and help them? So on top of child benefit, which is universal, and a universal recognition of the costs of bringing up children, there is also, I think, some recognition for the low-income families (or, if you like, middle-income families in this country because child tax credit goes right up the income scale to over £50,000) of the costs that particular families that are not the wealthiest families have to bear as well.

Q453 Mr Breed: However, you must accept that child benefit is not targeting the low income, in that sense.
Mr Brown: No, but child benefit, I hope the Committee would agree, is a good benefit because it goes to every mother and to every child. It is a recognition that we in Britain have of the responsibilities of parenthood and society's duty, in my view, to help people with the costs of bringing up their children.

Q454 Mr Breed: Is it not really an admission that the tax credits system has become so complicated now that to add another part to that would just exacerbate an already difficult situation.
Mr Brown: You started your question by asking about child poverty. I think you would have to agree that the biggest single factor in reducing child poverty in this country in recent years, and the reason we met our first target and the reason we have reduced child poverty continuously, is because of the child tax credit. I just repeat: when we came into power the poorest child—

Q455 Mr Breed: If it is so successful why are you not extending that?
Mr Brown: I am sorry; I am saying there are two purposes in public policy: one is to recognise the needs of every parent and every child, which I hope you would agree is necessary, and the second is to recognise the particular circumstances of a large number of families in this country who need more income than simply the standard child benefit.

Q456 Mr Breed: So you did not consider at all extending the full tax credits system to those with 29 weeks—
Mr Brown: In case it is not known, support available for low-income families after 29 weeks includes a maternity grant at £500, which is paid in stages. That is something we introduced; it was £100 before and now it is £500, and we made it possible to be paid so that mothers could buy clothes and other things that a child would need when they were born. There is a second element of our help as well, and that is support for diet and nutrition, where we provide between £6 and £12 a week for mothers for the nutrition of the mother-to-be and, then for the nutrition of the child in the years from 0–1. So for low-income families, in addition to child tax credit at

a higher level, there is also available the maternity grant and, as I have just said, help in particular payments for nutritious food, including milk and other baby foods. So I think we are doing quite a lot to help mothers at this stage in their pregnancy and at the point at which a child is born; I think the issue for us was that we wished to recognise the needs of every mother as well as the specific needs of low-income families.

Q457 Mr Breed: Can I just briefly turn to transportation. The costs of motoring have, effectively, declined over a long period of time. In fact, the real costs of bus and rail travel have shot up, and we certainly know that in rural areas of Cornwall, which I represent. You decided against the reintroduction of a fuel duty escalator, which I suspect was a relief to lots of people, but if you are not going to do that how are we going to really ensure that motoring starts to be addressed and that we try and get down transportation costs in order to try to attract people on to public transport for all the environmental reasons?
Mr Brown: I think you will find that the support that has been given to public transport over recent years, both locally and nationally, has risen very considerably. Our bus schemes for rural areas—

Q458 Mr Breed: Do you accept that fares have really gone up very high?
Mr Brown: You have also got to accept that provision in railways and in buses has also improved as a result of changes that we have made, and a very considerable amount of public money goes to help with bus fares and to help with rail fares. We have always got to get the balance right. In the end, this is an individual choice that motorists, or travellers, have got to make themselves. I think people have to be aware of the real costs in terms of emissions of different forms of transport, and we are trying to make people aware, but I do not think it is true to say that we have not supported public transport; we have supported public transport with a very considerable increase in support for the rail network, the Underground refurbishment, of course, is taking place, and also the road network.

Q459 Mr Breed: Do you believe that the balance is right at the present time?
Mr Brown: We always have to look at what is the best balance moving forward, and that is why we commissioned the Eddington Review, to look at some of the problems in transport that we now have to deal with. We have now got—and this comes back to the Chairman's question at the beginning—a period where people can absorb what the Eddington Review has said, give us their views on that as on the other reports, and it will allow us to make further decisions both in the Budget and then in the spending review.

Q460 Kerry McCarthy: If I can return to child poverty, in terms of trying to meet this 2010 target there has been a fair amount of debate about whether, as Colin Breed said, a targeted approach is the best approach or whether more general increases across the board are the way forward. There is a campaign at the moment for the equalisation of child benefit. Is that something that you have been taking into account?
Mr Brown: Equalisation by means?

Q461 Kerry McCarthy: Yes. Maybe if I elaborate the question.
Mr Brown: Please do.

Q462 Kerry McCarthy: There are various campaign groups that are putting forward their views on how you could spend this £4.5 billion that they suggest you might need to spend to meet the child poverty target. One suggestion is equalising child benefit so that the second, third and fourth children in a family get the same as the first child, which obviously is not a targeted approach as such, although you could say that poor families tend to be larger families. Another suggestion has been that in order, perhaps, to reach those families that are lower down the poverty scale seasonal grants might be a good idea, and they would be very much targeted at the poorest families. Could you give us some idea of what you think of those two approaches?
Mr Brown: I had a meeting with some of the pressure groups yesterday. There are a number of different proposals, and obviously it is right, particularly in the spending review period, to look at all the suggestions that are being made. One, of course, is about equalising the level of child benefit for the second and future children to that of the first child. That is a proposal that is particularly targeted at dealing with the poverty amongst large families in this country. A second proposal is what has come from a network of pressure groups, including Save the Children. It is that you have a seasonal grant, rather like the pensioners' winter allowance; you have a Christmas allowance. The issue there, if I may say so, is that if you look at a child's life over the course of a year, there are different pressure points. Christmas is certainly one of them, when children expect that you recognise Christmas by gifts, but birthdays are another, the summer holidays are another, when there are extra costs associated with children being out of school, and then there is the return to school in September when school uniforms and other forms of additional expenditure are likely to be incurred. So there is no one point in the year, it seems to me; there are many points in the year which are pressure points for families. I think that points to the general level of benefits being the issue rather than, particularly, Christmas or summer or a birthday, or whatever, being the issue to be dealt with. It then comes back to this issue about how best are we going to deal with the problem of children's poverty in future years. We all start from the proposition that every child should have the best possible start in life. That would normally, if it is possible, be in families where the breadwinner is actually in work rather than out of work, and we are trying our best to encourage more employment

opportunities for heads of families. I think we have had some success, and we have got to do more in future years. To some extent, our support is now targeted on getting the things that, for example, a single parent needs, which is child care and training to get into a job. I think that will probably do quite a lot to help more people out of poverty in future years.

Q463 Kerry McCarthy: If I can just push you a bit more on the question of grants as opposed to child benefit increases, I think if you look at the Save the Children proposal they would be suggesting £100 per child as a summer grant—
Mr Brown: They want a summer grant as well?

Q464 Kerry McCarthy: Yes. So if you had a two-child family it would be £200 at the beginning of the summer to cover the fact that, for example, if a child is on free school meals a parent has then got to feed them throughout the six-week summer holiday and you have things like school uniform costs, and maybe, even take them on holiday. Then a £200 winter grant, plus £100 for the household. So you are talking about £500 every year. If, instead of that, there was an equalisation of child benefit (I am not quite sure of the difference between the payments for the first child and the second, but I think it is about £5) that would bring in £250 to that family.
Mr Brown: The difference is about £7.

Q465 Kerry McCarthy: It would still bring in quite a bit less to the household than having grants. In terms of the costs to the Exchequer though, because it would be paid to all families with two children or more, equalising child benefit could be more expensive. You do not sound like you are that enthused by the idea of grants. Are there other mechanisms? Are we looking then at increases in the tax credits system to try to achieve that more targeted approach?
Mr Brown: We are increasing the child tax credit in April from £62 to £64 for the first child. For a two-income household the combined child tax credit with child benefit on top of that will be something in the order of £100, and so we have raised benefits significantly. Obviously, it is right that in this period, when we are looking at the issues related to child poverty, we look at all the representations and I cannot give you any particular new answer today. What we did announce about child benefit and more support for children who are falling behind in schools we announced last week but we obviously will look at future measures for future announcements, whether it is in the Budget or in the spending review, and we keep all these things under review. Our aim is to use resources to best effect to deal with these problems of poverty, and there is also focus on helping children gain literacy and numeracy to enable them to benefit from their education. That is very big issue and that is why, for example, we give books to children and families where it is not normal or common to have lots of books in their homes and yet literacy is so important. At one, two and three we give books. At five we are now going to give books. At the age of 11 we are going to give children the choice of a book as they go to secondary school because we simply realise that we have to encourage reading and literacy in our children if they are going to benefit from their education.

Q466 Kerry McCarthy: To what extent is child poverty a cross-cutting issue? I say that because I did an event with Save the Children recently and it was young people, 16 to 18-year olds, who were talking about the problems that they had getting into training and work. The biggest issue they came up with was transport because they lived in a rural part of south Wales. They wanted to study, they wanted to go work but there just were not the bus services because transport was seen as a completely separate issue from helping them go to college or work.
Mr Brown: I think school transport is an issue but also, obviously, is travel to college, which I think is probably what you are talking about in the case of these young people.

Q467 Kerry McCarthy: Yes, to things like apprenticeship schemes.
Mr Brown: Education maintenance allowances are now available for people over 16, not just for school but in some cases for college courses. We are trying to make it possible for people from low paid families to benefit from education and encourage them to stay on. I think the Welsh Assembly has done particular things in relation to public transport that may be of help here. I will write you a note on that.

Q468 Kerry McCarthy: If I can move on to planning, the Barker review, if it is implemented, will make a huge difference in terms of regeneration and being able to move forward inner city development. There is some suggestion in there that is talking about the transaction costs associated with planning delays and the burdens on business and developers that result. You flag up in the Pre-Budget Report one of Barker's suggestions, which is that firms may be able to pay for additional resources to speed up applications. I know that certainly in my constituency, which includes a major part of Bristol city centre, there have been really significant delays of several years in trying to get major applications through and it is because of a shortage of planning staff. The fact that you have flagged up that specific proposal in the Pre-Budget Report makes me think that you might look more favourably on that than other things. How do you make sure that that does not mean that people are buying their way into getting a favourable outcome from the planning process?
Mr Brown: You are right to say that there is a number of proposals in the Barker report, but we are in a period of consultation, so I think the best thing is to listen to your views, the Committee's views and other people's views on this before we make any final decisions. It is a cross-departmental review, obviously, because it affects the Treasury,

the Department of Communities, the Transport Department and all sorts of different people, so I think it is important that we listen to people's views and if the Committee wishes to express a view on this we are interested to listen to that.

Q469 Mr Love: Can I take you back, Chancellor, to a question the Chairman asked? I was slightly surprised by your up-beat assessment of the possibilities of an agreement on world trade talks. That seems to reflect Tony Blair's view but I am sure that the US Treasury Secretary would probably also share that view. If you look at the United States at the present time, we have an unpopular and beleaguered President with less than two years to go and a newly elected Congress that appears not to be as favourable to international trade agreements as the previous Congress. Are you not somewhat worried that protectionist sentiment is beginning to grow and how do we stop that growing to keep the world economy on the move?
Mr Brown: I think protectionist sentiment is growing and I think that is all the more reason to strive harder to get a world trade deal. I think in Europe itself you have seen, despite the fact that there is a single market, countries acting to either protect their own industries or to prevent cross-border mergers, takeovers and acquisitions, and I think that is putting the single market under huge pressure. In just about every major European country there are protectionist sentiments growing. In America we have also seen that people believe that in some cases they can protect or shelter their industries from foreign competition, and we need to point out to people that this is self-defeating because in the long run you are going to have to face up to that competition, and indeed you may do more damage to your economy by protecting and sheltering it than by taking the steps that prepare you for the future. We have got to win the argument, therefore, that it would be a mistake to allow the trade talks to completely lapse. The spillover from that would not just be in agriculture without tariff reductions and subsidy reductions; it would also mean that on almost every world issue on trade when the World Trade Organisation tried to act it would find it more difficult to do so. It is incumbent upon us and an imperative that we try our best in these remaining few months to try and get these trade talks going. As long as the United States has fast-track authority and as long as the negotiations are being pushed forward by Pascal Lamy I think we should try our best to support him. When I look at the detail I think that there is not such a huge difference between what Europe and America are offering at the moment and what they would need to offer to get these trade talks moving forward.

Q470 Mr Love: So is what we are talking about just keeping the trade talks going at the present time in the hope that protectionist sentiment will not grow, or is it trying to reverse protectionist sentiment, and do you think that we are in a position where there could be a concluded agreement?
Mr Brown: The biggest blow to protectionism would be that the world was capable of signing a trade deal which was basically people opening up trade in all the different continents, and, obviously, because it is the Doha Development Round, helping in particular the developing countries. We have also a duty to try and persuade people that the modern equation is free markets, free trade, flexibility, plus investment in education and in science and infrastructure in fairness to people who have got to equip themselves for the future, but the modern equation that will not work in reaction to there being free trade is to simply become protectionist when things start to go wrong. We have got a big persuasion job to do, partly with our electorates and certainly in every country of the world where protectionist sentiment is growing, to show people that the way to deal with these problems, which is essentially the result of the global restructuring that is taking place because of the entry of China and India into the world economy, is not to shelter yourself and try and postpone the inevitable but actually face up to it by moving up a gear in your economy by investing in education, infrastructure and helping people equip themselves and their companies and their communities for the future.

Q471 Mr Love: Can I move on to efficiency targets in administrative savings that were announced in the PBR? You suggested a 3% efficiency target across the whole lot, and yet Professor Colin Talbot told us in one of our previous hearings that under the Gershon review the Cabinet Office only saved something like 0.4% whereas the Department for Work and Pensions saved 5.8% per year over the three-year period. How confident are you that the 3% across the board can be delivered by all departments?
Mr Brown: That is what we talked about before they reached this agreement with us, that this is what they will actually do. We are talking about the next stage. The Gershon report will take us through to 2007–08. The next stage is setting these cash efficiency targets, then the administrative savings, which will release substantial resources that will enable us to make our commitments to the front-line services that continue to need to expand. Although the departments will find it challenging I think it is the right thing to do.

Q472 Mr Love: Some people are suggesting that "challenging" is the appropriate word since the overall increase in productivity in the economy is 2.4% at the present time. Are all departments confident that they can reach what is a fairly challenging target, because if you add into that the administrative savings of 5% you are talking significant figures?
Mr Brown: But that is exactly how modern organisations should be coping with the challenges of the future. New technology makes it possible to reduce administrative costs and to replace jobs that are no longer essential by giving you resources at the front line where you need them most, and it is right to challenge all the departments to do so, so yes, it is

better to have a tougher target in the next round than we had in the previous round in terms of both efficiency and administrative savings, but I am confident that that is the right thing for both the British public services and for the British economy. The results of that, of course, will be something that will be beneficial to all of us because they will enable us to do the best we can by education, health and the other front-line services.

Q473 Chairman: Chancellor, I am looking at table B12 on page 232. Revisions to the national accounts data, by the way, in there suggest that economic growth has been stronger in recent years than previously thought. However, looking at this table, tax receipts have still been below forecast in these years, and I am looking at VAT and non-North Sea corporation tax, which have been down in both years, 2005–06 and 2006–07. Does that suggest that tax receipts are less responsive to output growth than previously thought?
Mr Brown: I think if you look at the figures you are talking about –0.3 and –0.7 for non-North Sea corporation tax and that is a relatively small figure in relation to the overall increase that has taken place in revenues. If you look at VAT, to some extent I answered your question earlier. When we have been dealing with this very big attack on the VAT system I do not think we should underestimate the potential loss of revenues if we cannot reach agreements that will deal with missing trader fraud. We have had a long negotiation with France in particular on this issue and to have brought it to a conclusion last night, where we got an agreement to attack VAT fraud, means that we are in a better position looking forward. I am hopeful that the revenues that will result from that, by eliminating this loss of money in the VAT returns, is going to be something that will be beneficial in future years.

Q474 Chairman: But there has been a view, even in the USA, that if you have increased growth you get less tax receipts in this globalised world; that is all. Is there a trend there?
Mr Brown: I do not have the exact figure here but I think that corporation tax revenues are up something like 10% or 12% this year. I think you are talking about quite a big rise in corporation tax receipts rather than a fall in them over the course of the year, and I think in VAT you are talking about this particular issue that we are dealing with, and where fraud takes place you have to deal with it, just as where there is avoidance you also have to deal with it, as we had to do in this Pre-Budget Report.

Q475 Chairman: Chancellor, we spoke to the Governor of the Bank of England and others about the migration statistics and—
Mr Brown: Maybe I should just give you the figures. For non-North Sea corporation tax in 2004–05 £30 billion income, 2005–06 £34.8 billion, 2006–07 £39.9 billion, and it is a 14.8% rise percentage in the annual growth from the rapid growth of the economy. By the way, the non-North Sea corporation tax shift, the £0.3 billion you are talking about, particularly the £0.7 billion in 2006–07, just so the Committee is aware, is mainly due to private decisions that have been made by insurance companies to switch from equities to bonds and so profits are less linked in our calculations to share prices, so I think that specific corporation tax issue can be explained. I hope that information is helpful.

Q476 Chairman: Mr Mudie is telling me that that it is as good as we get, Chancellor, but do not worry about that.
Mr Brown: I can also give Mr Mudie the figures for schools now—17,500 primary schools are part of the programme.

Q477 Chairman: He wants some blood!
Mr Brown: You will have them in writing in the next few days.

Q478 Chairman: Can I turn to the migration statistics, Chancellor? I mentioned that the Governor of the Bank of England and others expressed concern to us about that and I think the best he could conclude was "cloudy". Are you confident in the assumptions of migration that have been made and, if you are not, what are you going to do about it?
Mr Brown: I think the issue for us is the numbers of people in employment. It is clear that there has been a labour force growth in the country. Some of it is due to migration, some of it is due to more people who were inactive coming into work, some of it is due to just changes in the way people are living their lives as families, but there has been a labour force growth and that is what the issue is as far as the economy and the growth period of the economy in future years is concerned.

Q479 Chairman: I will quote to you the Governor's remarks to us. He was talking about the flights between the UK and Poland, 516,000 in 2003. Almost all of them were to Gatwick, Heathrow and Manchester, and over the following two years that went up from 516,000 to 1.8 million and almost all of that increase was airports other than Heathrow, Gatwick and Manchester, so we have gone from a figure of 11,000 in 2003 to more than a million flights two years later and the international passengers surveys are only handed out at Heathrow, Gatwick and Manchester. They have missed a huge amount of people, so there is something wrong there with the migration statistics, Chancellor. It is to see how we can fix that.
Mr Brown: The ONS are looking at these estimates at the moment and I think they will publish a report soon. It has just been pointed out to me that the trend growth figures are not taking account of the accession countries as things stand.

Q480 Chairman: Just a last couple of questions. The planning assumption in the Pre-Budget Report is that public sector current expenditure will grow by 1.9% in 2009–10 and 2010–12. That is below

economic growth and significantly below previous rates of growth of public expenditure since 2000. What impact will the expected increases in net migration levels have on both total public expenditure and public expenditure per head?

Mr Brown: That is rising real terms growth in public expenditure but, as I said earlier in answer to a question, this is an assumption; it is not a decision. These things are all to be looked at during the course of the spending review and in the run-up to any announcements. As far as the pressures on public spending are concerned, clearly you have to look at all pressures on public spending and that is why we are conducting what is called a zero-based review. We are looking at what the costs of meeting our commitments to particular services are in the context of the population of the country, the changing demographic trends, the rising number of elderly people, the need to prepare for the global economy. All these things are part of this very extensive and complex review.

Q481 Chairman: My last question is on emissions trading schemes. Under the EU ETS, while UK power companies may have been allocated 4.6 million tonnes of carbon less than their projected needs they have met this shortfall not by cutting emissions but by buying up surplus, and comparatively cheap, allowances. If the EU ETS fails what back-up does the UK Government have in place?

Mr Brown: I think what is happening is that people are learning the lessons of experience in the EU ETS and that will be applied to the next round. We have already made different dispositions for the next round than for the previous round.

Q482 Chairman: Chancellor, can I thank you and your colleagues for your attendance this morning.

Mr Brown: Thank you very much, Chairman. Best wishes for Christmas. I hope you will finish your report by then.

Written evidence

Memorandum submitted by the Institute of Chartered Accountants in England and Wales

SECTION ONE—BROAD ISSUES

1. *Measures to Improve UK Productivity (Leitch, Barker and Eddington)*
   — The ICAEW welcomes the Leitch, Barker and Eddington Reports.

2. *Improving the UK Tax System*
   — The need to keep UK corporation tax rates globally competitive.
   — Ensuring UK taxation on foreign profits does not disadvantage UK companies compared to those in the EU.
   — The need for real progress on simplifying the UK tax system.

3. *Delivering Efficient and High Quality HMRC Services*
   — Transition without investment in HMRC is resulting in poorer tax services.

4. *Regulation & the Administrative Burden*
   — Government must act to address the cost of new regulation on the smallest businesses.

SECTION TWO- SPECIFIC ISSUES

5. *Missing Trader Intra-Community Fraud (MTIC)*
   — The fundamental incentive for fraud has still to be addressed.

6. *Controlled Foreign Companies (CFC)*
   — CFC changes should be EC Treaty compliant.

7. *Six year limitation period for all Direct Tax claims*
   — The retrospective nature of the legislation and the way it pre-empts a legal ruling is of concern.

8. *Managed Service Companies*
   — We welcome the consultation on these changes, as safeguards are needed for workers.

9. *Construction Industry Scheme (CIS)*
   — Lack of evidence for revenue raising from small construction operators.

1. MEASURES TO IMPROVE UK PRODUCTIVITY (LEITCH, BARKER AND EDDINGTON)

The ICAEW warmly welcomes the publication of the Leitch, Barker and Eddington Reports. As out own Enterprise Survey Report 2006 demonstrated, UK business is experiencing a unique challenge from increasingly global competition as well as unique opportunities. Tackling core barriers to UK productivity growth, particularly skills, is essential to equipping business to compete on a global scale. Improving the UK tax system and dealing with regulation are however areas where we would have liked to see a similar level of progress in this PBR.

2. IMPROVING THE UK TAX SYSTEM

The ICAEW welcomes the Government's determination (paragraph 5.102 of the PBR Book) to maintain the overall competitiveness of the UK tax system. We also welcome the Government's announcement that next year it will consult with business on a wider package of reform. However, we believe there were a number of lost opportunities for improvement in this PBR.

We have welcomed the recent proposal in the Varney review "Links with large business" which do make a significant contribution on the issue of uncertainty. The recommendations are ambitious but will require investment in appropriate resources. However, the Varney proposals still do not address the fundamental complexity of the UK tax system. Complexity is a significant factor in the investment decisions of multinational businesses. For small business it impacts upon such decisions as expansion and taking on their first employees.

The Global Competitiveness of the UK Corporate Tax System

We believe that PBR could have gone significantly further to maintain and improve the UK's competitive position. The ICAEW believes there are two particular initiatives that the PBR should have included:

— Reducing the headline rate of corporation tax. The UK's level of 30% is now looking expensive relative to European Union neighbours over whom we would wish to maintain our competitive edge.

— Improving way in which the UK taxes foreign profits so that UK companies operating abroad are not at a relative disadvantage to EU companies operating here. The UK's credit method system results in a far higher ratio of business compliance costs to the revenue raised by government, than the exemption system of most other EU countries. The UK Government has been considering the issue but it is now time for open consideration of the advantages to UK business from moving to an exemption system.

Addressing, as well as consulting on the above two concerns in 2007 would help address the increasing belief of business that the UK tax system is becoming less competitive.

Potential Measures to Address the Complexity of the UK Tax System

The ICAEW has consistently drawn attention to the increase in volume of tax legislation, doubling in the past 10 years. Finance Acts are now three times longer than they were in the 1980s. Complexity, like regulation (see further section) has a much greater impact proportionately on the smallest businesses and tackling this is of key importance for the UK's enterprise economy.

The Government has sought to examine the particular burdens faced by business in complying with the tax system, for example in the Admin burdens project published earlier this year. But initiatives to reduce the burdens on smaller businesses appear to be stalled, for example the work of the Small Business Review, launched in 2001, has yet to be taken forward.

We believe that action is required in a number of areas:

— The Government needs to move forward with the Small Business Review and bring forward proposals to reduce some of the key burdens that small businesses face, for example taking on your first employee.

— The Government needs to make a formal policy commitment to tax simplification and set a timescale for implementation. We appreciate that the Tax Law Rewrite Project has produced benefits and made the UK's tax rules clearer, but it does not address tax simplification, which was the original intention of the legislation which gave rise to this project. The use of an independent committee, including representatives from business and the tax profession, should be considered to help achieve consensus on a long-term programme.

3. Delivering Efficient and High Quality HMRC Services

We welcome the Government's aim to create world-class tax services through sustained investment and far-reaching reform. In principle, we support the Government's drive to make public services more efficient and therefore freeing up resources for frontline services. We will work with HMRC to help build a tax system that is fit for the 21 century.

Nevertheless, we are concerned that the ambitious cost-cutting proposals, and consequent reductions in staff numbers, are resulting in far-reaching reform now without the level of investment necessarily needed to improve services. In any event, technological improvements take time to feed through to real improvements in the tax system, as they need to be designed, built and tested thoroughly to ensure that they work properly and are implemented efficiently.

The result is that, on the ground, services have deteriorated with the closure of local offices and the increased reliance on call centres. HMRC's local support structure has been dismantled but no mechanisms have been put in place to replace it, let alone lead to improvements. These developments have led to considerable frustrations for taxpayers and their agents and advisers, and are probably the largest single cause for complaints that we receive. Given the year-on-year budget reductions faced by HMRC, it looks inevitable that services will get worse in the short-term, calling into question the benefit of any longer-term improvements.

Our recommendations for improvement are as follows:

— If customer services are to be improved, there needs to be greater transparency about HMRC's reorganisation and restructuring and how existing services will be maintained and improved. This process needs input from tax professionals and its customers. Whilst returning to the former "District" structure may no longer be possible, practical steps can be taken to improve local dialogue and accountability. HMRC is working on a number of initiatives, for example by nominated staff "owning" particular issues and by the nomination of named staff as a contact point for tax agents, but this needs to be translated into sustained action on the ground and a willingness to work more closely with agents.

— There also needs to be recognition that year-on-year reductions in department budgets may not be realistic if services are to be improved. A year on year budget reduction of 5% may not reflect the longer lead-time needed for investment in new technology to lead to cost savings. A commitment to a savings in the medium term would focus attention on the necessary investment required to feed through to improvements rather than short-term cost-cutting.

4. Regulation and Administrative Burdens

The ICAEW understands the Administrative Burdens Project Reports quantifying the administrative impact of current Government regulation will soon be released, together with details of a 25% across the board reduction target. Though they were not made available with the Pre-Budget Report, this project has been cited regularly in Budgets and PBR statements. Together with the implementation of the Hampton Review, these will make a substantial contribution to improving current regulation and its enforcement as well as to wider culture change.

The ICAEW still finds, however, that the cost of new regulation remains unabated and has actually risen to £7.7 billion this year, with 74% of that impact falling upon businesses with less than 10 employees (ICAEW Enterprise Survey Report 2006). The regressive nature of regulation is perhaps the most troubling aspect of the regulation agenda due to its impact on UK entrepreneurs. The ICAEW also believes this is the issue least dealt with in the regulatory agenda and again has not been addressed in the PBR.

To help ensure the forthcoming publications of the Administration Burdens Reports have the greatest impact on the UK regulatory culture, Treasury Committee may wish to consider the following timely recommendations:

— The figure for the total sum of annual administrative burden should be published together with the individual reports.

— The proportion of the administrative burden falling upon different sizes of business should be made clear.

— That the 25% reduction in administrative burden should focus most on the smallest business currently realising the bulk of the burden.

— That new administrative burden should not be "grandfathered" into the targets ie burden should be 25% less than now even if new regulations have come forward.

— That Government widen its Better Regulation Agenda to include the tackling of the regressive nature of the cost of new regulation on the smallest businesses.

Section Two—Specific Issues

5. Missing Trader Intra-Community Fraud (MTIC)

We welcome the Government's announcement of the measures it is introducing to tackle the fraud and that more staff are being deployed to help tackle this pernicious attack upon the tax system. We remain committed to assisting the Government in its fight against MTIC.

Nevertheless, we remain concerned that the proposed measures do not address the root cause of the problem and that unless co-ordinated action is taken at the EU level to address this issue, MTIC will remain a serious threat to the UK's tax system. As we said in our PBR submission, the UK Government needs to work with other Member States and combat MTIC fraud by addressing the incentive for fraud. The proposed derogation to impose a reverse charge mechanism is in our view only a short-term fix and in any event there remains the possibility that the derogation will not be obtained, which would take the UK back to square one. The UK needs to consider other possible solutions to reduce MTIC. Our recommendations are:

— The imposition of a limit on the amount of input tax that each VAT-registered business could reclaim in an accounting period. It would be set at an amount that in the normal course of events the business would not reach, with a fast-track clearance procedure for abnormal transactions such as a property purchase.

— In the longer term, national VAT systems need to be changed so that VAT is charged on cross-border transactions between registered traders. We recognise that this may inhibit cross border trade and will require fundamental changes to the current VAT systems, but operationally we see such a system as most likely to end the fraud.

6. Controlled Foreign Companies (CFC)

The UK has been required to amend its existing CFC rules to make them EC Treaty compliant.

On 12 September 2006, in the *Cadbury Schweppes* case, the European Court of Justice held that the UK CFC regime is prima facie contrary to the freedom of establishment provisions of the EC Treaty. However, the breach may be justified provided the regime applies only to "wholly artificial arrangements" which do not reflect economic reality. In other words companies which carry on genuine economic activities in the EEA (the European Union plus Iceland, Norway and Switzerland) should not be caught by the UK CFC rules once they have been made compliant with the EC Treaty. It is this case that has resulted in the requirement to change the rules.

A company is a CFC if it is resident outside the UK and is controlled by UK residents and is subject to less than 75% of the tax that it would pay if it were UK resident. Any UK resident company that has an interest in the CFC and to which, with connected persons, at least 25% of the chargeable profits would be apportioned, must pay tax on the apportioned profit of the CFC. There is no such apportionment if one of several exemptions applies.

The first of the PBR proposals is that companies which have an EEA business establishment, which comes within the CFC rules, may apply to HMRC to exclude from an apportionment that part of the chargeable profits of the CFC which represents the net economic value created by work carried out by individuals working for the CFC in business establishments within the EEA.

The second main proposal in the PBR is a change to the exempt activities test. Currently a CFC satisfies the exempt activities test if it has a business establishment in its territory of (overseas) residence, its business affairs in that territory are effectively managed there, and it does not undertake certain types of (non-exempt) business. This rule is to be amended so that a CFC resident in an EEA territory will only be treated as effectively managed in that territory if there are sufficient individuals working in that territory who have the competence and authority to undertake the company's business.

The two proposals are likely to give rise to the apportionment of profits of CFCs which go beyond profits attributed to "wholly artificial arrangements which do not reflect economic reality".

We submitted a paper to HM Treasury and HM Revenue and Customs in November 2006 setting out amendments to the existing CFC rules which we believe are proportionate and would make the UK regime EC Treaty compliant.

We recommend the UK Government amend the CFC rules along the lines proposed in our paper (Appendix 1).

7. Six Year Limitation Period for all Direct Tax Claims

New provisions will be introduced in FA 2007 which will amend section 32 in respect of any direct tax action involving mistake of law brought before 8 September 2003 except where a claimant is subject to a final judgment given by the Courts before 6 December 2006.

The House of Lords recently determined in the case of *Deutsche Morgan Grenfell* that the company had paid CT earlier than it need to have done [because it should not have been subject to ACT accounting] under a mistake of law (paragraph 143 of the decision) and that the mistake could be held to have been discovered only when the ECJ gave its Judgement in the *Hoechst* case in March 2001. The fact that the early payment represented a mistake of law meant that section 32 of the Limitation Act 1980 was in point and section 32 provides that the period of limitation, for making a claim, only starts when the mistake is discovered.

The effect of the proposal will be to deprive claimants which have commenced litigation to benefit, in restitution (or damages), from the rectification of their earlier mistake of law. In these cases the litigation is a civil law procedure under common law, and not a Taxes Act claim.

In the context of EU law, the ECJ has held that limitation periods cannot be reduced without allowing an adequate period after the enactment of the legislation for lodging the claims for repayments which persons were entitled to submit under the original legislation. The current proposal does not give effect to this and in our view is itself therefore a new and inexcusable breach of the EU law principle of effective remedy.

The Treasury Committee may wish to ask HM Treasury what other alternatives to this drastic action were considered and the reasons for their rejection.

8. Managed Service Companies

Managed Service Companies (MSCs) are corporate structures through which workers provide labour services. The current proposals seek to differentiate MSCs from Personal Service Companies (PSC), which will continue to be dealt with by the IR35 legislation.

MSC structures are most commonly used by persons working in construction, information technology, teaching and health workers, but could be used by any sector. The workers are not usually managing their own businesses, but are performing in the same capacity as an employee doing the same work, with the management of the umbrella company being undertaken by a corporate provider. It is this lack of control which distinguishes workers in MSCs from those in PSCs and which be most difficult to define in legislation.

MSCs are used to reduce income tax and national insurance liabilities by paying each of the workers within it using dividends rather than using a salary. However, it is important to stress that another key reason for using these structures is to cut costs by trying to deny the worker employment rights. In most cases this succeeds because of the practical difficulties of having to go through the employment tribunal process to gain redress.

We understand the difficulties associated with trying to use the IR35 legislation against MSCs and support the Government's attempts to tackle this problem without disturbing the vast number of PSCs. However, we are concerned that the workers employed by MSCs do not usually have a choice when they accept work, about how the engagement is structured. Indeed many will not even realise that they are involved in MSCs.

We are pleased that these proposals are going to be the subject of wide consultation and believe there should be adequate safeguards to protect vulnerable low paid workers who could otherwise be those hurt most by this legislation.

9. Construction Industry Scheme (CIS)

The standard deduction rate for the new CIS is set at 20%. The equivalent rate for deduction under the current scheme is 18%.

The new CIS comes into operation on 6 April 2007 and will operate very differently from the current one. The existing system of exemption certificates, registration cards and annual returns, will be replaced by a system which will be heavily reliant on online facilities and a monthly return. For contractors, the entire key to the new scheme is to classify workers quickly and accurately and then take appropriate steps to deal with the consequences. This classification of workers falls into two stages, with the second leading on from the first under certain circumstances.

A contractor has first and foremost an obligation to determine whether the person he wishes to engage is in fact an employee. In such cases, all payments are subject to PAYE and the CIS is not relevant. If the subcontractor is correctly classified as self employed, then under the new scheme, on engagement the contractor will check with HMRC to enable him to decide whether the subcontractor is to be paid gross or is subject to tax deduction at one of two rates (please see appendix two). Such self employed subcontractors will settle their eventual exact tax liability under the self assessment system in the usual way, having deducted any CIS deduction already suffered.

The ICAEW does not see the evidence for justifying such an increase in accelerated tax collection. This standard deduction rate of tax is meant to be an estimate of the tax that a subcontractor will eventually be paying for a tax year. This seems to suggest that the current 18% rate has resulted in serious underpayment of CIS tax in recent years, but no evidence has been produced to support this.

We also note that this increase, and presumably the current under collection of tax which has given rise to it, has not been discussed at any of the current consultation meetings with representative bodies and other interested parties.

We suggest that Treasury Committee might ask for further evidence as to why increasing the deduction is necessary in order to deal with the justification given in the PBR.

About the ICAEW

The Institute of Chartered Accountants in England and Wales (ICAEW) works in the public interest to promote enterprise, innovation and sustainable growth in a socially-responsible business environment.

Our strength and knowledge are drawn from that of our members who hold the world's most highly-respected finance qualification. They work in every sector of the economy, size of business and public body, from FTSE 100 boardrooms and Government departments, to high street practitioners, small businesses and charities.

11 December 2006

APPENDIX 1

TAXREP 35/06

CONTROLLED FOREIGN COMPANIES

Review of the current UK regime with recommendations for change to make a future regime FC Treaty compliant

Paper submitted to HM Treasury and HM Revenue and Customs—November 2006

CONTENTS

CONTROLLED FOREIGN COMPANIES

Introduction

1. The present paper has been prepared by a working party established under the auspices of the Large Business and International Tax Committee of the ICAEW Tax Faculty working under the chairmanship of Peter Cussons.

2. The intention of the working party, and of this paper, is to assist HM Government in its review of the existing controlled foreign companies (CFC) regime so as to develop a system that will meet the needs of business which is compliant with the EC Treaty and addresses the concerns of HM Government particularly in ensuring that the UK tax system remains, internationally, competitive.

3. The paper considers the background to the current CFC regime and reviews it in the light of the Judgment of the European Court of Justice (ECJ) in the Cadbury Schweppes case (C-196/04).

4. Information about the Institute of Chartered Accountants in England and Wales and the Tax Faculty is set out in Appendix 2.

Objectives for an EC Treaty Compliant CFC Regime

5. We believe that a future UK CFC regime should be:
   - objective and as certain as is possible;
   - easy to comply with;
   - not open to further EU challenges;
   - a single system applying to CFCs established within the EU and CFCs established outside the EU (this would follow the precedent set following the ECJ judgment in *ICI v Colmer* when the relevant UK legislation was amended for all non resident companies); and
   - designed with a view to keeping compliance costs to a minimum.

Changes may need to be introduced over a period of time to accommodate the arrival of relevant ECJ Judgments and to allow business to adapt from the existing regime.

Background

6. On 12 September 2006, the ECJ gave its judgment in the Cadbury Schweppes case concluding that:

> "Articles 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that controlled company is actually established in the host Member State and carries on genuine economic activities there."

7. The case will now be referred back to the Special Commissioners, from whom the case was originally referred, to determine the implications of the Judgment in respect of Cadbury Schweppes.

8. The UK Government will also need to consider what changes are required to existing UK legislation to reflect the Judgment.

Analysis of Existing CFC System

9. We consider in this section the extent to which the existing exemptions can and should be retained under a reformed, EC Treaty compliant, CFC regime.

Exempt Activities Test

10. The exempt activities test allows companies engaged in certain trading activities and particular types of holding company to fall outside the CFC rules on the basis that, as such, they can reasonably be assumed not to be used for reducing UK tax. To satisfy the exemption, a company must have proper "substance" evidenced by adequate premises and sufficient employees in its territory of residence to carry on its business there.

11. However, a company which is engaged in one of the "precluded" activities listed in the legislation is prevented from satisfying the exempt activities test even if it meets the substance requirements. Finance Acts 2000 and 2003 both expanded the precluded activities so that they now consist of investment business and dealing in goods for delivery to or from the UK or to or from connected or associated persons, as well as wholesale, distributive financial or service business where 50% or more of gross trading receipts are derived directly or indirectly from, broadly, related persons or unrelated UK persons. This means, for example, that intra-group service companies, service and certain insurance companies deriving the majority of their income from UK customers and banks which receive non-interest income from UK customers amounting to more than 10% of their total income are no longer able to satisfy the exempt activities test. Unfortunately, our experience has been that HMRC are normally unwilling to accept that these types of company can satisfy the motive test (see below).

12. We consider that on its own an exemption which does not apply to companies carrying on particular activities cannot be EC Treaty compliant hence it cannot be retained following Cadbury Schweppes since the sole test laid down in the ECJ's judgment is the requirement that the CFC is actually established in the host country and carries on genuine economic activities there. In addition, there is no permissible active versus passive test. The ECJ's judgment on the recently heard Columbus Container case will cover this issue (see paragraph 26 below).

13. **We consider that the easiest way to create an EC Treaty compliant CFC regime following Cadbury Schweppes would be to amend the exempt activities test so that a company is no longer prevented from satisfying the test where it is carrying on one of the precluded activities.** This would leave the existing substance requirements in the exempt activities test, which appear similar to those set out in the Cadbury Schweppes decision (given the ECJ's reference to a CFC needing to have "staff, premises and equipment"), to be satisfied. The advantage of this approach is that substance would then be based on long established and well understood tests. In this case, the motive test could be left in place for companies that fail the exempt activities test but nevertheless are not in existence to avoid UK tax by a diversion of profits.

14. In addition to the above, there are a number of areas where we believe changes should be made to the existing legislation. These are covered in Appendix 1 to this paper.

Excluded Countries Regulations

15. This exemption was originally introduced to reduce the compliance burden for UK companies by giving them a relatively easy way of confirming that overseas subsidiaries are not subject to the CFC rules. Companies resident in a territory on an approved list of countries and deriving the majority of their income from local sources are able to fall outside the CFC rules on the basis that, as such, they are unlikely to be involved in UK tax avoidance. The exemption, originally set out in an HMRC press release of 5 October 1993, was given statutory basis in regulations following the introduction of corporation tax self assessment to give UK companies certainty when relying on it.

16. Following the 2004 Pre-Budget Report, a number of anti-avoidance provisions were included in the regulations as a result of perceived abuse of the exemption. The new "motive" condition (set out in Regulation 4(A1) and (A2)), in particular, which is widely drafted has made it much more difficult for UK companies to be certain that the exemption applies in any given situation, which clearly goes against the original intention for having this exemption.

17. Given its importance in reducing the compliance burden for UK companies, we believe that the excluded countries regulations should be retained. However, **we consider that the motive condition should be removed as it creates too much uncertainty for companies looking to rely on it.** Where HMRC become aware of tax avoidance schemes which rely on the excluded countries regulations, we do not see a particular problem with the introduction of anti-avoidance provisions provided that they are properly targeted at the

perceived abuse. If the motive condition is not removed, it is important that HMRC issue proper guidance, particularly on the difference in approach as compared to the motive test itself. **In order to be EC Treaty compliant we also believe that all EU Member States should be included on the list of excluded countries**, otherwise the exemption breaches Article 12 EC Treaty (prohibition of discrimination on grounds of nationality).

Acceptable Distribution Policy

18. A company falls outside the CFC rules provided it distributes not less than 90% of its "net chargeable profits" during or within 18 months of the end of the particular accounting period. Although in form the acceptable distribution policy (ADP) test resembles the other exemptions, in substance it represents an alternative form of tax charge as it is only satisfied if the CFC pays dividends which are chargeable to tax in the hands of UK residents.

19. This forced distribution is in our view a breach of either the freedom of establishment or the free movement of capital, where the CFC is actually established in the member state concerned and carrying on genuine economic activity there. **We believe that this exemption should however be retained in relation to CFCs not genuinely locally established** as it does still provide some advantage as compared to suffering a CFC apportionment (even though this is limited following the "ring-fencing" of ADP dividends for double tax relief purposes).

Public Quotation Condition

20. A company falls outside the CFC rules, broadly, if shares representing not less than 35% of the voting power are held by the public, those shares have been listed on the official list of a recognised stock exchange during the 12 months before the end of the relevant accounting period and there have been dealings in the shares on a recognised stock exchange during that period.

21. We believe that this exemption should be retained, **but would advocate that consideration be given to extending it to cover the subsidiaries of a qualifying quoted parent company.**

De Minimis Exclusion

22. Companies with chargeable profits of less than £50,000 per annum fall outside the CFC rules.

23. **We consider that this exemption should be retained but that the "de minimis" amount which has only been raised once since the CFC legislation was introduced in Finance Act 1984 should be raised to at least £100,000 per annum.**

Motive Test

24. In addition to all the above exemptions which can potentially take a company outside the scope of the CFC rules, there is also the motive test, although this is often seen as a last resort. Both legs of the motive test have to be satisfied. The first leg is that transactions which are reflected in the profits of the subsidiary company must not have achieved more than a minimal reduction in UK tax or the reduction must not be a main purpose of the transactions. The second leg is that it must not be a main reason for the company's existence to achieve a reduction in UK tax by a diversion of profits from the UK. Our previous experience of HMRC's approach to the motive test is that even if there are strong commercial reasons for establishing a company offshore to carry on one of the precluded activities set out in the exempt activities test, HMRC will normally argue that the reduction in UK tax, if it is significant, must have been one of the main reasons for the company's existence and that, therefore, the second leg of the test is not satisfied. In our view, the motive test and the way in which HMRC apply it is contrary to the ECJ's decision in Cadbury Schweppes as the focus is very much on tax motives.

25. If the exempt activities test is changed, as we have recommended above, **then it might be possible to leave the motive test unchanged** to allow companies which do not have the necessary substance but nevertheless are not in existence to avoid UK tax to fall outside the CFC rules. If the Treasury/HMRC decide not to change the exempt activities test to make the CFC rules EC Treaty compliant, we consider that **the next best option would be to amend the motive test so that it is additionally satisfied where a company has sufficient substance to carry on its activities**. If this were done, it would be important for there to be objective criteria for establishing whether there was adequate substance in any particular situation, otherwise taxpayers would be faced with significant uncertainty. Our strong preference would be for these criteria to be set out in the legislation itself, rather than being dealt with in guidance issued by HMRC.

Distinction between Passive and Active Income

26. One possibility, which we have heard suggested, would be for a completely new CFC regime to be introduced which focuses on types of income rather than entities (similar to the US subpart F rules) so that only passive income would be potentially caught. However, we can see nothing in the Cadbury Schweppes judgment to suggest that such a regime would be EC Treaty compliant unless it targeted only "wholly artificial arrangements". This would mean that passive income could still not be taxed under the CFC rules if it was supported by the necessary substance. The German case of Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt (C-298/05), which was heard before the ECJ on 28 September 2006, should confirm this point (the Advocate-General's Opinion and ECJ Judgment will presumably be available some time in 2007). We believe that it is likely that the ECJ will conclude that Germany is not allowed, under EC law, to move from tax exemption to an ordinary tax credit due to a domestic anti-avoidance measure that applies to the low-tax passive foreign income of foreign Permanent Establishments.

Clearance Procedure

27. We believe that an ongoing clearance procedure for all material aspects of any revised CFC regime is highly desirable. We do not believe that the COP 10 regime in its current form, particularly with its limitation on advice on the effect of legislation passed in the previous four Finance Acts, is adequate. Accordingly, the existing CFC clearance procedure either needs to be given a statutory basis or there needs to be an undertaking from HMRC that it will be available for the long-term. We, therefore, welcome the proposals contained in the Varney Review Report published on 17 November 2006.

RECOMMENDATIONS

28. We have summarised below our recommendations for changes to be made to the CFC regime in the light of the Cadbury Schweppes judgment:

Exempt activities test

29. In order to ensure that the CFC regime is EC Treaty compliant:

— the exempt activities test should be amended so that it can be satisfied regardless of the activities carried on, provided that the company in question satisfies the existing substance requirements set out in the legislation.

This would have the advantage of "substance" being based on long established and well understood tests and could leave the existing motive test in place to be satisfied by companies which despite not having the necessary substance are not in existence to avoid UK tax.

Other exemptions

30. The other exemptions should be retained allowing taxpayers to rely on the exemption which is the easiest to satisfy in any particular situation. However, the following changes should be made to those exemptions:

— *Excluded countries regulations*—the new "motive" condition should be removed and the list of excluded countries amended so that it includes all of the EU Member States.

— *Public quotation condition*—this exemption should be extended to cover the subsidiaries of a qualifying quoted parent company.

— *De minimis exclusion*—the "de minimis" amount should be raised to at least £100,000 per annum.

Changes to apply not just to the EU Member States

31. The changes which are made should apply to both EU and non-EU subsidiaries. Otherwise, taxpayers will be faced with the added difficulty of having to apply two sets of CFC rules.

The need for an ongoing clearance procedure

32. Given the importance of having an ongoing clearance procedure for all material aspects of any revised CFC regime, the existing CFC clearance procedure either needs to be given a statutory basis or there needs to be an undertaking from HMRC that it will be available for the long-term. We, therefore, welcome the proposals contained in the Varney Review Report published on 17 November 2006.

RECOMMENDED CHANGES TO THE EXEMPT ACTIVITIES TEST

APPENDIX 1

We believe that the provisions introduced in FA 2003 (Section 200 and Schedule 42) and in particularly the "habitually resident" point which, for example, catches Irish subsidiaries of UK banks which are prevented from doing business with the UK, constitute a constraint on the freedom to provide services within the EU. Accordingly, these provisions need to be removed from the legislation.

While it is helpful that holding companies are able to meet the exempt activities test, the relevant conditions can be difficult to satisfy in practice. In particular:

— A relatively small amount of "bad" income can cause the 90% income tests in Paragraphs 6(3), 6(4) and 6(4A) Schedule 25 to be failed. It would be more reasonable if the threshold was reduced to, say, 80%.

— Paragraph 12(5) Schedule 25 means that the 90% income test can be failed in purely commercial structures (particularly where there are a number of tiers of trading company, which is not uncommon). Paragraph 12(5) should be removed or at least amended to exclude dividends from non-trading income.

— The ability to treat a 40/40 joint venture company as controlled for the purposes of the holding and income tests is only allowed under Paragraph 6(ZA) Schedule 25 where the company in question is a CFC (ie subject to a lower level of taxation) and a trading company. This is unnecessarily restrictive. Paragraph 6(ZA) should treat any 40/40 joint venture company (whether or not it is subject to a lower level of taxation or trading) as controlled for the purposes of the holding and income tests.

APPENDIX 2

Construction Industry Scheme

Contractor Registered Status	*Payment Arrangements*
Registered for gross payment	Pay without deduction of CISTax.
Registered for net payment	Deduct CIS tax at the first rate from payments for labour. This rate is currently 18%, but following the PBR announcement will be 20% for the new scheme. Do not deduct tax from payments for the cost of materials, but record the amount allowed for materials.
Not registered	Deduct CIS tax at the second (higher) rate from payments for labour. This rate has been announced to be 30% in the PBR 2006. Do not deduct tax from payments for the cost of materials, but record the amount allowed for materials.

7 December 2006

Memorandum submitted by Mr Martin Weale, National Institute of Economic and Social Research

THE MACRO-ECONOMY

The Economic Outlook

The growth projected for next year is slightly faster than the National Institute's expectation of $2\frac{1}{2}$% although we have similar views about prospects in the world economy and the Euro Area. The forecast record of the Treasury is similar to that of the National Institute[1]. The main cause of the difference is that we see import volumes rising faster than export volumes while the Treasury sees these two moving in step

The trend rate of growth

The increase in the trend rate of growth allows the Chancellor of the Exchequer to project revenue growth faster than would otherwise be the case. Only hindsight will tell whether the change to the trend is justified; at this point it is probably safest to accept that there is a margin of uncertainty substantially greater than that indicated by Table 4 on page 21 of *Trend Growth: New Evidence and Prospects.* Recent growth in the economy has been facilitated by a surge in immigration from Central and Eastern Europe; it seems most

[1] See "Forecast Comparisons" *National Institute Economic Review*, July 2005 by Ray Barrell, Simon Kirby and Robert Metz.

unlikely that these very high levels of immigration are going to continue, and indeed the policy with respect to Rumania and Bulgaria is designed specifically to prevent this. Thus the Treasury's assumption that immigration will continue at the 2005 level is questionable.

But of perhaps greater concern is the implication for the public finances if immigration does continue at a high level. The Treasury projections assume that, while there is a favourable impact on the revenue side as a result of faster growth, there are no implications for public spending. It is true that, because immigrants are disproportionately young adults, their arrival is fiscally favourable but it is unlikely that there will be no upward pressure on spending, or alternatively increasing complaints that services are congested. The reality is that faster trend growth arising from immigration is likely to lead to higher public spending.

The Cycle

The chart on p 198 of the *Pre-budget Report* shows plainly that the current cycle began late in 2003. The political need is nevertheless to maintain the artefact of the long cycle which started in1997 and continues until next year so as to ensure that the Golden Rule is met on Treasury calculations. Although the cycle is not itself a government or national statistic, the repeated redefinition of the cycle may be one of the factors which has led to a low level of public trust in statistics. The re-definition of the cycle is accompanied by a re-evaluation of the scale of spare capacity in the economy. In the 2006 Budget this was postulated to be 1.5% of GDP whereas it is now estimated at 0.5% of GDP, in line with the National Institute's estimates.

The end of the cycle as identified by the Treasury creates an opportunity to consider how to learn from the experience using the Golden Rule since 1997. Suggestions for a revised rule are presented below.

The Budgetary Position

The table below shows that the current budgetary position has been tightened by £5 billion since the 2005 Budget. Taxes have risen slightly more because these data take account of extra expenditure on items such as increased winter fuel payments. The underlying budgetary position has worsened by £10 billion, since the projected surplus of £4 billion for 2007–08 has fallen to a deficit on £1 billion. The discretionary tightening, combined with the slow projected growth in public spending in the years ahead suggest that the government has now addressed the problem of structural fiscal weakness identified by bodies such as the National Institute.

Table 1

BUDGETARY TIGHTENING SINCE THE 2005 BUDGET: FIGURES RELATE TO CURRENT BALANCE FOR 2007–08, £ BILLION

Discretionary Revision PRB 2005	2
Discretionary Revision Budget 2006	1
Discretionary Revision PBR 2006	2
Total Discretionary Revision since Budget 2005	5
Change to forecast current balance since 2005 Budget	−5

The National Institute continues to expect a position worse than that shown in the *Pre-budget Report* with the deficits likely to be £5 billion or so worse than the Treasury forecasts However with an average absolute error of £13 billion in Treasury forecasts one year ahead, this difference is not of great importance. Even with our figures the current budget is still expected to move into surplus eventually and the budgetary position is sustainable.

A Revision to the Golden Rule

The end of the economic cycle as imminent makes this an ideal time for the Select Committee to review the working of the Golden Rule and to consider what other options might be available. Although it is likely that the Golden Rule has played a valuable role in keeping government expenditure under reasonable control, its working in real time has been less than satisfactory. There have been two main problems and a third minor one. The most fundamental point is that the rule does not deliver "fairness and prudence". A prior issue is that, whatever budgetary target is set, policy has to be such that it is achievable in a reasonable time.

The existing Golden Rule is one way of setting the target. But whatever target is set a means for assessing whether that target is being delivered needs to be in place. At present the Golden Rule offers a great deal of flexibility at the start of the cycle and very little at the end; indeed by the end of cycle policy is constrained by the events of several years ago. Furthermore the current assessment "over the cycle" is clearly discredited. A sensible replacement which addresses the question of inflexibility would be provided by a simple forward-looking rule. Such a rule might state that, if the budget balance is currently off-target, the government should

aim to return to target over some relatively short horizon- say three years. A horizon of this length provides time for the government to ride out the normal economic cycle without allowing them to defer any adjustment far into the future.

However, the Golden Rule may not be appropriate. It is perfectly possible for the current budget to be in balance but the structure of policy to be such that deficits will emerge in the future, or to imply that taxes will need to rise. Such a situation can arise as a result of an ageing population with state pensions funded on a pay as you go basis. In such circumstances fairness- defined by keeping expected future tax and contribution rates constant- would imply a surplus on the current budget. The government explores these issues in the *Long-term Public Finance Report: an Analysis of Fiscal Sustainability* but they stand outside the structure of the fiscal rules. A revision of the Golden Rule to deliver fairness between generations would, instead of adopting a target for the current balance of "in balance or surplus over the cycle" choose a target to keep expected future tax rates approximately constant, after allowing for any definitive policy choices that tax rates should change over time.

As at present, both rules could be implemented without any formal external assessment. The structure would, however, be much stronger if there were an independent group with the task of assessing both the budgetary target consistent with fairness between generations and the government's plans to take the current budget back to target after any divergence.

This structure does not take any account of the "40% rule"—that government debt should not exceed 40% of GDP. When the Golden Rule is met, such a rule serves to limit public investment. Our view is that the desirability of public investment is determined by means of cost-benefit analysis to establish whether the social return on the investment is adequate. Estimates of social return need to take into account the dead-weight cost of raising the taxes needed to service public borrowing. If instead the 40% rule is used to determine the extent of public investment it is highly likely that the amount of public investment will be sub-optimal and the nation's resources will not be allocated efficiently. Thus the 40% rule needs to be replaced by audit of public investment projects to establish whether they offer value for money.

11 December 2006

Memorandum submitted by Bridget Rosewell, Volterra Consulting

Introduction

It is hard to discern the purpose of this report, beyond a list of achievements and of lengthy descriptions of minor schemes.

Thinking back to a decade ago, the Pre-Budget Report was billed to increase the transparency of the Budget process by adding to the interim review of the state of the economy and the old process of setting out spending plans a more balanced view of government finances which also signalled new tax initiatives.

If only this was the outcome. It is impossible in this report to easily separate the new from old announcements. Some tables do this—here we discover that the Chancellor is proposing to raise another £2 billion in taxes, half of which comes from airline passengers and the other half from various changes to corporation tax and other business tax arrangements. However, this is not a "Pre-Budget" announcement but a "Budget" one. No consultation required.

And on the state of government finances, and how they are projected to perform, there is little until after p140. The previous pages are a paean of praise for the government's record in everything that you could possibly imagine and proposals on everything from children's reading to women's enterprise and why the business formation rate by women is lower in the UK than in the US. For example, we find described a scheme called "Every Child a Reader", which aims to help 30,000 children with their reading. This is not to say the scheme is not worthy—it may or may not be—but can hardly be judged or evaluated as part of a report such as this.

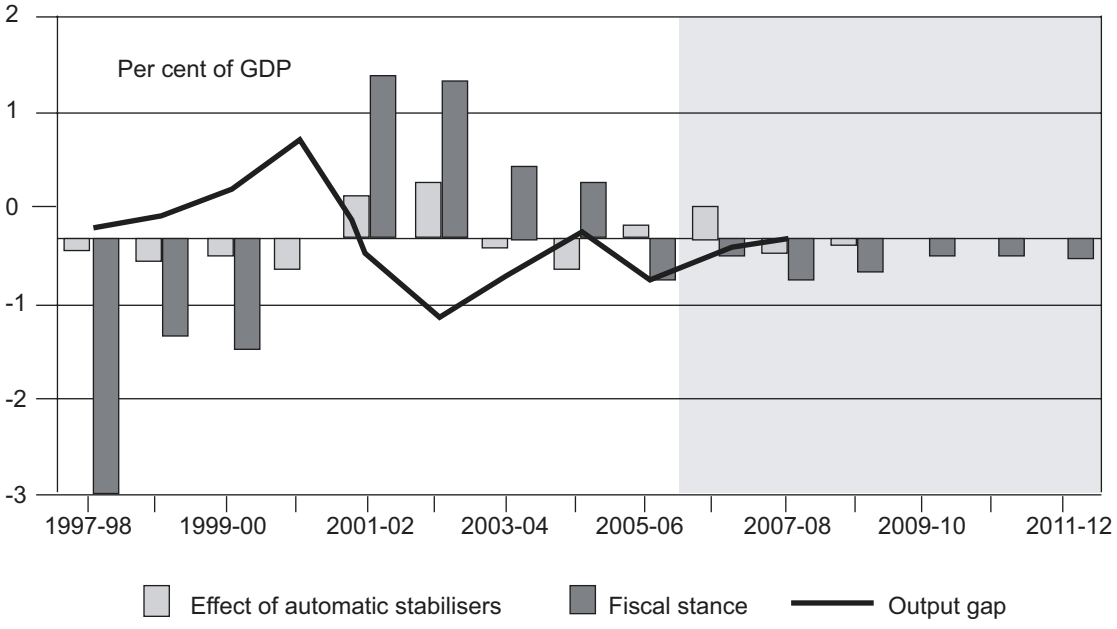
The report is therefore full of waffle and twiddle and commissions and reports and investigations. It is probably also full of twaddle but it is very hard to tell. When you contemplate the cost of preparing this magnum opus and the time also spent trying to read it and work out what it means by all of the commentators and economists, it is hard to see whether the benefits outweigh the costs. And it is hard not to be suspicious that the purpose of all the flowery phrases is to disguise reality. Discomfort might not be so acute if some of the pronouncements—around efficiency in the public services and cost savings for example—were not so reminiscent of the pronouncements of achievements under Soviet five year plans.

So here are some reality checks.

MEETING THE GOLDEN RULE AND FINANCING INVESTMENT

The golden rule will be met because the economic cycle is about to come to an end. This is planned for early 2007 and will therefore mean that the public finances have been just in surplus over this cycle. But "the cycle" is not a simple concept. The start and end of a cycle are meant to be identified as points where the economy is in balance and on trend. The chart on p 33 of the PBR illustrates this. The output gap apparently closed but then opened again in 2004, and so the cycle was not held to be complete.

Chart 2.6: Fiscal policy supporting monetary policy



Note: The fiscal stance equals the annual change in the cyclally=adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, i.e. the difference between PSNB and the cyclically-adjusted PSNB.
Source: HM Treasury

Indeed if the chart's projections are correct the cycle will never be complete, as the economy does not pass into a position in which it is above trend.

There are several issues here. One is what the trend position might be and the other is how it is in any case dependent on the actions of government itself. The rhetoric suggests that the economy operates in one place while the government manages the fiscal position. But since the government itself takes such a large share of resources and uses them directly as well as in redistribution, there is no independence of management.

Further, there are still no well established and empirically verified theories of the cycle which could be used to anchor points at which a cycle begins or ends. Each cycle is unique. In these circumstances, policy has been locked onto a base which can only be created by the application of considerable amounts of judgement and all the arcane discussions cannot disguise this. Appropriate choice of dates will always produce some kind of answer, and since data is so often revised, backward looking analysis will then always produce a different answer, so no position can ever be falsified subsequently.

However, what is beyond dispute is that the public finances are in considerable disarray if we are so close to the end of the cycle. In both last year and this, borrowing has been bigger than planned. £15 billion last year, and £8 billion this. If it is indeed the case that the cycle is ending then finances should also be close to balance. They are not.

Plans for continued spending growth are also extensive, and again there is no clear presentation of why until you reach the appendices. The tax take is expected to rise by 6.6% in 2007–08 and will then be over 40% of GDP. At the same time, investment is set to rise by 13%, and then by hardly anything.

The report speaks extensively of taking forward the Eddington recommendations and the Barker review of planning and of making it possible for greater public and private investment. At the same time, it faces overruns on investments which are being made, such as the Olympics, and is failing to guarantee that the important investments in urban transport to keep London moving, such as Crossrail, can be made.

In the section on investment, the report discusses the incentives to make long term investment when costs of finance are low and how this creates an upside for business. Surely it should create an upside opportunity for the government as well.

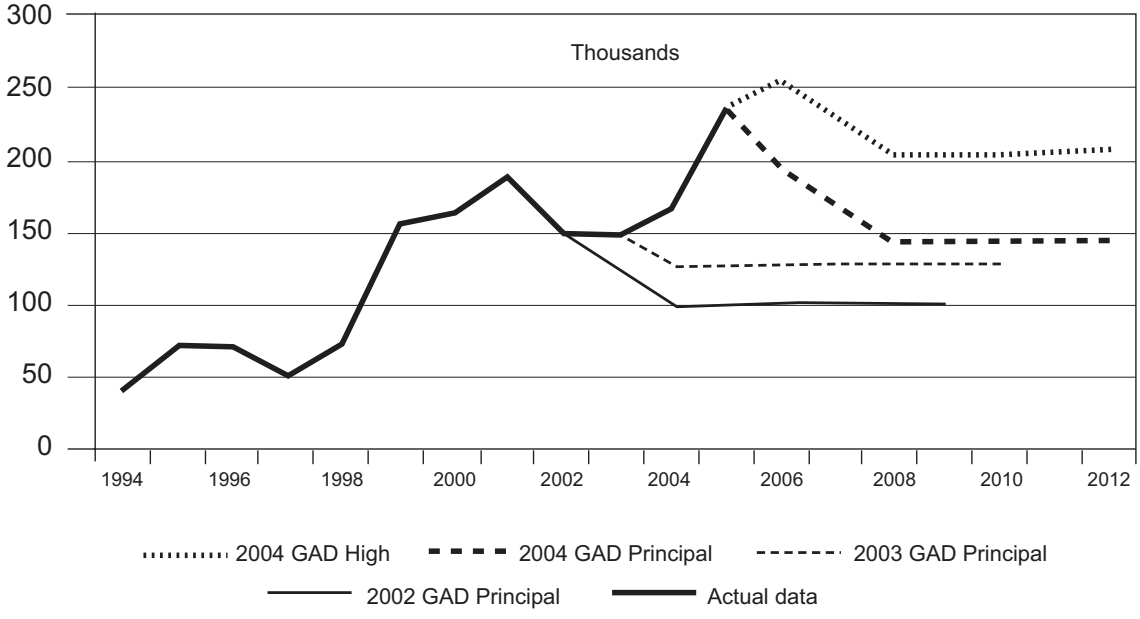
WHAT IS THE LONG TERM GROWTH RATE?

A simple person might think this is a simple question. In a developed economy, operating under market conditions, there is not much variation in long term growth. If we simply take the available statistics and an average, then this should be the answer. The usual answer is the same as the Treasury's previous view of the matter, that is 2.5%. However, in this Pre-Budget report, the rate has been raised to 2.75%.

It is important to realise that this is not what is meant by the trend growth concept as used by the Treasury. They want to ask what the potential growth rate is over the cycle. Such growth depends on two key factors, the number of people likely to be working and the productivity that they have. Employment multiplied by productivity equals total output. Thus the prospective growth over the next cycle, which is what the Treasury are trying to measure, depends on the assumptions made about these two elements. It is unfortunate that they are both uncertain.

Population growth is provided by demographers, immigration is guessed at by the same people. From this can be derived the number of people who might work, depending both on the ability to forecast the numbers of working age and the proportion who will work. All of this is difficult. The Chart shows how estimates and forecasts of migration have previously been wrong, and there may be considerable measurement error in the statistics themselves. They are based on 3,000 interviews held at a limited numbers of ports and airports. They rely on individuals giving truthful answers to a question on their likely length of stay. If, as many suspect, there are indeed more people already here and working, then measured productivity will be too high and the government's view on its acceleration too rosy.

Chart 5: Net migration outturns and GAD projections



Source: ONS and GAD

Output growth then depends on the estimate of productivity growth. The measurement of productivity is much more fraught than is usually thought. Industries in which the UK is a world leader such as retailing and financial services, apparently have poor productivity records. Equally, there are considerable revisions on a continuous basis to this series.

So this upward revision rests on some very uncertain areas of analysis. The Treasury buttress their conclusion by comparing their view with that of other forecasters. These are however also not looking at trend growth as the simple person understands it. These figures are the average growth numbers for future years published by the forecasters in question. They mostly use cyclical models which are driven by some underlying assumptions taken from the same kinds of sources as the Treasury models. So it is not surprising that the same results. In addition, most of the analysis in the most recent report on long term growth looks at only two cycles and concentrates on the most recent.

This is not of course to say that the conclusions are definitively wrong, but the caution that they say they are showing is likely still to be insufficient.

Moreover, there are distinct signs that pressures may be rising in the opposite direction which would reduce growth potential. Businesses and self-employed increasingly report that regulation and nannying is

stifling enterprise and innovation. The cost of form filling and the greatly increased numbers of persons employed to inspect, regulate and interfere produce a disincentive to take risks in the hope of reward. This is now too often described as greedy speculation.

11 December 2006

Memorandum submitted by Mr John Whiting, PricewaterhouseCoopers[2]

The tax changes associated with the PBR this year seemed, on the surface, minor—even if they do raise £2 billion. However, the considerable volume of papers released by HMRC & the Treasury shows that there is in fact quite a lot to get to grips with. It also demonstrates the amount of consultation going on, which is very much to be applauded.

Environmental Aspects

Although one focus of the PBR was on environmental issues, what did not feature was a clear framework for how the UK is to use environmental taxes. Business needs a proper direction setting, so it can plan/respond accordingly. The key issue, perhaps, is whether the UK's environmental taxes simply raise money or try to change behaviour. Both routes are currently in use; the main change this time (the doubling of air passenger duty) seems solely to a revenue-raiser, given that the change was not at a level likely to change taxpayers' behaviour.

The zero-carbon housing move is interesting, though it has to be said that giving a tax incentive here (clearly a behaviour-change environmental levy) needs to consider whether appropriate repair/refurbishment of houses should similarly be tax-encouraged. Wouldn"t such actions be more carbon-efficient?

Property

The discussions that have continued between the industry and HMRC on the rules for REITs have been constructive and there are some sensible points being brought forward now. That said, given that the regime starts at 1 January, it is disappointing that we do not have the final framework in place—nor will the guidance on the rules be issued until late January.

The extension of the REITs regime to new companies wishing to become REITs is welcome. It might be better to allow a two-year period for the new company to meet the REITs tests rather than one year.

The announcements on the planning-gain supplement seem sensible.

Insurance Companies

In the past there have been a number of precipitate announcements in PBRs (and Budgets), often poorly directed and arriving without consultation. It is good to acknowledge that the technical changes this year seem appropriate and targeted.

Pensions (and Insurance Company Aspects)

What has been less well-handled have been the changes to the post-A day pensions regime. Whilst the direction of the changes may well be appropriate (and the correction of some technical defects from April 2006 was sensible), the manner and timing of the main changes was much less so and are damaging to the industry. The main changes in question are in two areas: pensions/term assurance and alternatively secured pensions (ASPs).

The Treasury might argue that the placing of term insurance in a pensions "wrapper" is inappropriate. If so, why was the route allowed to continue until now? It is an idea that was well flagged up in discussions on the new rules; when no action was taken, can the industry be faulted for continuing to market the idea? Blocking the idea from 6 December has caused practical difficulties and uncertainties in view of arrangements in hand. There are distinct shades of the announcement 12 months ago about residential property and SIPPs here.

As for ASPs, perhaps inadvertently, the Treasury raised hopes that ASPs could be used to preserve capital that could be bequeathed in some way. The response might be that the policy was set out in various documents—but again the way that hopes have been raised is unfortunate. If the ASP route is to be tightened as outlined, the tax charges involved—which could amount to 70% with a 40% scheme administrator charge—needs to be reviewed and made fairer.

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[2] This paper is a commentary on some of the taxation measures contained in the Chancellor's 6 December Pre-Budget Report (PBR) speech, associated press releases and other papers. It does not attempt full analysis and cannot be exhaustive.

As a final pensions matter, it is good to see that HMRC are willing to look at the position of pensioners who are, post-A day, taxed on their occupation of properties that would have been tax-free whilst they were in active work. Such people—often low-paid farm workers—are often promised continuation, post-retirement, of their accommodation rights as part of their overall "package". It seems inappropriate that they suddenly have a tax charge just because they have retired. Such charges are the result of A-day changes that were not fully appreciated.

Anti-avoidance Measures

Most of the anti-avoidance measures seem to be targeted and a sign that the Tax Avoidance Disclosure regime is working. The possible extension to the disclosure regime to police situations where HMRC suspect inappropriate non-disclosure is understandable but any change in this way will need careful targeting. It must not become a proxy for HMRC fishing expeditions. Consultation is particularly important here.

The moves against "Managed Service Companies" are unsurprising. Tightening the "IR35" rules in this area have been expected for some time. The route indicated seems reasonable but there is a need to ensure valid administrative arrangements are not unfairly targeted and also that the "look through" powers to attach unpaid tax liabilities to those involved in the wider arrangements are tightly defined. There is understandable concern that this moving of a tax liability to others not immediately liable should not become more widespread.

Action Following ECJ Cases

In *Deutsche Morgan Grenfell v CIR*, the House of Lords ruled that where a taxpayer claimed repayment of tax paid under a mistake of law (here, not appreciating that UK law was inconsistent with EU law), the time limit for challenging the decision was six years from the date of the ECJ's decision, not the normal six years from the date the tax was paid.

The case was of narrow impact: it primarily applies to cases about advance corporation tax (ACT); the law has already been changed so that it does not apply to cases started on or after 8 September 2003. The PBR announcement limits the impact of the case still further. It will now not even apply to cases started before 8 September 2003, unless the judgment is given before 6 December 2006.

Whilst the government's wish to restrict the impact of the case is perhaps understandable, the further restriction does seem unfair to those who have paid tax under what has now been established as a mistake of law. Also, this change is almost certainly not compliant with European law—the Court has established that a taxpayer's treaty rights cannot be taken away without adequate notice being given—so yet more litigation seems likely.

It is also debateable whether the changes to the CFC regime, announced in the wake of the ECJ Cadbury Schweppes case, fully meet the requirements of the judgement.

Complexity of the UK Tax System

As a final comment, there needs to be a continuing focus on maintaining/improving the international competitiveness of the UK's tax system and tackling complexity where possible. The Varney report's recommendations, and their endorsement by the Chancellor, are positive in this regard.

11 December 2006

Supplementary memorandum by Mr John Whiting, PricewaterhouseCoopers

Reflecting on the discussion with the Committee on the proposed Air Passenger Duty increase[3], there is another issue that needs consideration—namely whether the notice period before the increased amounts take effect is sufficient.

Clearly a date has to be set and, as the duty is one on flights, it is logical that the increase applies to flights taken from that date. However:

(1) many people who had already booked flights and holiday packages formed the initial impression that the increases did not apply to them; and

(2) travel operators are faced with the administrative burden of charging and collecting the additional duty from such people, as well as making system changes to cater for the increases for the future.

On the previous occasion when Air Passenger Duty was increased, over 12 months notice was given—the announcement in Budget 2000 foreshadowed a change from April 2001. There would have been hardly any existing bookings affected by the change.

[3] Q 115

This time, with less than two months notice, operators have a considerable administrative burden to shoulder in respect of existing bookings—or are faced with having to absorb the additional duty themselves. (There have also been suggestions that regulations on surcharging passengers may make it difficult to impose the additional duty.) It would seem appropriate to question the Treasury over the period of notice—has a proper balance been struck between the desire to raise additional revenue and the burdens, administrative and financial, placed on the industry? It seems, at best, doubtful whether it has been.

14 December 2006

Memorandum submitted by Colin Talbot, Manchester Business School

Realism and Efficiency

The Pre-Budget Report 2006 claims that the government is on track to meet its Gershon efficiency target of £21.5 billion in savings and has so far accrued £13.3 billion. In a written answer the Chief Secretary moreover claimed specifically that £5.5 billion had come from procurement savings, £2.5 billion from productive time and £1.5 billion from policy, funding and regulation. The government also announced a target of 3% pa efficiency savings across central and local government for the period of the 2007 CSR (up from 2.5% pa) and a target for savings from administrative budgets of 5%.

These are big claims and ambitious targets which deserve serious scrutiny. The NAO is due to issue its 2nd Report on the efficiency programme early next year, so we will have to wait until then to see if the problems with measuring efficiency gains have, in the NAO's view, been overcome since their 1st Report in February 2006.

The PBR 2006 however offers surprisingly little evidence for the claimed £13.3 billion savings, other than a few examples. **The Committee might wish to consider asking for the six monthly reports of the OGC Chief Executive to the Prime Minister and Chancellor to be made public as a way of getting at the data behind these claims.**[4] There seems little reason for these reports to remain secret and every reason to see how the government is making its calculations about efficiency savings. They must have arrived at these totals somehow and even if the reports cannot be made public the OGC and HMT can certainly make public how they arrived at the claims made in the PBR and by the Chief Secretary.

This note seeks to clarify some of the problematic issues surrounding the government's efficiency agenda. It seeks to ensure firstly that these issues are discussed using the same terminology and definitions, which otherwise can lead to great a great deal of confusion and misinformation. And secondly it tries to identify what are the key challenges in achieving the substance and measuring the reality of efficiency savings in government.

Terminology

It may appear to be somewhat over-academic to place great emphasis on getting the terminology right in discussions of efficiency but it is actually an immensely practical issue: one person's "efficiency gain" can easily be someone else's "cuts" unless we can at least agree on terms.

Back in 2001 HM Treasury, together with Cabinet Office, NAO, Audit Commission and ONS issued a small booklet called "Choosing the right FABRIC—A Framework for Performance Information" (Treasury . One of the main purposes of this publication was to clarify terminology so that some of the confusion in discussions about performance, delivery and efficiency could be minimised. Unfortunately the Treasury seems to have forgotten this agreed set of terminology in reporting on the efficiency programme.

FABRIC made an important and useful distinction between "efficiency", which it defined simply as the ratio of inputs to outputs, and "cost-effectiveness" or "value for money" (VFM), which it defined as the relationship between resources consumed (inputs) and outcomes.

These definitions are important for several reasons:

- They help to clarify the difference between narrow efficiency (input:output ratios) and VFM which are clearly highly important in policy-terms. It is quite possible to have activities which are efficient, but not cost-effective and vice-versa.
- This also helps to clarify that some so-called "efficiency" savings are nothing of the sort. For example, proving that the cost of inputs has been reduced (eg in purchasing and supply) is merely an "economy" unless it can also be shown that these reductions have not led to a reduction in the quantity or quality of outputs. Indeed it is perfectly feasible to have economies in purchasing lead to reductions in efficiency (due, for example, to higher failure rates due to inferior supplies being used) and also of VFM (due to, for example, adverse outcomes caused by lower quality inputs). Given that 37% of the Gershon target is due to come from procurement these are vital distinctions to maintain.

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[4] The author has made an FOI request to OGC for these reports which as yet has neither been accepted nor declined.

Throughout much of the government documentation on the efficiency programme the concepts of efficiency, economy and VFM are regularly confused.

This matters because opponents of the government and critics of the efficiency programme, such as the trade unions, will seize on these inconsistencies to argue (rightly or wrongly) that the efficiency measures are actually leading to reductions in services or outcomes. This debate—which is a very important one and should be taken seriously—will be meaningless and sterile unless common definitions are consistently applied. Moreover government itself will not know what is real and what is "smoke and mirrors" if it doesn't stick to rigorous definitions (and measurement procedures).

Gershon Targets

For the purposes of this note the Gershon targets split by "work streams" (Computer and Auditor General 2006 p 4) are the most useful.

This breakdown is important because the different work streams have very different dynamics in achieving and measuring successful efficiency improvements.

A basic issue here is how labour or capital intensive the areas of work are. As a general rule, it is much easier to achieve substantial net efficiency and productivity gains in areas of higher capital intensity than in those of greater labour intensity—although of course the initial capital costs are much higher.

Table 1

GERSHON EFFICIENCY TARGETS BY WORK STREAM

	Target (£ billion)	*Percentage of target*	*Actual as of December 2006*[5]	*Percentage of target met*
Procurement	7.96	37%	5.5	70%
Productive time	5.16	24%	2.4	49%
Policy, funding and regulation	3.66	17%	1.5	41%
Corporate services	1.51	7%		
Transactions	0.86	4%		
Other	2.37	11%		
	21.5			

Thus it can be assumed that those areas of more capital intensive activity—procurement, corporate services and transactions—are going to be in principle areas where efficiency gains are easier to achieve—with the right investment—than in the area of productive working. This seems to be at least partly born out by the partial figures we have which suggest that 70% of the procurement target has been met as against only 49% of the productive time target.

The productive time efficiency gains are mainly targeted at very labour intensive public services. Education is expected to produce £1.3 billion and health £3.25 billion—which together comprise 88% of the total productive working target.

These are areas where technical solutions have limited scope for improving individual productivity. Indeed, the recent emphasis on:

— successful outcomes in education and health (and some other fields);

— on the need for much more "co-production"—ie actively engaging "users" in the production of services and outcomes (eg in health promotion); and

— and addressing so-called "wicked issues" across organisational boundaries;

can all demand the increased use of labour power—for example longer consultations with GPs; more counselling type activities; more intensive pupil engagement; etc These may all increase VFM whilst appearing initially to reduce narrow efficiency.

The crucial point here is that a "one size fits all" efficiency agenda—including an across the board 3% pa target across al departments and areas of activity—is simply unrealistic. Some areas can make much greater efficiency gains—with the right investment—whilst others will struggle to achieve anything like a 3% pa annual gain and may even appear to drop (more on this below).

Although efficiency in the public sector is clearly different in many respects from productivity growth in the economy as a whole it is interesting to compare the expected growth in efficiency with expected productivity growth. Most importantly, the public sector as a whole is much more labour intensive than the UK economy as a whole. It would therefore probably unrealistic to expect similar gains in productivity or efficiency in the two—the public sector would almost certainly lag the private sector.

[5] Based on Mr Timms written answer on 7 December 2006, col 435.

According to the PBR 2006 trend growth in productivity in the UK economy is running at 2.4% pa (in the period 2001Q3–2006Q3, p 39). Productivity (output per worker) is not the same as efficiency (input:output ratios), in fact it is a subset of efficiency. But especially in relation to the productive working targets it is fairly close.

The Committee may therefore wish to ask HMT to explain why it is reaslistic to expect a growth rate of 3% pa in public sector efficiency in the context of growth in national productivity of 2.4% pa?

Measurement Problems

The NAO's first report on the efficiency programme identified major concerns about the measurement of reported efficiency gains. These are reported in generic terms, but the issues of differentiated efficiency work programmes raised above also apply to measurement issues.

Put simply, there are some areas where at least some aspects of measurement are much easier than others. For example, purchasing areas are likely to have relatively good long-term data about the costs of various inputs. This is unlikely to be true of the measurement of working practices, where data is unlikely to be available from before the various efficiency initiatives started.

However, in all cases the biggest problem of all is measuring outputs accurately and especially the quality of outputs, an issue which the Atkinson Review and the ONS have been struggling with for some time. Although progress has been made, no-one would claim that this problem has been "solved" and there are still both technical and political disputes surrounding the measurement of outputs. Moreover the approaches developed by Atkinson and the ONS are designed for macro level analysis of outputs in relation to whole sectors (eg education) and are not fine-grained enough to address more micro-level issues of efficiency.

Without such agreed metrics measuring any efficiency gains is going to be at best problematic and probably impossible in most cases. It is very difficult to see, for example, how the reported efficiency gains of £2.4 billion from productive working—which must have come mainly from health and education—can be squared with existing ONS estimates of changes to productivity in these sectors which appear to be flat-lined or reducing, depending on the assumptions used.

This problem is compounded by the weakness of allocation systems—that is allocating the cost of inputs against specific outputs, even where these can be adequately measured. The NAO has rightly pointed out that the systems needed for this sort of analysis (activity costing systems) are relatively scarce in government. Even when they are put in place, back-dating them to create base-line data for analysing efficiency gains is often not possible or too expensive.

In the area of productive working all of these problems apply—weak or non-existent and problematic measurement of inputs; serious allocation issues (which work contributes to which outputs); and finally problematic measurement of outputs.

It should be noted this only deals with the main difficulties in measuring narrow efficiency. VFM measurement is even more problematic. And as noted previously, narrow efficiency gains can have detrimental effects on VFM. For example, when some NHS hospitals began using a particular artificial hip joint the initial analysis of narrow efficiency was positive—cheaper inputs for the same quantity and quality of output. It was only several years later that faults in these hip joints emerged which led to severe losses in VFM as the outcomes for the patients deteriorated badly.

Gaming and Unintended Consequences

The issue of "gaming" in relation to all kinds of performance data have been explored in a number of scrutiny and research projects. Whilst this is often exaggerated, one thing we do know is that the more narrow and focussed any measurement is, the more scope there is for both gaming and unintended consequences.

The Treasury and OGC seem to have now recognised these potential problems in relation to the efficiency programme and its relative autonomy from the "normal" business systems. The need for "mainstreaming" efficiency is currently more clearly recognised, but it is unclear how far the programme to date has produced gaming and/or unintended consequences. Not is it clear that the approaches of HMT, OGC or the NAO will expose such problems.

Realism, Efficiency and Public Value

This note has been a plea for more realism in how much efficiency can be both achieved and measured in the public services. Unrealistic promises and claims of success have a high negative impact generating cynicism amongst staff, managers, users and the public. It does not suggest that efficiency gains are either impossible to achieve or even impossible to measure, but the difficulties of both need to be recognised.

Also, a more nuanced and differentiated approach is needed—recognising the dynamics and characteristics of different areas of activity. As I pointed out to the Committee when the Gershon Report was first published in July 2004, there were in fact very different levels of relative efficiency savings expected from Whitehall departments (ranging from 1.2% to 17.4%).

No explanation for these variations has ever been given and they may indeed relate to the realistic possibilities for efficiency gains in different areas of work. So despite the apparent "one size fits all" policy, in fact there has been a great deal of variation –what is not clear is whether these variations are due to realistic analysis of efficiency possibilities or some other reason. Indeed, the fact that there are very big differences between the two departments where the expected biggest gains from productive working practices are to be realised—6.9% in health but 12.4% in education—suggests there are clearly other unknown factors at work.

The Committee may want to ascertain whether the new 3% pa target announced in the PBR is an across the board target or is as variable as the Gershon targets, and if so why?

There is an increasing discussion in the UK of "public value" which seeks to marry concerns about efficiency and VFM with issues of trust and legitimacy in the public domain. Especially in relation to co-production in areas such as education, health and criminal justice trust and legitimacy are crucial ingredients to achieving real efficiency and VFM in producing outputs and outcomes. People will not work with organisations they don't trust.

In terms of increasing the trust and legitimacy of public services, which is crucial to the value which the public attributes to public domain activities, the unintended impacts of unrealistic targets and claims can more than outweigh any genuine and objective efficiency gains. Paradoxically, rather than increasing public confidence in public services in the context of the expanded spending of the past few years, a lack of realism in the claims about efficiency gains can actually undermine public trust—perhaps a more serious negative outcome than any positive efficiency gains.

December 2006

References

Comptroller and Auditor General (2006). *Progress in Improving Government Efficiency (HC802-I*. London, National Audit Office.

HM Treasury (2001). *Choosing the Right FABRIC—A Framework for Performance Information*. London, HM Treasury.

Memorandum submitted by The Law Society

THE CADBURYS SCHWEPPES CASE AND THE CHANGES TO THE UK CFC REGIME

Comment on PBRN01

1. Under the UK controlled foreign company ("CFC") regime as it currently applies the profits of a controlled foreign company which is resident in a country which has a rate of tax which is lower than that in the UK are attributed to its UK parent and taxed in the hands of the UK parent. There are exclusions from the CFC regime but these are subject to a number of tests and conditions. In particular a CFC can be exempted if it carries out a full distribution policy (which means paying out 90% of its profits to the UK group), or if it carries on "exempt activities", which consist of three requirements, namely having a business establishment in the territory in which it is resident, ensuring that its business affairs are effectively managed there and satisfying any one of four tests which vary in complexity but which in many ways restrict the type of activities which can be undertaken and the relationship with the UK group. There is also a motive test but this is failed if the main reason or one of the main reasons for the establishment of the subsidiary is the diversion of profits from the UK, which it is assumed occurs if, had the subsidiary not existed, the receipts would have been received by a UK resident.

2. The Cadbury Schweppes case considered whether the UK rules breached articles 43 and 48 of the EC Treaty providing for freedom of establishment. The European Court held that a national of a member state could not be prevented from establishing a subsidiary in another state if the motive was to benefit from a beneficial regime in that other state. Such a motive was not incompatible with the principle of freedom of establishment. However, a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application to the legislation of the member state concerned. In this case the court held: "75. In the light of the preceding considerations, the answer to the question referred must be that arts 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a member state of profits made by a CFC in another member state, where those profits are subject in that state to a lower level of taxation than that applicable in the first state, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure must not be applied where it is

proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that CFC is actually established in the host member state and carries on genuine economic activities there."

3. All that is therefore required is an establishment and genuine activities in the state concerned. It states in the HMRC Press Release that the proposed new legislation maintains the effectiveness of the rules in protecting tax revenues, while at the same time complying with the Cadbury case. The proposed legislation introduces a new "net economic value" test which excludes from the CFC regime the real economic profit to the group concerned of the work of individuals working for a CFC in an EEA state after allowing for the costs of the individuals in carrying out the work. Profits that arise from capital activities are therefore not excluded from the CFC tests, because (effectively) intra group transactions which may move capital are ignored and the value has to be created through individuals' activity. The intention behind this change is to categorise what constitutes genuine economic activities and to limit these to the activities of people rather than, for example, financial activities. Contrary to the HMRC Press Release, we do not believe that there is any justification for this distinction in the European Court's judgment.

4. Furthermore, the revised exempt activities test for companies resident in any EEA territory applies a new definition for effective management for EEA resident companies of sufficient individuals working for the company in the territory to undertake the company's business but does not relax any of the other requirements in paragraph 6 of Schedule 25, in particular the detailed requirements of the exempt activities test relating to the type of activities carried on as described above. Nor is the motive test altered. This does not appear to us to go far enough to enact the Cadburys Schweppes test which requires that the CFC legislation can only apply to include the profits of a controlled foreign company in another member state where the inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Merely excluding the benefit of the work of individuals in a jurisdiction from the scope of the CFC rules and altering the definition of effective management does not comply with the case law: too little is assumed to constitute "genuine economic activities".

5. We should state that we understand that the provision has been brought forward as an interim response pending a further review of this area in 2007. We also appreciate the disruption caused to the UK tax system by judgments of the European Court such as this one and the difficulty of framing an appropriate response which safeguards UK revenues while complying with the EC Treaty. We are, however, concerned that to enact legislation which does not address in substance what the case law appears to require will merely invite more litigation and create uncertainty not merely for business but also as regards Exchequer receipts; we believe there is a risk of there being two alterations to the legislation, which will undermine the principle of certainty of tax treatment for business. We recommend that there is further full consultation and consideration to the changes required to UK legislation to meet the requirements of the EC Treaty and also to safeguard revenues.

11 December 2006

Memorandum submitted by the Board of Airline Representatives UK (BAR UK)

The Board of Airline Representatives in the UK (BAR UK) represents 91 scheduled airlines in their dealings with Government; a list of members is attached for your information.

The aviation community is unhappy with the APD increase in any event; however, it is the manner in which it is being implemented that is of much graver concern.

BAR UK was present at the meeting of aviation delegates at the Treasury on Monday when our concerns were expressed. At that time, we were informed that Treasury was aware that there would be issues arising out of its proposal, but decided to proceed with the implementation date of 1 February anyway. It was also apparent from what was said that the increase in APD has little, if anything, to do with the environment, but was a way of meeting the financial needs of the Exchequer. Their closing response in declining to change anything was "we are where we are". That could have been said as "you are where we have put you".

My point in writing to you is to make you aware of the implications outside of the UK.

APD is collected in respect of all travellers departing the UK, regardless of where tickets have been issued. The doubling of APD for all travellers from 1 February, with such little notice, has huge financial implications overseas, as well as here in the United Kingdom.

The issues are two-fold:

(a) tickets already purchased, and issued, for travel on/after 1 February; and

(b) tickets purchased and issued between the announcement of the increase, and the dates by which ticketing systems are updated.

In both cases, but especially the first, it is extremely impractical to collect additional monies from passengers. To do so would require such actions to take place at airports, something that could be expected to lead to chaos, and to scenes of disorder.

BAR UK has now received representations from airlines from around the world. They are all extremely concerned of the financial implications for their companies, each of whom faces a liability of several hundreds of thousands of pounds.

It can be expected that some foreign Governments may intervene on their behalf, as IATA (International Air Transport Association) already has.

The sensible remedy would be to adjust the policy so that the increased rates of APD applied to all tickets issued on/after 1 February; to date, the Treasury has shown no wish to do so.

I trust that this update, and the potential effects on foreign relationships, may be of use to your Committee.

15 December 2006

Memorandum submitted by HM Treasury

MATERIAL REQUESTED AT THE EVIDENCE SESSION ON 12 DECEMBER[6]

What is the effect on passengers and extra revenue of doubling APD on 1 February 2007 rather than 1 April 2007? Are there instances in the past where new rates of tax or duty (as opposed to technical tax avoidance measures) have come into force soon after the Pre-Budget Report and then been given retrospective parliamentary authority after the Budget? (Q 181–188)

Government policy on aviation needs to strike the right balance between economic, social and environmental factors.

The Government recognises the role that aviation can play in tackling the climate change impact of aviation. The Pre-Budget Report therefore announced that APD rates would increase from 1 February 2007.
A number of tax and duty rates changes, including alcohol and tobacco duties, are routinely announced before the start of a new financial year and come into effect before the start of that financial year.

How much will ASP measures raise in revenue? (Q 293)

As set out in the partial regulatory assessment on *Tax Relief for Pensions: 2006 Pre Budget Report Reforms*, the changes to the ASP rules will have no additional impact on Exchequer costs. The ASP changes are a revenue protection measure.

Capital funding for DfES over the CSR period- clarification of figures (Q 244)

The PBR announced that capital investment in education will rise by an £250 million, £750 million and £1,850 million over the years 2008–09 to 2010–11. This will result in a total of £8.6 billion in 2008–09, £9.1 billion in 2009–10 and £10.2 billion in 2010–11. This figure will allow us to meet the commitment to match 2005–06 levels of private sector per-pupil capital investment in real-terms by the end of the CSR period.

12 December 2006

Letter from the Paymaster General to the Chairman

UPDATE ON MTIC FRAUD

I am writing to provide you with further background to the 2005–06 estimates of Missing Trader Intra Community (MTIC) fraud published today in a HM Revenue and Customs publication "Measuring Indirect Tax Losses, 2006", and to update you on the impact of HMRC's strategy to date in 2006–07. A copy of this document is enclosed.

The latest estimates from HMRC, published today, show that the scale of *attempted* fraud over 2005–06 was between £3.75 billion and £4.75 billion. HMRC's operational strategy means that not all attempted fraud is successful. HMRC estimates that the potential impact of MTIC fraud on the VAT receipts over this period was between £2 billion and £3 billion.

Given the speculation over the scale of this fraud, I thought it would be helpful to explain these estimates in more detail. This is set out below.

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[6] Ev 18–37

As you know, MTIC fraud is a large-scale organised criminal attack on the EU VAT system. The most serious form of the fraud—known as carousel fraud—involves a series of contrived transactions within and beyond the EU, with the aim of creating large unpaid VAT liabilities and fraudulent VAT repayment claims. The UK is at the forefront in Europe in understanding and measuring MTIC fraud, and introducing a strategy comprising operational interventions and legislative tools to tackle this increasingly complex and sophisticated fraud.

Estimates of MTIC-Related Activity 2005–06

During 2005–06, the fraudsters involved changed their behaviour in an attempt to circumvent HMRC's controls. As a result, the previous published measure of attempted MTIC fraud, though a sound measure up to then, has failed to adequately take account of the full range of attacks on the system over this period. However, HMRC has used operational indicators to produce new estimates for the fraud in 2005–06, published today. The estimates show the scale of *attempted* MTIC fraud was between £3.5 billion and £4.75 billion in 2005–06. HMRC's operational strategy means that not all attempted fraud is successful and results in a loss to the exchequer. HMRC estimates that the potential negative impact of MTIC fraud on the VAT receipts in 2005–06 was between £2 billion and £3 billion. Much of this money is the subject of ongoing criminal investigations involving international co-operation.

The Government has been proactive in tackling MTIC fraud, and introduced anti-fraud legislative measures in 2003 and again in this year's Finance Act. However, the level of attempted fraud is driven largely by the fraudsters' confidence and their behavioural response to the changing environment in which they operate, including the outcome of legal action. The escalation in the scale of the attack on the VAT system in 2005–06 reflects a combination of factors. One significant factor was the fraudsters' response to a European Court case[7], which created an extended period of legal uncertainity between the Advocate General's Opinion in February 2005 and the Court's ruling in January 2006. The ruling took away one of the legal defences used by HMRC to deny suspect VAT repayment claims.

This prompted a significant increase in the trading activity associated with MTIC fraud during the second half of 2005–06, for which there was no commercial or economic rationale.

During 2005–06 HMRC took proportionate steps to strengthen its operational response to this attack, including:

— working closely with other law enforcement agencies in the UK and beyond to identify and destabilise the criminals behind the fraud; and

— introducing stronger frontier controls and more rigorous procedures to capture and record key information about the goods, people and tactics used in carousel frauds, and to share that information with international partners.

Further details of HMRC's operational response during 2005–06 will be published shortly in their Annual Report 2005–06.

Despite these efforts, while suspecting that some VAT repayment claims were associated with fraud, the increasingly complex nature of the fraud meant that over this period HMRC did not always have sufficient evidence necessary to deny all suspect claims. Nevertheless, these activities did help to mitigate the negative impact on VAT receipts in 2005–06 associated with the increasing scale of the attack on the system.

Impact of HMRC's Strategy in 2006–07

In 2006–07 further criminal and civil investigations have been instigated in respect of the repayments made during 2005–06 where HMRC contues to suspect that they were associated with fraud. Working closely with international partners, HMRC's investigations have followed global money trails to locate the proceeds of crime. A substantial number of accounts have been frozen, denying the fraudsters access to their money and severely restricting their ability to fund further fraudulent activity.

These investigations are uncovering evidence that can be used to deny fraudulent VAT repayment claims. In addition, a subsequent ruling by the European Court[8] in July this year has provided HMRC with a strengthened basis on which to refuse suspect and abusive VAT repayment claims. HMRC has also re-deployed a further 600 additional staff to the MTIC strategy—bringing the total to over 1,400. All of this has enabled HMRC to carry out in-depth checks on the vast majority of suspect VAT repayment claims submitted since April this year. These claims will not be paid unless and until HMRC is satisfied they are properly due.

Operational indicators are pointing to a much improved position in 2006–07. A significant proportion of attempted frauds are now being stopped and the strengthened strategy has greatly reduced the level of attack from attempted fraud in recent months, partially reflected in the latest ONS published trade statistics[9], which

[7] The joined cases of Bond House Systems Ltd and others (C-484/03, C-354/03, C-355/03).

[8] Joined cases of Axel Kittel and Recolta Recycling (C-439/04 and C-440/04).

[9] *Balance of Trade in Goods,* ONS, November 2006.

suggest MTIC-related activity fell sharply over the summer, by around two thirds compared with late 2005–06 and early 2006–07. The success of a significant proportion of these interventions will depend on the outcome of criminal and civil litigation over coming months and years.

The Government is determined to sustain the impact of its strategy and to ensure that HMRC has the tools it needs to combat MTIC fraud. As announced in today's Pre Budget Report, a further 100 HMRC staff are being redeployed to MTIC strategy, bring the total to 1,500. As part of its wider strategy of working internationally to combat cross-border fraud, the Government is continuing negotiations with its European partners to secure introduction of a reverse charge VAT accounting system for goods most commonly used in MTIC frauds. Further legislative measures will be brought forward in Budget 2007 as required.

I hope you find this helpful.

I am placing a copy of this letter in the Libraries of both Houses.

Dawn Primarolo MP

6 December 2006

Supplementary memorandum submitted by HM Treasury

FURTHER MATERIAL REQUESTED AT THE EVIDENCE SESSION ON 12 DECEMBER 2006[10]

In assessing the most effective way of tackling child poverty, has the Government undertaken a comparison of child tax credits and child benefits? (Q 273)

Increases in both Child Benefit and the child element of the Child Tax Credit can reduce the numbers of children living in poverty. Estimates of the changes in child poverty are sensitive to factors such the choice of income equivalisation scale, the treatment of housing costs, the poverty threshold, and other modelling choices.

However, the Treasury has made such estimates in response to recent, written Parliamentary Questions. As set out on 18 April 2006 (63256), an increase of £15 per week in all rates of Child Benefit would have lifted around 1 million children out of poverty in 2005–06, before housing costs. On the same basis, an increase of £14 per week in the child element of the Child Tax Credit would have lifted around 1 million children out of poverty. The increase in Child Benefit would have cost around £10 billion in 2005–06, while the increase in the Child Tax Credit would have cost around £5 billion. In addition, as set out in Parliamentary Questions answered on 17 January (41432) and 25 October 2006 (95739), raising the value of Child Benefit for all children to the rate payable for the eldest child is £1.7 billion, and would lift between 250,000 and 300,000 children out of poverty.

Why is the extension of Child Benefit to pregnant women not being introduced until April 2009? (Q 288)

The extension of Child Benefit to pregnant women represents a significant policy change. To implement this policy, the Government needs to make the necessary legislative changes, which will require primary legislation, and put in place the administrative arrangements, including changes to the IT system, to deliver the new entitlement.

The Government therefore announced an implementation date of April 2009. This is similar to previous lead times for Child Benefit policy announcements. For example, in March 2004, the Government announced its proposal to extend Child Benefit to the parents of unwaged trainees. This new entitlement came into effect in April 2006.

The Paymaster General said that a small proportion of claimants may experience disruption in their payments following the processing of changes in their circumstances. Which claimants are affected and why? (Q 282)

This will only impact on these claimants if they report a new change of circumstance before the IT system is updated in April 2007. HMRC is putting in place special arrangements for dealing with these claimants until then.

Has the Government undertaken analysis of marginal tax rates as recommended by the TSC at Budget 2006?[11] (Q 276)

Calculations take no account of the £25,000 disregard in tax credits (extended from £2,500 in April 2006), which significantly reduces shorter-term deduction rates.

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[10] Ev 18–37.

[11] Treasury Committee's Recommendation: 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.

The available research evidence 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.

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. The evidence so far has not revealed any widespread adverse impacts on average hours worked or on shorter-term wage progression.

Do we collect data on the distribution of the benefits of public service pensions across the workforce, for example, what proportion of such pensions are received by the low paid in the public sector? (Q 192)

Most public service pension schemes are final salary schemes, although some exceptions exist (such as the schemes for GPs and dentists).

Final salary schemes calculate an individual's pension according to a formula, which is based on salary close to retirement of the individual in question and the number of years of service.

The value of individual entitlements will vary with many factors including pay, service, age, future earnings patterns and gender. And these factors combine, so for example, the accrued pension for someone approaching retirement after a long career will generally be much larger than that of a younger employee in mid-career. There is not therefore a direct link between data on pension outcomes and data on the number of individuals who are or were low paid. This is because a low pension outcome might be associated with an individual who, for example, had low pay at retirement or had a short service, or left the public service early in their career. Also an individual who is low paid now may be more highly paid by the time they retire.

11 January 2007

Supplementary memorandum submitted by HM Treasury

FURTHER MATERIAL REQUESTED AT THE EVIDENCE SESSION ON 13 DECEMBER 2006[12]

What is the programme of capital investment in primary and secondary schools, including the allocation of spending, how many primary and secondary schools will be involved in this programme and progress to date? (Q 425–447)

Overall Investment Plans

The Pre Budget Report 2006 set out capital spending plans that will see overall investment in education, including PFI, rise from £8.3 billion in 2007–08 to £8.6 billion in 2008–09, £9.1 billion in 2009–10 and £10.2 billion by 2010–11. Within this, schools investment will rise from £6.4 billion in 2007–08 to £8.0 billion by 2010–11— supporting a range of strategic (including Building Schools for the Future, Academies and the Primary Capital Programme), targeted and devolved capital programmes.

Objectives: 21st Century Learning

The overarching objective driving the Government's strategic capital investment programmes is to ensure that all pupils are able to benefit from 21st century facilities that support learning as it continues to develop in the future.

This means:

- buildings that support **personalisation of teaching and learning**;
- buildings that support **extended and community use** of schools—with every child and family having access, either onsite or through schools, to year-round, 8 am to 6 pm childcare; parenting support; specialist support services; a good range of after-school activities; and access to ICT, sports and arts facilities after hours;
- every school providing **first class ICT facilities** so that pupils benefit from access to the latest technology and can study in the way that suits them; and
- **more energy efficient, sustainable schools**—with all new schools required to achieve at least a "very good" rating under the Building Research Establishment's environmental assessment method (BREEAM), ensuring high environmental performance. As a minimum, all new schools will achieve a reduction in carbon emissions of 40% compared to standards in place prior to 2002. PBR 2006 announced that the Government will now pilot even higher standards for school buildings, in some cases up to carbon neutrality.

[12] Ev 38–59

BSF and the Primary Capital Programme will also contribute to a range of other objectives, including:

— responding to demographic change across the country and within authorities;
— increasing the diversity of school provision;
— ensuring effective delivery of the 14–19 entitlement;
— effective integration of the Every Child Matters agenda into schools;
— greater support for, and inclusion of, children with Special Educational Needs;
— improving sports and recreational facilities and the use of school grounds; and
— supporting healthy eating through improved kitchen/dining facilities.

Each local authority participating in BSF is expected to produce a "Strategy for Change" which outlines how they will meet these objectives. Funding is not approved until Government is satisfied that these visions are sufficiently ambitious and robust.

Building Schools for the Future (BSF)

There are approximately 3,500 secondary schools in England. The programme to rebuild or refurbish all secondary schools was announced in 2003 and, after consultation, was launched in February 2004. The first wave of investment came on stream in 2005–06. Over £2 billion a year, including PFI, is available for the BSF programme over the Spending Review 2004 period. The programme will be rolled out to all authorities and schools over 15 years of investment, subject to future spending decisions.

There is a presumption that schools less than 15 years old will not require additional investment through BSF. This means that overall, around 3,100 of the 3,500 secondary schools in England are expected to benefit from BSF. It is anticipated that approximately 50% of construction work carried out through BSF will involve building entirely new schools. A further 35% will involve major refurbishment and a remaining 15% minor refurbishment.

Progress to date

BSF is being delivered through waves of local authorities. Waves 1 to 3 are now underway—covering 38 local authorities (over a quarter of all local authorities) and about 370 schools. These authorities were prioritised according to social and educational need, meaning that pupils with the greatest need, usually in the most deprived areas of the country, will receive the benefits of this major capital investment first.

At present, over 20 local authorities have developed their schemes sufficiently to have passed through all necessary approvals and taken their projects to the market. Four projects have reached financial close and construction is underway in three areas. The first all new school is due to open in September 2007 in Bristol.

Recognising that there have been some delays to the early roll out of the programme, DfES and Partnerships for Schools (PfS) are working closely with authorities to identify and overcome the barriers to faster progress. In particular, they are disseminating lessons learned about the advanced work that authorities can do, and the resources required, to be ready to deliver.

On 15 December 2006, the Government announced the 15 local authorities participating in wave 4 of BSF, of whom 10 are new to the programme. As well as their social and educational needs, these authorities were prioritised on a thorough appraisal of their capacity to deliver.

Academies

As of 2006, academies will be delivered through the BSF programme—ensuring efficiency gains in procurement. The Government has committed to having 200 academies open or in the pipeline by 2010. At present, there are 46 academies open with an additional 63 having already been approved for development. The Government is therefore on target for reaching this commitment and going further in the longer-term; in November 2006, the Prime Minister expressed an ambition eventually to deliver 400 academies.

Primary Capital

There are approximately 17,500 primary schools in England. The Primary Capital programme, announced in 2005, aims to rebuild or refurbish at least half of all primary schools in 15 years from 2008–09, subject to future spending decisions. The Government has already allocated £150 million in 2008–09 and £500 million in each of 2009–10 and 2010–11 with investment expected to continue at least at this level into the future.

In November, the 23 authorities which will receive a share of the 2008–09 funding as primary pathfinders were announced. Authorities will be expected to take a strategic approach to the renewal of their primary estate but, unlike BSF, the programme will not be delivered in waves and all local authorities will receive funding from 2009–10.

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