House of Commons
Treasury Committee

The 2008 Budget

Ninth Report of Session 2007–08

Report, together with formal minutes, oral and written evidence

Ordered by the House of Commons
to be printed 1 April 2008
The Treasury Committee

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Contacts

All correspondence should be addressed to the Clerks 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.
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Summary

The economy

We note that the lower boundaries of the Treasury’s forecasts for economic growth in 2008 and 2009 are above the average of independent forecasters. We conclude that the Treasury may have given insufficient weight to the risks of continued financial market turbulence and that some of the UK economy’s characteristics that have proven beneficial in past crises (rapidly rising residential property prices, close links with the US and an increasing reliance on the financial services industry, for example) might prove to be conduits through which the current problems in global financial markets are transmitted to the UK real economy.

The public finances

We note that there has been a further weakening of the Treasury’s forecasts of the current budget balance from 2008–09 onwards and that the latest forecasts for the fiscal position are based on forecasts for economic growth that are subject to considerable downside risks. We continue to believe that the golden rule should be more forward looking. Even on the Treasury’s own current formulation, it appears to us to be premature for the Treasury to state that it is “on course” to meet the golden rule in the next economic cycle, given the lack of an end date for the previous economic cycle. We note that the margin by which the Treasury forecasts that it will meet the sustainable investment rule is extremely tight, especially considering the uncertainty surrounding the overall economic situation. We call for the Government to clarify in the 2008 Pre-Budget Report how it proposes to revise the sustainable investment rule in the light of implementation of International Financial Reporting Standards.

Child poverty

We welcome the measures on child poverty in this year’s Budget, which will make an important contribution towards reducing child poverty. However, we remain concerned that the Government has yet to provide a clear explanation of the linkage between its target to halve child poverty by 2010–11 and the proposed deployment of resources to meet that target. We emphasise that it is of crucial importance that the Government makes it clear that the necessary resources to meet the 2010–11 target are available and that the Government is committed to deploying those resources directly to support low-income families.

Fuel poverty

We note that it is important that the Government continues to tackle fuel poverty through a combination of targeted and universal measures. In view of the importance of measures announced in Budgets and Pre-Budget Reports to the progress of the targets to eradicate fuel poverty set by the Government itself and by the devolved administrations, we
recommend that the Government report in Budgets and Pre-Budget Reports on the effect of any measures announced at that time on progress towards meeting fuel poverty targets.

The 10 pence rate of income tax and tax credit take-up

We note that those most affected by the abolition of the 10 pence rate of income tax appear to be those below the age of 65 with an income under £18,500 who are in childless households. We accept that there are benefits in tax simplification and that there are merits to focus on both the needs of children and motivation to work, but conclude that the group of main losers from the abolition of the 10 pence rate of income tax seem an unreasonable target for raising additional tax revenues to fund these and other initiatives. We are concerned by the poor take-up rate of working tax credit among eligible families without children, especially given that working tax credits are intended to mitigate for low-income households the effect of the removal of the 10 pence starting rate of income tax. We recommend that the Treasury commission research into whether the withdrawal of the 10 pence income tax band and high marginal deduction rates are creating disincentives that could frustrate the Government’s welfare to work objectives.

The Saving Gateway

We have previously called for the introduction of a national Saving Gateway targeted on low-income households. We suggest that the first priority for extension beyond the initial proposals should be those who would qualify initially in terms of income, but are not in receipt of a qualifying benefit or tax credit. We argue that both the simplicity of operation and the appeal of the Saving Gateway would be assisted if it were offered on a tax-free basis.

The tax treatment of residence and domicile

We are concerned that, as a result of the focus on wealthy individual non-domiciles, there has been insufficient consideration of the possible impact of tax changes announced in the Budget on the middle and lower income groups of non-domiciled taxpayers. Due to the complex nature of the policies on domicile and residence, and the distinction between how liability is incurred for the annual £30,000 charge and the loss of personal tax allowances, we are concerned that the new policies will create a group of non-domiciled taxpayers who would be unwittingly in breach of the new law. We are also not convinced that sufficient consideration has been given to the possible further burden that the measure will place on HM Revenue & Customs.

Income shifting

We welcome the Chancellor of the Exchequer’s decision to undertake a further consultation on the issue of income shifting. However, we are concerned that this proposed legislation would place an additional tax burden on small businesses. We recommend that the terms of the consultation be widened to constitute a full review of the principles of small business taxation to ensure that the taxation system rests on practical, workable rules for the small business community.
1 Introduction

1. The Chancellor of the Exchequer, the Rt. Hon. Alistair Darling MP, delivered his first Budget on Wednesday 12 March 2008. In accordance with past practice, we held an inquiry into the Budget with a view to reporting to the House of Commons prior to the Second Reading of the Finance Bill. We held three evidence sessions in the week following the Budget—from outside experts on Monday 17 March, from Treasury officials on Tuesday 18 March and from the Chancellor of the Exchequer on Wednesday 19 March. In addition, we received a range of written evidence which is being published with this Report. We are most grateful to all those who gave evidence to the Committee, and to Professor David Heald of Aberdeen University and to Professor Colin Talbot of Manchester Business School for their specialist advice.

2. Our inquiry into the Budget is closely linked to other aspects of our programme of work. Shortly before the Budget, we took evidence from the Financial Reporting Advisory Board and from the Office for National Statistics (ONS) on Financial Reporting and National Accounts, and this Report draws upon evidence taken on that occasion. Our Report has also been informed by 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 Wednesday 26 March as part of our scrutiny of the MPC’s February 2008 Inflation Report.

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2 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 Mr John Whiting, PricewaterhouseCoopers, together with Mr Chote and Dr Weale).


2 The economy

Economic outlook and the resilience of the economy

**Forecasts and uncertainties**

3. In the 2008 Budget, the Treasury forecast GDP growth of 1¾% to 2¼% in 2008, 2¼% to 2¼% in 2009 and 2½% in 2010. This represents a downgrading of the Treasury’s expectations since the 2007 Pre-Budget Report, which itself featured a downward revision to growth forecasts made in the 2007 Budget, as Table 1 shows.

<table>
<thead>
<tr>
<th>GDP growth forecasts (%)</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007 Budget</td>
<td>2½ to 3</td>
<td>2½ to 3</td>
<td>n/a</td>
</tr>
<tr>
<td>2007 Pre-Budget Report</td>
<td>2 to 2½</td>
<td>2½ to 3</td>
<td>2½ to 3</td>
</tr>
<tr>
<td>2008 Budget</td>
<td>1¾ to 2¼</td>
<td>2¼ to 2¼</td>
<td>2½ to 3</td>
</tr>
</tbody>
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*Sources: Budget 2007, p 26, Table 2.2; Pre-Budget Report 2007, p 21, Table 2.1; Budget 2008, p 19, Table 2.1*

The Chancellor of the Exchequer explained that the Treasury had downgraded its growth forecast, both in the 2007 Pre-Budget Report and again in the 2008 Budget, because

we were acutely aware that the present uncertainty and turbulence, which is unprecedented in recent times, will have an effect over the coming year and it will affect the growth not just of our country but of countries right across the world … There is a great deal of uncertainty and turbulence in the financial markets at the moment.

4. Some evidence suggested that the Treasury’s growth forecasts remained optimistic despite the downward revisions. The average of independent economists’ recent forecasts for GDP growth was 1.6% in 2008 and 1.8% in 2009, both lower than the lower boundary of the Treasury’s forecast. Ms Bridget Rosewell of Volterra Consulting thought that it was “quite odd that the [Budget] forecasts should be as optimistic as they are”, suggesting that this might have been because a less optimistic forecast would have “shown up rather more obviously” strains in the public finances, an issue which we consider in the next chapter. The CBI contended that the Treasury’s forecast was “a little over-optimistic”:

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5 Budget 2008, p 19, Table 2.1
6 Q 297
7 HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, March 2008, p 1, Table 1 and p 4, Table 4
8 Q 2
The consensus GDP growth forecast for 2009 is just 2%. Given the constraints on real household disposable income and the shifting attitude to borrowing and debt here in the UK, plus unhelpful developments in the global economy, we would not be at all surprised to see at least two years of clearly below-par growth.\(^\text{10}\)

Dr Martin Weale of the National Institute of Economic and Social Research was less concerned about the growth forecast in the Budget, arguing that the Treasury was “slightly more optimistic than the consensus, but justifiably, so on that basis the Treasury is optimistic but not over-optimistic”.\(^\text{11}\) He was, however, critical of the Budget’s consideration of the risks and uncertainty prevalent in the economy, in particular the “significant downside risk that a prolonged financial credit squeeze will create”. He characterised the Budget report as a “document that says very little about how things might go wrong”,\(^\text{12}\) contending that the Treasury “do not give enough attention to alternatives, or any attention to alternatives”.\(^\text{13}\) Ms Rosewell agreed that “the failure to discuss some of the risks which are in this Budget Report at this particular time seems to be so complacent”.\(^\text{14}\)

5. The Chancellor of the Exchequer defended the Budget’s forecast, and cited the strong track record of previous Budget forecasts:

If you look at the range that we set out, the growth for this coming year and thereafter, I believe that what we have done is realistic. If you look at the Treasury’s forecasts over the last few years in relation to growth they have been pretty good and they have been recognised as such.\(^\text{15}\)

Mr Dave Ramsden, Managing Director, Macroeconomic and Fiscal Policy at the Treasury, acknowledged that, in compiling the Budget forecasts, the Treasury has been required to take account of an “incredibly challenging global environment” and “a period of exceptional uncertainty in the global financial markets”.\(^\text{16}\) He admitted that the current uncertainty surrounding financial markets was “unlike anything I have seen in the last 15 years that I have been working in the Treasury”.\(^\text{17}\) He identified two particular issues that would affect economic performance: the duration of “these extremely unusual credit conditions” and their impact on the real economy. According to Mr Ramsden, the Treasury forecast differed from those of outside forecasters by paying close attention to data on the real economy and the resilience of the UK economy. He believed that this resilience, combined with momentum from 2007, demonstrated by strong business surveys and a robust labour market, justified the more upbeat forecasts of the Treasury compared with those of some independent forecasters.\(^\text{18}\)
6. The continuation and intensification of turmoil in the financial markets threatens to affect the real economy via the price and availability of credit, which has already begun to dampen private consumption and investment. At the time of the 2007 Pre-Budget Report, the Treasury assumed that there would be “some feed-through to tighter credit conditions and to household and company spending in the short term”. Since then, the disruption in financial markets has continued. The 2008 Budget reported that

conditions in credit markets [have] deteriorated and a number of markets remain effectively closed. There has been further evidence of developments in financial markets feeding through to tighter credit conditions facing households and companies. The Budget 2008 forecast assumes the negative impact on growth from these developments will be somewhat larger and more prolonged than expected in the 2007 Pre-Budget Report.

Mr Ramsden explained that the Treasury was assuming “a normalisation of conditions by the middle of 2009 and with a start in that normalisation from the end of this year”. Normalisation in this context would not mean a return to the interest rate spreads seen in mid-2007, but would see a reduction from the current unusually high levels. Mr Ramsden argued that the Budget forecasts had taken full account of the ongoing credit crisis:

Because of the interconnectedness of global financial markets we can expect that the credit problems that have spread out across the world financial sector are going to have more of an impact on us than we thought at PBR time … I really want to get across to this Committee that we are not under-estimating the impact of the difficult credit conditions at the moment, but we have made judgments based on both the latest data and our expectations of how the credit market positions are going to unfold and normalise to lead to that forecast judgment.

7. Since the publication of the 2008 Budget, the US investment bank Bear Stearns has been forced to request emergency funding from the US Federal Reserve in order to fund its liabilities. Upon the Federal Reserve acceding to the request, investors and counterparties rushed to extricate themselves from Bear Stearns, resulting in the bank’s proposed takeover by a competitor investment bank, JPMorgan Chase. Ms Rosewell highlighted the potential threat posed by a continuation of “the credit crunch crisis”, with banks requiring public support: “That is the bit that we should hope will come to an end in the next few months because if it does not come to an end in the next few months we really are for the high jump”. When asked whether the events surrounding Bear Stearns had caused the

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20 Budget 2008, p 14, para 2.4
21 Q 123
22 Q 134
24 Q 34
Treasury to reconsider its 2008 Budget forecasts, both Treasury officials and the Chancellor of the Exchequer replied that their view had not changed as a result of those events.\textsuperscript{25}

\textbf{Resilience}

8. As we have already noted, the Treasury’s confidence in the capacity of the UK economy to weather the current market flows in part from its assessment of the resilience of the economy.\textsuperscript{26} The Chancellor of the Exchequer’s 2008 Budget Statement referred to the “resilience” of the UK economy on six occasions.\textsuperscript{27} Alongside the 2008 Budget, the Treasury published a Working Paper comparing the resilience of the UK with that of other OECD countries. That paper defined resilience as

the capacity of an economy to maintain levels of employment and to keep actual output close to its potential level in response to shocks that affect both the demand-side and supply-side of the economy.\textsuperscript{28}

The key conclusion from the Treasury’s Working Paper was that, over the last couple of decades, the UK’s resilience had shown a “marked improvement”, linked to improved macroeconomic policy and reforms to improve the flexibility of labour and product markets.\textsuperscript{29} Mr Ramsden expanded on why the Treasury thought that the UK was now more resilient than other OECD countries and compared to previous decades:

The conclusion of people like the IMF and the OECD is that the combination of a long-term agenda on microeconomic reform, starting with the labour market reforms that were instituted in the 1980s and feeding right through to the present day, has over time improved the working of the UK as a market economy. At a macro level particularly the reforms instituted since 1997 where you have seen a monetary policy framework and a fiscal policy framework which enables you to support and encourage stability has led to this position where the UK has had very, very stable outcomes in terms of a growth in inflation. The fact that we have had 62 quarters of successive growth sounds like a sound bite, but when you contrast that with Germany, which has had technical recessions this decade, Italy, which has had technical recessions this decade, and France that has seen quarters of falling output, we have not seen any of that in the UK going back to 1992. We think that that resilience is still there today.\textsuperscript{30}

9. Ms Rosewell argued that, during the dot-com collapse of 2001, the UK had suffered “quite a sharp fall in output”, but had been shielded from the worst effects by significant increases in public spending.\textsuperscript{31} She was worried by the “complacency” implied in an

\begin{itemize}
\item \textsuperscript{25} Qq 125, 297
\item \textsuperscript{26} See paragraph 5.
\item \textsuperscript{27} HC Deb, 12 March 2008, cols 285–298
\item \textsuperscript{29} \textit{Ibid.}, abstract
\item \textsuperscript{30} Q 140
\item \textsuperscript{31} Q 4
\end{itemize}
exercise which was backwards looking, arguing that performance in the face of previous difficulties did not assure resilience in the future.\textsuperscript{32} Dr Weale did “not understand the argument about the resilience of the UK economy”.\textsuperscript{33} He contended that the UK economy was more highly leveraged than those of its competitors, including Germany, and had had a house price bubble even more pronounced than that of the United States.\textsuperscript{34}

10. The Chancellor of the Exchequer saw ample evidence of the UK’s economy’s strong resilience, including the continued economic growth in the face of both the Asian crisis of the late 1990s, and the dot-com bubble bursting in the first years of this century. He also noted that, following the terrorist attacks in the US on 11 September 2001, UK stock markets had suffered a dramatic drop, but “were able to come back quickly because we have a resilient economy, we have much more flexible labour markets, we have flexible capital [and] employment markets, which we simply did not have [before] then”.\textsuperscript{35} He also referred to the recently published labour and output statistics:

if you look at two of the indicators that are very important—the employment and unemployment figures which were published this morning, which yet again show strong growth, particularly an increase in jobs over the last quarter, which is during this period of financial instability—I think 166,000 extra jobs—in addition to that you will see that unemployment is the lowest it has been since 1975. The other thing is the CBI’s Industrial Survey published today again shows, especially in relation to output, some very healthy figures. I have always made the point that you cannot read too much into any one set of figures but I think if you look at the data that is published today it bears out our forecast and that is that there will be a slowdown but our economy remains fundamentally strong; it remains resilient and we are well placed to deal with a period of great uncertainty.\textsuperscript{36}

The Chancellor of the Exchequer argued that “Inevitably, if you want to examine how resilient the UK economy is you do need to look backwards to see what happened when there have been shocks in the past”.\textsuperscript{37} Mr Ramsden concurred: “If you are trying to make a judgment about the future you typically do focus on the track record of the recent past”.\textsuperscript{38}

**Conclusions**

11. In our Report on last year’s Pre-Budget Report, we noted the risk that the credit crunch would have a greater macroeconomic effect than the Treasury was then forecasting. We argued then that, in view of the risks in the financial sector, “the Treasury’s optimism that the growth rate should revert to trend in 2009 has not been adequately explained”.\textsuperscript{39} Our

\begin{itemize}
  \item \textsuperscript{32} Q4
  \item \textsuperscript{33} Ibid.
  \item \textsuperscript{34} Ibid.
  \item \textsuperscript{35} Q 300
  \item \textsuperscript{36} Q 297
  \item \textsuperscript{37} Q 301
  \item \textsuperscript{38} Q 141
  \item \textsuperscript{39} Treasury Committee, Second Report of Session 2007–08, The 2007 Pre-Budget Report, HC 54–I, paras 6–9
\end{itemize}
concerns have been largely borne out by subsequent developments, and the further downward revision of the Treasury’s forecast. We also argued that the Treasury should improve the presentation of risks to its forecast, including through quantification.\footnote{\textit{Ibid.}, para 13} We note that the lower boundaries of the Treasury’s forecasts for economic growth in 2008 and 2009 remain above the average of outside forecasters, and we are concerned that the Treasury has provided little evidence of analysis of upside or downside risk and specifically may have given insufficient weight to the risks of continued financial market turbulence and has failed to be more specific about the risks associated with such continued turbulence. The Treasury’s optimism is based on its contention that the UK economy is better placed than other OECD economies in the face of market turmoil. We remain concerned that some of the economy’s characteristics that have proven beneficial during past crises (rapidly rising residential property prices, close links with the US and an increasing reliance on the financial services industry, for example) might prove to be conduits through which the current problems in global financial markets are transmitted to the United Kingdom real economy.

The international economy and net trade

\textit{Prospects for the US economy}

12. The US economy is currently undergoing significant difficulties resulting from the sub-prime crisis and the market turbulence since mid–2007. Treasury officials told us “that the position of the US economy is considerably weaker than we were expecting at PBR time”.\footnote{Q 134} The 2008 Budget observed that the consensus forecast for US GDP growth in 2008 had been cut by 0.8 percentage points and was now 1.6%, with growth expected to be very weak in the first half of 2008. Thereafter, the consensus among forecasters is for US economic growth to recover, with that economy growing by 2.6% in 2009, close to estimates of trend growth in the USA of around 2¾%\footnote{\textit{Budget 2008}, p 143, para B.13}. Ms Rosewell saw that the outlook for the US economy as “finely balanced”, adding that:

if the economy recovers and business as usual returns in the back end of this year, then the American economy is very flexible and it could bounce back in 2009, and you would have a picture much like the end of the dot-com boom, for example, a sharp decline and then a bounce back.\footnote{Q 14}

However, she went on to say that that conditions in the US economy were “clearly getting worse at the moment”.\footnote{\textit{Ibid.}}
Prospects for the euro area

13. The 2008 Budget noted solid growth in the euro area of 2½% in 2007. Mr Ramsden told us that the Treasury was forecasting euro area growth of 1.75% in 2008, reflecting the fact that current “credit conditions will have an impact on the euro area”. However, he cited the latest data on industrial production for the euro area in January which “was actually really quite strong”, following strong performance in December 2007, adding that “there have also been encouraging business surveys in Germany”. The Government has predicted that euro area GDP growth will return to its estimated trend rate of growth of 2% in 2009. Dr Weale believed that the forecasts for euro area growth, like those for the US economy, were “contingent upon how you expect the credit crisis to play itself out”, and suggested that the Treasury had not paid sufficient attention to alternative scenarios for the euro economy.

Exports and net trade

14. The slowdown in the US and euro area economies will impact on the UK, with year-on-year growth in UK export markets expected to slow to 5¾% in 2008, compared with 6¾% in 2007. This moderation is expected to exceed that in world trade overall, because around two-thirds of UK exports go to the US and the euro area, where demand growth is expected to slow more than in emerging economies. Mr Ramsden, while acknowledging that “16% of our exports are to the US” so that there would be an impact from the US slowdown, emphasised that “our key trading partner is very much the euro area which accounts for at least 50% of our trade”. This meant that the downturn in the euro area was of potentially greater significance than that of the US economy. He concluded that “the US is probably a source of downside risk to our growth forecast and the euro area is potentially a source of upside risk to our forecast”.

15. In the 2008 Budget, the Treasury forecast that net trade would contribute positively to GDP growth in 2008. This compared with an estimated negative contribution of half a percentage point to GDP growth from net trade in 2007. Treasury officials attributed the positive contribution net trade would make to growth in 2008 to the 7% depreciation of sterling since the time of the 2007 Pre-Budget Report, telling us that “the position of the UK economy in terms of the contribution from exports and net trade will improve as a result of that exchange rate depreciation”. The Budget also forecast that UK export
growth would strengthen further in 2009 and 2010 as demand growth in the US and euro area recovered.\textsuperscript{56}

\textbf{Business investment}

16. Despite recent profit growth remaining strong and surveys of investment intentions remaining consistent with sustained growth, this year’s Budget forecast that business investment growth would slow more than had been assumed at the time of the 2007 Pre-Budget Report. The main causes of this slowdown were cited as uncertainty over demand prospects and the potential impact of tighter credit conditions. The Budget forecast showed a significant slowdown in annual business investment growth from 6¾% in 2007 to 1¾% to 2¼% in 2008.\textsuperscript{57} However, Mr Ramsden found the official data on business investment “a little bit puzzling”, because that data did not accord with the more upbeat surveys of business investment.\textsuperscript{58} Ms Rosewell commented that the Government “may be being too optimistic about investment”, and was particularly concerned about firms’ ability to raise finance for working capital in a tighter credit environment.\textsuperscript{59} Dr Weale pointed out that “the business sector as a whole is fairly flush with funds at the moment”, but warned that if the premium on lending rates persisted for a substantial period, then investment “undoubtedly will be rather weak”.\textsuperscript{60}

\textbf{Labour market}

17. Employment growth was strong in 2007, with the number in employment rising by nearly 300,000 over the course of the year, to a record high of almost 29½ million.\textsuperscript{61} The Chancellor of the Exchequer was upbeat about the state of the UK labour market:

\begin{quote}
the employment and unemployment figures which were published this morning … show strong growth, particularly an increase in jobs over the last quarter … I think 166,000 extra jobs—in addition to that you will see that unemployment is the lowest it has been since 1975.\textsuperscript{62}
\end{quote}

Asked about the outlook for employment, Mr Ramsden told us that:

\begin{quote}
The business surveys suggest a bit of softness compared to the recent strength in employment. I think it is fair to say that I would be surprised if we were still having the kind of growth rates of 300,000 in employment that we saw a year earlier in 2007 Q4, in 2008 Q4.\textsuperscript{63}
\end{quote}

\textsuperscript{56} \textit{Budget 2008}, p 165, para B.80
\textsuperscript{57} Ibid., pp 163–164, paras B.73–B.74
\textsuperscript{58} Q 142
\textsuperscript{59} Q 35
\textsuperscript{60} Qq 36–37
\textsuperscript{61} \textit{Budget 2008}, p 156, para B.51
\textsuperscript{62} Q 297
\textsuperscript{63} Q 143
While employment growth was not expected to be as strong as in 2007, Mr Ramsden did “not expect anything more worrying in the UK labour market other than a slowdown in employment growth”.64 He attributed this to the resilience of the UK labour market, which had strengthened over time as a result of the “labour market reforms that were instituted in the 1980s and feeding right through to the present day”.65 Dr Weale agreed that employment would probably be more resilient in an economic slowdown than previously, but warned that “it is unclear because the slowdown may be of a nature that we have not had for a while … and things like the minimum wage do significantly reduce flexibility”.66 Ms Rosewell was also worried about labour market flexibility, telling us that in a severe downturn individuals tended to move into self-employment or part-time work, but that “with part-time and temporary workers increasingly being treated as if they are permanent workers, people may be less willing to offer that kind of employment flexibility in the future”.67

**The property market and housing finance**

**Prospects for the housing market**

18. The 2008 Budget observed that annual house price inflation had slowed, from above 10% in August 2007 to around 2½% in February 2008, and that commercial property prices in the UK had fallen. In addition, the Budget noted that the effective closure of markets for securitised assets had put added strain on banks’ funding positions, which could affect house price inflation in coming months, and seemed likely to reduce the volume of activity in property markets.68 Mr Ramsden said that the Treasury was not forecasting a fall in house prices, but was expecting them to be a little bit weaker in the short term than forecast in the 2007 Pre-Budget Report.69

19. When we asked witnesses whether the UK property market was vulnerable to the problems that had afflicted the US property market in 2007 and early 2008, the consensus was that UK property markets shared some features with the US, but differed in vital ways. Professor David Miles of Morgan Stanley argued that the risks facing the UK property market had not yet crystallised:

> there really is no firm and strong evidence of sharp rises in defaults on mortgages. As yet in the UK although people are very worried about that, we really have not seen a very significant deterioration and we are still in a position where bad debts and arrears on mortgages and repossessions of property are still running historically at a
really rather low level. So it is a risk as opposed to the situation in the US something that really is already playing out in front of our eyes.\textsuperscript{70}

He noted that the UK was one of the few countries apart from the US that had a recognisable sub-prime mortgage market, where individuals with impaired credit histories and county court judgments against them could borrow.\textsuperscript{71} In October 2007, Hector Sants, the Chief Executive of the Financial Services Authority, told us that around 8\% of the UK housing market was characterised as sub-prime, compared to 25\% in the US.\textsuperscript{72} Professor Miles noted that the UK did not suffer from the “toxic” mortgage products that had caused problems in the US, where people were given mortgage debt with very little prospect of repayment. He concluded that he was “a little bit more optimistic than some that we can avoid the worst aspects of what is playing out in the US”.\textsuperscript{73} The Chancellor of the Exchequer disputed the notion that the UK housing market was very similar to that of the US:

In our housing market clearly there are similarities but there are quite big differences between us and the United States, and I would highlight three of them in particular. One is in this country we have historically had more people wanting to buy houses than there are houses there to be bought; in other words, the supply of housing is not meeting the demand and that is what has pushed house prices … growing at about 10\% a year. In America at the moment they have thousands of unsold houses and in parts of the country people are handing back the keys and you simply cannot sell houses for anything ... The second thing is that our regulatory regime here in relation to the selling of mortgages is tougher than it is in the United States. The [Financial Services Authority] has made changes to try and avoid people getting themselves into a position where they take on a mortgage that they cannot pay, and if you look at the default rates in this country they are at a historically low level. The third thing I would say in relation to housing is that if you look at the root cause of the present difficulties, the sub-prime problem, we just have not had this problem on anything like the scale that has happened in the United States.\textsuperscript{74}

20. Professor Miles thought that a prolonged period of slowly falling house prices was “not at all implausible” and “would not be such a bad thing”, suggesting that it would help improve affordability for first-time buyers and arguing that there was not a very strong link between movement in house prices and people’s general spending, so that consumption would be unlikely to suffer too much of a decline in the face of slowly falling house prices.\textsuperscript{75} This strength of this link between house prices and household expenditure is important, not least because it has a bearing on the prospects for economic growth. Mr Ramsden explained why the Treasury did not believe this link to be very strong:

\textsuperscript{70} Q 7
\textsuperscript{71} Q 31
\textsuperscript{72} Treasury Committee, Fifth Report of Session 2007–08, The run on the Rock, HC 56–II, Q 245
\textsuperscript{73} Q 31
\textsuperscript{74} Q 301
\textsuperscript{75} Q 29
In the past when there has been an apparent link between house prices and consumption that has been more the result of third factors such as a wider instability or a wider weakness in the labour market. The wider instability would mean high interest rates. I do not see those conditions now. We have the conditions for stability in the UK economy and, as I have said, I think we have a strong and resilient labour market … We would recognise that if in the UK there were to turn out to be a collateral effect, so it was harder to borrow on the back of a lower evaluation of housing assets, then there may be some impact there, but we are factoring in quite a significant slowdown in consumption already.76

**Housing market finance**

21. The Government has long been examining ways of improving mortgage finance. At the time of the 2004 Budget, the Government published a Review by Professor David Miles of methods of improving the supply of, and demand for, fixed-rate mortgages,77 and the Government and the Financial Services Authority subsequently acted on some of his recommendations.78 The case for action in this area has been strengthened by the impact on mortgage markets of the tightening of credit conditions since mid–2007. As the Chancellor of the Exchequer put it in evidence to us, measures to improve housing finance “were important even before the recent events and they are extremely important now”.79 This year’s Budget examined measures with the aim of enabling the mortgage market, in the Chancellor of the Exchequer’s words, to operate “as efficiently as possible because that … would apply downward pressure on the costs of getting mortgages and therefore the amount of money that people actually pay”.80

22. The dependence of mortgage lenders on securitisation81 increased markedly between 2005 and mid–2007.82 In 2006, nearly one third of all UK mortgages were funded through secondary markets,83 in other words, markets where the lending institutions seek finance from outside sources using securitisation. The main forms of secondary finance are “covered bonds”—a class of bond issued by the credit institution and backed by a pool of assets, generally mortgages or public sector loans—and residential mortgage-backed securities. Since the start of the current financial market disruption, these markets have effectively been closed to new issuance.84 The Government has already taken action to assist the covered bond market through a new legislative framework,85 and in the Budget
the Chancellor of the Exchequer announced the creation of a Working Group to take forward market-led initiatives to improve liquidity in the mortgage-backed securities market. The Working Group will report initially to the Chancellor of the Exchequer in the Summer of 2008 and present proposals at the time of this year’s Pre-Budget Report.

23. In January this year, Professor Miles noted the possibility of radical measures being taken to unblock the market for mortgage-backed securities, including a very substantial increase in the scale of Bank of England lending against a much broader range of collateral or the establishment of a State agency to lend to mortgage institutions. In evidence, Professor Miles characterised the establishment of the Working Group as “sensible”, while also noting the importance of recent actions taken by the Bank of England to extend its lending activities. He speculated that “we may see more announcements by the Bank of England in due course”. Ms Rosewell also emphasised the importance of Bank of England action in this context, not least because the problems of housing finance were linked to the difficulties the banks faced in obtaining finance on a “business as usual” basis. The Governor of the Bank of England told us:

It is unrealistic to assume that markets for many asset-backed securities are likely to re-open speedily or, when they do, to their previous levels of activity. So we are discussing with the banks how a longer-term resolution of the problem might be reached. It is too soon to say where those discussions will lead, but two principles would underlie any central bank role. First, the risk of losses on their lending should remain with banks’ shareholders. The banks neither need nor want the taxpayer to insure them against these losses. Second, a longer-term solution must focus on the overhang of assets and not subsidise issues of new assets. One of the lessons of this financial crisis is that providers of mortgage finance had underestimated the risks, and hence the true cost, of the securitisation process.

We note the establishment of a Working Group to examine market-led initiatives to improve liquidity in the mortgage-backed securities market. We expect to continue to monitor developments in asset-backed securities markets and their impact on housing finance. We believe that the Working Group should also consider any need for new mortgage support schemes for low-income homeowners in difficulty. We look forward to the Working Group reporting back to the Chancellor of the Exchequer in the Summer and producing a final report at the time of the 2008 Pre-Budget Report.

24. In the Budget, the Government also sought to promote the market for long-term fixed-rate mortgages, following the earlier proposals in the 2004 Miles Review. Over the last five
years, the popularity of 2-year fixed-rate mortgages has increased, but the UK has a low percentage of long-term fixed-rate mortgages compared with countries with similar income levels. The Government has pointed to evidence of “latent demand” for longer term fixed-rate mortgages. In order to increase supply, the Government has announced its intention of working with industry to investigate whether data on prepayment behaviour can be pooled and published, which could benefit lenders, investors and ultimately borrowers. The Government has also invited views on options for a UK framework to deliver more affordable long-term fixed-rate mortgages, including the lessons to be learned from international markets and institutions. Professor Miles thought that there was “good reason for the Government to continue to be concerned about this area”, not least because the tightening of credit conditions would lead to an increase in the risks to consumers associated with variable rate mortgages, regardless of movements in the Bank of England’s short-term interest rates and because of the general unpredictability of interest rates. However, he also emphasised that the Government and the Financial Services Authority had to continue to examine factors affecting the demand for fixed-rate mortgages, including consumer understanding of risks and incentives. We expect to continue to monitor endeavours by the Government and the Financial Services Authority to promote the supply of, and demand for, long-term fixed-rate mortgages.

Inflation and monetary policy

25. Measured by the Consumer Prices Index (CPI) annual inflation fell from its March 2007 peak of 3.1% through 2007, but has now started to rise again. On 18 March 2008, the ONS announced that CPI inflation had increased to 2.5% in February 2008, from 2.2% in January. In the year to February 2008, Retail Prices Index (RPI) inflation was 4.1%. The increase in CPI inflation to 2.5% had been foreshadowed in the 2008 Budget, which had stated that “significant increases in global agricultural commodity and energy prices are expected to lift inflation in the short term”. The 2008 Budget also cautioned that the recent depreciation of sterling would exert continued upward pressure on prices. The Governor of the Bank of England has acknowledged the possibility that inflation could again rise above 3% in the short term, saying “inflation could rise to the level at which I would need to write an open letter of explanation, possibly more than one, to the Chancellor”. The Chancellor of the Exchequer told us that, following the expected rise in inflation during 2008, he expected inflation to “return back down to the target towards the

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93  Housing Finance Review, pp 16–17, paras 1.25–1.26
94  Ibid., p 40, para 3.11
95  Ibid., pp 46–47, paras 3.34–3.41
96  Qq 10–11
97  Q 10
99  Budget 2008, p 19, para 2.22
100  Ibid.
101  Speech by the Governor of the Bank of England to Institute of Directors South West and the CBI, 22 January 2008
end of this year”.\(^{102}\) The Budget forecast that inflation would fall back to 2.5% by the end of 2008, returning to its target level of 2% in 2009 and remaining on target thereafter.\(^{103}\) Ms Rosewell broadly endorsed these forecasts.\(^{104}\) Dr Weale pointed out that there was also a risk of inflation falling below target if a marked collapse in demand were to occur.\(^{105}\)

26. Since November 2007, sterling has fallen sharply, recording its largest three-month fall since sterling’s exit from the Exchange Rate Mechanism in 1992.\(^ {106}\) Sterling depreciated by 7% between the 2007 Pre-Budget Report and the 2008 Budget.\(^ {107}\) Mr Ramsden acknowledged that the depreciation of sterling did result in the risk of “imported inflation”, but said that the inflationary impact “would depend on how in the production pipeline those factors are taken into account”. He noted that “over recent years there have been real squeezes on margins throughout the pipeline which has meant that inflation has not picked up in the UK”.\(^ {108}\) Professor Miles believed that, while a “steady and gradual decline in sterling” was the most desirable outcome, a sharp depreciation over two or three months would “generate a lot of inflation six or 12 months down the road”.\(^ {109}\)

27. Ms Rosewell believed that there was limited scope for the Bank of England to cut rates and said further cuts would be “more or less consistent with what the market is expecting, which is another two cuts this year”.\(^ {110}\) She went on to speculate that declining economic growth in the UK could even result in the Bank of England becoming “more willing to break its inflation target in order to try and maintain some pace of growth if things look particularly bad”.\(^ {111}\) Professor Sheila Dow, from Stirling University, summarised the problems facing the MPC at the present time:

The MPC faces two conflicting problems, which are clear from the [February 2008] Inflation Report. First, in relation to the inflation target, cost-push inflation is building up, particularly with respect to energy and food. Second the financial turmoil which started last year continues to build up forces which can reasonably be expected to weaken demand over the coming year. The first might suggest a tighter monetary policy and the second a looser monetary policy.\(^ {112}\)

28. One perceived risk to the economy from rising levels of inflation is that increased inflation might push up inflation expectations and lead to upward pressure on wage settlements and earnings growth. The Government acknowledged this risk in the 2008
Budget, stating that recent survey measures of inflation expectations had risen following the period of above-target inflation earlier in 2007. The 2008 Budget went on to warn that:

With CPI inflation expected to rise again in the near term, there is a risk that higher inflation expectations could feed through to second-round effects on wage settlements and earnings growth, though there has been no evidence of that as yet, with underlying earnings growth remaining stable and subdued.¹¹³

According to the 2008 Budget, underlying earnings growth was “stable” and “subdued”, despite the increase in inflation and inflation expectations, with average earnings growth excluding bonuses, ranging between 3½% and 3¾% on a year earlier.¹¹⁴ The Bank of England’s February 2008 Inflation Report told a similar story, stating that “private sector pay growth remained muted in late 2007, rising by 4.2% in the three months to November, compared with a year earlier”. That document also reported that the Bank’s Regional Agents “expected little change in settlements this year compared to 2007”.¹¹⁵ Professor Miles told us that “expectations about where inflation will go remain pretty well controlled”, saying that “if you look in the government bond market the yields on government bond levels have stayed at an exceptionally low level which suggests to me that most people believe inflation will stay very low in the UK”.¹¹⁶ He concluded that this had allowed the UK to avoid a “catastrophic situation” where a combination of economic difficulties combined with the fact that people had lost faith that inflation would stay low resulted in a much tighter monetary policy to curb inflationary expectations, compounding the pressures on the UK economy resulting from economic slowdown.¹¹⁷
3 The public finances

The fiscal framework

29. In its *Code for Fiscal Stability*, published in November 1998, the Government set out the principles by which it would conduct fiscal policy. These were:

a. transparency in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts;

b. stability in the fiscal policy-making process and in the way fiscal policy impacts on the economy;

c. responsibility in the management of the public finances;

d. fairness, including between generations; and

e. efficiency in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.\(^{118}\)

The Government has two fiscal policy objectives, which are:

over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and

over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.\(^{119}\)

To achieve these two objectives, the Government has established two fiscal rules. These are:

- **the golden rule**: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and

- **the sustainable investment rule**: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40% of GDP over the economic cycle.\(^ {120}\)

It is, in part, against these self-imposed rules that we have examined the overall state of the public finances.

The state of the public finances

30. At the time of the last year’s Pre-Budget Report, the Treasury forecast that the current budget would move into surplus in 2009–10.\(^ {121}\) In our Report arising from that document, we noted the risks to that forecast:

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\(^{119}\) *Budget 2008*, p 23, para 2.32

\(^{120}\) *Ibid.*, p 23, para 2.33
The weaker budget balances now forecast for 2007–08 and 2008–09 in part reflect the expected impact of recent financial market turbulence on broader economic growth and, therefore, receipts. The expected rebound in the budget balance from 2008–09 onwards is partly dependent upon a timely recovery in the financial sector such that economic growth quickly returns to trend.122

This year’s Budget forecast a deterioration in the public finances for the year 2008–09. Table 2 illustrates the performance of the public finances and the Treasury’s changing forecasts since the 2003 Budget.

Table 2: HM Treasury projections of current budget surpluses, £ billion

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<td>−21.3</td>
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<td>−5</td>
<td>−7</td>
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Sources: Budgets 2003–2008 Table C2, PBRs 2003–2007 Table B2

Cells shaded grey show the year in which a current budget surplus (or balanced budget) was first forecast in each Budget and PBR document. Figures in italics are outturns, all other figures are forecasts (for the year in which the document was published) or projections.

As Table 2 shows, the current budget is not now expected to move into surplus until 2010–11, a year later than expected at the time of the 2007 Pre-Budget Report. However, Table 2 also illustrates that the Government is now expecting the budget balance outturn in 2007–08 to be slightly better than was forecast at the time of last year’s Pre-Budget Report. Mr Robert Chote, Director of the Institute for Fiscal Studies, explained the decisions that had been made by the Government about how it was to cope with the forecast deterioration in the public finances:

The Treasury has effectively admitted to about a £7.5 billion permanent deterioration in the outlook for the public finances which clearly reflects in large part

121 Pre-Budget Report and Comprehensive Spending Review 2007, p 159, para B.8
122 HC (2007–08) 54–I, para 23
the movements in equity prices since the Pre-Budget Report, expectations that were
described to be a sluggish or flat house price growth, associated conditions in the
property market, the mix of consumer spend, consumer spending being weak
relative to GDP overall, and more consumer spending going on things on which less
VAT is paid. Confronted with that £7.5 billion gap they have essentially said, ‘We are
going to raise £2.5 billion of taxes looking five years out’ and they have also tightened
the assumed spending squeeze in Spending Review 2009 and are borrowing a bit
more. So they have dealt with some of it by measures, some of it by assumption and
some of it just by borrowing more. History suggests … there are very big variations
either side of the likely path but so far it has been seven budgets running in which the
errors have been in the same direction.123

31. Mr Ramsden explained that the change in the Treasury’s forecast
was necessary in the
light of the prolonged effects of the financial market turbulence. He told us that:

Since Budget 2007 and since the PBR … the credit shock that has hit the global
economy and the UK economy has intensified. We are in a position where we can
allow the public finances to be flexible to support the economy. That explains why
we have significant increases in borrowing over the early years of the forecast period
and why the year in which we go back into surplus goes back a year.124

As we noted in our Report on the 2007 Pre-Budget Report, the weakening in the forecast
for the public finances came about from the impact of the turmoil in financial markets on
the forecasts for economic growth, and thus tax receipts.125 As we observed earlier,126
Treasury forecasts for economic growth remain above those of many outside forecasters,
and there are considerable downside risks to those forecasts. Ms Rosewell believed that the
forecasts were deliberately over-optimistic so that the Treasury’s forecasts for the fiscal
position would not be even worse:

I think that it is quite odd that the forecasts should be as optimistic as they are,
particularly as the consensus itself is continuing to fall, and indeed is likely to fall still
further in the light of most recent events. Of course if there is weaker growth then
there are weaker tax revenues and that makes it even more difficult to sustain the
public finances, which are already running £6 billion ahead of where they were
estimated to be even six months ago.127

However, Mr Ramsden defended the Treasury’s growth forecasts and how they were used
for fiscal forecasting:

We have attempted to put the current position in a longer-term context, looking at
the performance of the UK economy and how it has dealt with past shocks, it is what

123 Q 42
124 Q 153
125 HC (2007–08) 54–I, para 28
126 See paragraph 11.
127 Q 2
we have described as its resilience. Where that leaves us is with a forecast, which I think is a very realistic forecast, of growth of 1.75 to 2.25% this year and growth of 2.25 to 2.75% in 2009. We produce these forecasts to frame our fiscal judgments and our assessment of the fiscal position and, as you know, to do that we take the bottom end of the range of our forecasts to drive our fiscal forecast. Our fiscal forecast is running off a forecast for growth in 2008 which is 1.75%, which is actually in line with the independent average for 2008. In 2009 our forecast is running off a bottom end of the range which is 2.25%.

There has been a further weakening of the Treasury’s forecasts of the current budget balance from 2008–09 onwards since last year and the latest forecasts for the fiscal position are based on forecasts for economic growth that are subject to considerable downside risks.

The golden rule

32. Despite the weakening of the forecasts for the public finances from 2008–09 onwards, the Treasury stated in this year’s Budget that it was on course to meet the golden rule—that, over the economic cycle, the Government will borrow only to invest and not to fund current spending:

Progress against the golden rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began. On this basis, and on the basis of cautious assumptions, the Government has met the golden rule for the cycle that began in 1997–98.

However, to assess whether the Government has met the golden rule requires an assessment of when the economic cycle began and ended. The Government stated in this year’s Budget that, while 1997–98 represented the beginning of a new cycle and “the latest National Accounts data and the Treasury’s trend output assumptions imply that output passed through trend in the second half of 2006”, the Treasury’s overall conclusion was that “it is too soon to assess whether or not the economic cycle has ended”. In explaining why it had been difficult to ascertain the end of the cycle, the Treasury observed that “The current uncertainty over dating of the cycle is expected partly to recede once the ONS National Accounts modernisation programme secures improvements to the quality of the data for recent years”. We have commented previously on the problems inherent in trying to use a rule dependent upon the measurement of the economic cycle. In our Report on the 2007 Budget, we stated:

The reduction in amplitude of the economic cycles in the past decade or so and the difficulties of measuring the output gap have made the dating of the economic cycle and application of the golden rule a particularly difficult process. We reiterate our

128 Q 122
129 Budget 2008, p 177, para C.12
130 Ibid., p 176, para C.11
131 Ibid., pp 153–154, para B.46
recommendation that the Government review the golden rule and consider how to make it more forward-looking and its application less dependent on the dating of the economic cycle.\textsuperscript{132}

33. Despite being unable conclusively to determine when the economic cycle had ended, this year’s Budget stated that:

The projections show that the deficit on the current budget remains significantly below the 1.1% deficit recorded in 2005–06 and moves into surplus in 2010–11, with the surplus rising to 1.0% of GDP by 2012–13. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule in the next economic cycle. The cyclically-adjusted surplus, which allows a clearer view of underlying or structural trends in the public finances by removing the estimated effects of the economic cycle, shows a rising surplus from 2009–10, as the economy returns to trend.\textsuperscript{133}

When we asked Treasury officials how they could determine whether they would meet the golden rule in the next economic cycle, when they did not know when the current one had ended, Mr Ramsden first told us that:

We have an average surplus over the whole period from 1997–98, which was the start of the last cycle and what we say is that we are, over the forecast period, meeting the golden rule. We do not say over the next cycle.\textsuperscript{134}

He then explained that the key part of the sentence in this year’s Budget was the phrase that the Government was \textit{on course} to meet the golden rule in the next economic cycle.\textsuperscript{135}

34. Mr Chote suggested that the latest delay by the Government in fixing the end of the cycle had not aided the credibility of the golden rule, telling us that “There is no harm in saying again that this approach on a fixed end of the cycle seems to be ever more absurd with every passing year”.\textsuperscript{136} However, Mr Ramsden strongly defended the Treasury’s ability to determine the end of the cycle, telling us that:

I do not think it is that we are incapable. It is just that we are in the middle of this period of real uncertainty. There is also uncertainty over the evolution of the data. We are very much looking forward to when the ONS produce their blue book national accounts figures, as they are planning to this summer, which we think will give us a clearer idea of what has been happening to growth. In a sense because we are still over the forecast period meeting the Golden Rule I do not think it is making it any more difficult to assess the fiscal framework and frame a fiscal judgment.\textsuperscript{137}

\begin{flushleft}
\textsuperscript{133} Budget 2008, p 177, para C.13
\textsuperscript{134} Q 167
\textsuperscript{135} Qq 316–317
\textsuperscript{136} Q 50
\textsuperscript{137} Q 168
\end{flushleft}
The Chancellor of the Exchequer also defended the use of the economic cycle as part of the golden rule, despite the problems in determining an end date for the last economic cycle. He told us that:

I certainly do not see any difficulty, far from it, of having rules that span a cycle because the whole point of doing that is to allow for the fact that in any cycle there will be some years that the economy will be growing above its trend road to growth and other times it will be growing below it. It is a perfectly stateable case to say that you balance the books every single year but I think that would lead to some very disjointed planning. As I said earlier, … if you had had another fiscal rule which said you cannot borrow when the economy is growing above trend that would have resulted in quite a substantial cutback in public investment. So I think looking across the cycle is fine but there are always going to be arguments—and I know that this is an argument that many of the groups that come and see you have—as to the difficulty in defining when the cycle came to an end, and I can appreciate that you could have an interesting debate on the matter, but I think the principle is a sound one.\(^{138}\)

In our previous recommendations in our Reports on the 2007 Budget and 2007 Pre-Budget Report, we argued that the Government should review the golden rule such that it becomes more forward-looking and less dependent upon the dating of the economic cycle. The current inability of the Treasury to date the end of the economic cycle works against the positive attributes of a fiscal rule founded on judgements about economic cycles. We continue to believe that the golden rule should be more forward-looking, but, even on the Treasury’s own current formulation, it appears to us to be premature for the Treasury to state that it is “on course” to meet the golden rule in the next economic cycle, given the lack of an end date for the previous economic cycle.

**The sustainable investment rule**

35. This year’s Budget sets out the Government’s position that it is on track over the forecast horizon to meet the sustainable investment rule—that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level and that, other things being equal, net debt will be maintained below 40% of GDP over the economic cycle:

Public sector net debt remains below 40% of GDP throughout the projection period and starts to decline by 2012–13, reaching 39.3% of GDP. Therefore the Government meets its sustainable investment rule while continuing to fund increased long-term capital investment in public services. The projections for core debt, which exclude the estimated impact of the economic cycle, remain below 39% of GDP. This is consistent with the fiscal rules, and with the key objective of intergenerational fairness that underpins the fiscal framework.\(^{139}\)

\(^{138}\) Q 314

\(^{139}\) Budget 2008, pp 177–178, para C.14
Table 3 illustrates how forecasts of public sector net debt have changed since last year’s Budget.

Table 3: Forecasts of Public Sector Net Debt as a proportion of GDP

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Sources: Budget 2007, p 278, Table C5; Pre-Budget Report 2007, p 165, Table B6; Budget 2008, p 184, Table C5

Figures in italics are outturns, all other figures are forecasts (for the year in which the document was published) or projections.

36. As Table 3 shows, the forecasts as presented in the 2008 Budget showed a further reduction in the margin by which the Government expects it will meet the sustainable investment rule over the next few years. Accordingly, by 2010–11, the latest Treasury forecasts suggest that there will be headroom of only 0.2 percentage points, which Mr Chote suggested equated to £2.8 billion.\(^\text{140}\) Such a margin appears small when, as Mr Chote noted, “the average forecasting error for the budget deficit one year ahead is about \(£\)13–14 billion”.\(^\text{141}\) As such, he suggested that there was a fifty-fifty chance that the Government would breach the sustainable investment rule over the forecast period.\(^\text{142}\) However, Treasury officials were reluctant to suggest how likely it was that the Government would breach the rule, with Mr Ramsden telling us that “We do not do our forecasts in that way”.\(^\text{143}\) He also explained that the Treasury saw the sustainable investment rule as “a strict rule”.\(^\text{144}\) However, he defended the reduction in the margin with which the sustainable investment rule would be met, explaining that:

It is very much because of the present uncertainties over the economy and in thinking about the operation and the purpose of the fiscal rules to support monetary policy and stabilise the economy that we are seeing increased borrowing and actually that the margin on the sustainable investment rule has gone down from the kind of levels we had at PBR time. Since the alternative would have been to tighten policy

\(^{140}\) Q 44
\(^{141}\) Ibid.
\(^{142}\) Ibid.
\(^{143}\) Q 170
\(^{144}\) Q 169
during a period when the economy is forecast to operate below trend, looking at the way the fiscal framework gives flexibility, we thought it was the right thing to do to allow current borrowing to increase and to continue to borrow to invest. That is why we have got closer to the sustainable investment rule margin.\footnote{145}

The Chancellor of the Exchequer rejected the notion that, given the tight margin in the forecasts for the Government meeting the sustainable investment rule, the sustainable investment rule was no longer achieving its aim.\footnote{146} He considered that “the sustainable investment rule has a lot of merit because what it says is that it allows you to maintain public investment but it says that it should be kept at a prudent level, which we say is 40%; but it does allow you, even when there are times when the economy is not growing as strongly as it has been, that you can maintain your public investment, which I think is very important”.\footnote{147} The Government has forecast that it will meet the sustainable investment rule over the period up to 2012–13. However, the margin by which it is now forecasting that it will meet the rule is extremely tight, especially considering the uncertainty surrounding the overall economic situation.

\textit{International Financial Reporting Standards}

37. The Government’s performance against the sustainable investment rule is measured using Public Sector Net Debt (PSND) as a proportion of Gross Domestic Product. The calculation of PSND may be affected by accounting changes. The Government announced in last year’s Budget that it would introduce International Financial Reporting Standards (IFRS) for use in central government accounts from 2008–09.\footnote{148} However, in this year’s Budget, the Treasury announced a postponement of the implementation of IFRS in central government accounts to 2009–10.\footnote{149} We explore the reasons for this postponement and its accounting effects later.\footnote{150} In this section we are concerned with its effects on the measurement of PSND and thus of the Sustainable Investment Rule. As part of the implementation of IFRS, the accounting treatment of Private Finance Initiatives and Public–Private Partnership agreements is likely to change, leading to the potential for some of these projects to be moved to ‘on-balance sheet’. When we discussed with the Office of National Statistics how the implementation of IFRS would impact on the measurement of PSND, they told us that:

IFRS introduces new standards for government accounts. We recognise that there is an issue here as to whether it would change the approach that we have been adopting to the public sector finances. The short answer to the question about whether it will make a difference is that we do not know. It will depend on precisely how the new IFRS standards are applied in the public sector and we do not yet know whether it

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will continue to produce similar results to the results you would get from applying national accounts. There is an open question there going forward but it is certainly part of our work programme to examine that question. That is where we are at. We are using existing government accounting standards to estimate public sector net debt at the moment but we will be examining the new standards to see whether we need to change our approach going forward.\textsuperscript{151}

38. Others have argued that the impact of such a change on the measurement of PSND could be quite large, with Mr Chote suggesting that “The maximum you end up with is something like [£]30 [billion] if everything goes on that is currently off”.\textsuperscript{152} If the implementation of IFRS does lead to many more assets being treated as ‘on balance sheet’ and that flows into the classification of PSND, then the limit under the sustainable investment rule as currently defined is almost certain to be breached. Mr Chote was critical of the Treasury’s lack of early notice of how it would deal with a definitional change affecting the national accounts:

The Treasury is still sticking with this, ‘We are below 40%, what is the issue?’ There is no discussion of, ‘If for a variety of reasons that might not be the case, what is the sensible approach? Are we going to change the rules? Do we think we have breached this but we just explain the circumstances.’ The worst thing you can do is basically say, ‘There is no problem. There is no problem. There is no problem’ and then just move the goalposts at exactly the point at which you would cross it, which was what happened with the Golden Rule and it looks like they are setting themselves up for exactly the same thing with the sustainable investment rule.\textsuperscript{153}

39. Mr Ken Wild, a member of the Financial Reporting Advisory Board, argued that a rise in the recorded level of PSND arising from a reclassification of liabilities should lead to a change in the interpretation of the sustainable investment rule, rather than policy changes to reduce PSND:

I think better information should not affect the rule. The rule is there to achieve something. The rule is there to achieve stability and it is based on information. If you get better information and better understanding you can say, ‘Ah, I now understand better and the implications for what I was trying to do in achieving stability are this’, but you should not have the rule distort the decision against the facts. If you get better understanding of the facts you ought to be able to take better decisions, so you should not let the rule drive it. If the rule has been written on the basis that the facts will be presented in a particular way and you present the facts in a different way you will need to adjust the rule to achieve the same effect, but if you are improving the information it cannot essentially undermine the quality of the rule; it can just alter the way it is defined.\textsuperscript{154}

\textsuperscript{151} HC (2007–08) 397–i, Q 48
\textsuperscript{152} Q 49
\textsuperscript{153} Ibid.
\textsuperscript{154} HC (2007–08) 397–i, Q 43
The Chancellor of the Exchequer told us that the Treasury’s response to a breach of the sustainable investment rule from an IFRS related breach of the rules was something he was “still reflecting upon”.\footnote{\textit{Q 320}} \textbf{It seems highly likely that, following the move to International Financial Reporting Standards for central government, the sustainable investment rule as currently defined and interpreted will be breached in 2009–10 as a result of the reclassification of PFI projects. As such, the delay announced in Budget 2008 in the implementation of International Financial Reporting Standards gives the Government a chance to announce in advance whether and how it proposes to revise the sustainable investment rule in the light of the implementation of International Financial Reporting Standards. We recommend that the Government publish in the 2008 Pre-Budget Report any proposed changes to the sustainable investment rule and its interpretation arising from classification changes resulting from International Financial Reporting Standards.}

\textbf{Northern Rock}

40. On 7 February 2008, the ONS determined that, as a result of the nature of the support that the Bank of England had provided Northern Rock, Northern Rock would be classified as a Public Financial Corporation when compiling the National Accounts and that this reclassification would be backdated to 9 October 2007.\footnote{\textit{Ibid.}, p 2, para 1.2} The ONS explained that “The decision is based on a judgement that the public sector has the power to control Northern Rock plc’s general corporate policy through clauses in the legal documents defining the arrangements” of the Bank of England’s loans to Northern Rock.\footnote{\textit{Ibid.}, p 2, para 1.3} As a result of this reclassification, Northern Rock’s liabilities, minus its liquid assets, would be counted as part of PSND.\footnote{\textit{Ibid.}, p 2, para 1.6} In evidence to us, Mr Kellaway, Head of Classifications and Adviser, Public Sector Accounts at the Office of National Statistics, outlined the potential effects this would have on PSND as a percentage of GDP, telling us: 

\begin{quote}
At the time that we gave this indicative figure, which was at December, it [the inclusion of Northern Rock] would have added 6.7\% and so that would have taken it to the range of 43\%, 44\%.\footnote{HC (2007–08) 397–i, Q 56}
\end{quote}

Northern Rock’s inclusion in the PSND figures would therefore have meant that the Government would have breached the existing ceiling set on the sustainable investment rule for the economic cycle that began in 1997–98.

41. The Government announced in this year’s Budget that it had decided that the liabilities associated with Northern Rock would not be counted as part of PSND when calculating whether the Government had met the sustainable investment rule. The Government provided the following reasoning for its decision:

\begin{quote}
\par
\end{quote}

\begin{footnotesize}
\begin{enumerate}
\item \footnote{\textit{Q 320}}
\item \textit{National Statistics, Northern Rock Plc, 7 February 2008, p 2, para 1.2}
\item \textit{Ibid.}, p 2, para 1.2
\item \textit{Ibid.}, p 2, para 1.3
\item \textit{Ibid.}, p 2, para 1.6
\item HC (2007–08) 397–i, Q 56
\end{enumerate}
\end{footnotesize}
The purpose of the sustainable investment rule, to protect intergenerational fairness and ensure sound public finances, provides the context for measurement decisions. The impact of Northern Rock on public sector net debt provides a good example. Northern Rock is temporarily in public ownership and its liabilities are fully backed by other financial assets held by the company, and therefore its impact on PSND does not reflect future calls on the taxpayer or affect sustainability. PSND does not take account of temporary ownership or net off all financial assets. As the sustainable investment rule aims to capture the burden of debt that will fall on future taxpayers, it would not be appropriate to include the liabilities of Northern Rock in the measure of performance against the rule. The Code for fiscal stability provides for such circumstances. The Government remains committed to best practice fiscal reporting, and to improving the assessment of fairness and sustainability where further opportunities arise, maintaining the integrity of the constraints set by the fiscal framework.

Dr Weale broadly agreed with the Government’s position on the inclusion of Northern Rock, but felt that its simple exclusion from the figures was wrong:

I must say what I would have done is to say the 40% is a target, the nature of the world is that things happen that you do not expect and we have exceeded the target, but on this occasion we think we do not need to do anything about it because crossing the target has come about because we have taken over Northern Rock and unless it appears that the taxpayer is going to suffer financial loss as a consequence we can simply wait for Northern Rock to be taken off the balance sheet again. Presentationally it has been very bad but the conclusion that they have come to is correct.

Treasury officials were confident that they had dealt with Northern Rock’s exclusion from the sustainable investment rule correctly. Mr Ramsden told us that “What we are always trying to do is to ensure the credibility of our fiscal framework and the fiscal framework through the Code of Conduct allows us … to approach considerations like Northern Rock in the way that we have”. The Chancellor of the Exchequer was more strident in his criticism of any attempt to include Northern Rock in the sustainable investment rule. He told us that to do so would be “absolutely bonkers” because “it would mean you would have to slash large amounts of public expenditure to accommodate what is a temporary arrangement, and I cannot see the sense of that and I do not know if any sensible commentator is arguing that we should”. We accept that Northern Rock’s inclusion within calculations of Public Sector Net Debt should not influence decision-making under the fiscal framework. It is nevertheless important that the Government reports transparently on the effects of Northern Rock in its forecasts of Public Sector Net Debt as a proportion of GDP.

160 Budget 2008, p 28, Box 2.6
161 Q 46
162 Q 175
163 Q 322
The relationship between monetary policy and fiscal policy

42. The 2008 Budget stated that:

The Government uses cautious NAO audited assumptions, including a cautious view of trend growth, to build a safety margin in the public finances against unexpected events. Combined with the decision to consolidate the public finances when the economy was above trend, this has resulted in low debt. As a result, this has allowed the Government to safeguard the increase in investment in priority public services, to allow the automatic stabilisers to work fully during a period of global economic uncertainty, and to meet in full the UK’s international commitments, while continuing to meet the fiscal rules.\textsuperscript{164}

As we have seen, this year’s Budget reported a further weakening since the 2007 Pre-Budget Report in the forecasts for the public finances from 2008–09 onwards, and the margin by which the Government forecasts that it will meet the sustainable investment rule is very slim. Dr Weale thought that there was little room at the present juncture for the Government to support monetary policy through fiscal measures, given its own policy rules. He told us that:

If you take the view that is what you should be doing with fiscal policy when the country is in difficulties then there [is] quite a lot of scope because, after all, the limits that the Government set on its borrowing are just arbitrary. On the other hand, if the Government wanted to maintain, I suppose, the letter as they define it of the fiscal rules—because I think they have given up on the spirit of them— … then … I do not think there was room to support monetary policy.\textsuperscript{165}

Ms Rosewell agreed, stating that:

Clearly the Government could go out and borrow; there is nothing to stop it going out into the market, although it might have to pay a bit more. If you ask for more money you might have to pay a bit more, but it is a triple-A rated institution and it can go out and raise funds. Indeed, there are increases in borrowing put into this. The self-imposed constraints are clearly very serious indeed.\textsuperscript{166}

Mr Chote pointed out that there was an additional constraint on how far the Government could use fiscal policy to stimulate the economy, namely the Bank of England. He explained that:

I think one of the difficulties with the way the current framework is set up is that at the moment with having the Bank of England given an inflation target, it is the Bank of England that is the second mover and essentially decides how much aggregate spending it is safe to have in the economy. If you were to do something much more expansionary on fiscal policy and the Bank thought that was over-egging it, the sort

\textsuperscript{164} Budget 2008, p 181, para C.34
\textsuperscript{165} Q 38
\textsuperscript{166} Q 39
of discussions we have had before, then they would offset that, and similarly if they went in the other direction. In a sense, the Treasury is only able to affect the policy mix. The Bank of England decides how much overall expansion or contraction is appropriate and, as you discussed earlier, at the moment they are caught between the desire to shallow out the downturn and at the same time not wishing to see the short-term inflation boost get into wage constraints so I think there is a broader issue about the way in which responsibilities are given leaving aside the fiscal rules.\textsuperscript{167}

43. Treasury officials defended the Government’s position, saying that the increased borrowing in the Budget had been to support monetary policy. They told us that:

It is very much because of the present uncertainties over the economy and in thinking about the operation and the purpose of the fiscal rules to support monetary policy and stabilise the economy that we are seeing increased borrowing and actually that the margin on the sustainable investment rule has gone down from the kind of levels we had at [Pre-Budget Report] time. Since the alternative would have been to tighten policy during a period when the economy is forecast to operate below trend, looking at the way the fiscal framework gives flexibility, we thought it was the right thing to do to allow current borrowing to increase and to continue to borrow to invest.\textsuperscript{168}

The Chancellor of the Exchequer dismissed the idea that the Government had not been able to support monetary policy, arguing that “The important thing is to have the scope to do these things and by getting borrowing debt down to a level that is much lower than we had in the past we do have that room for manoeuvre that we would not have had in the past; and, of course, as you know, the Bank of England has been able to reduce rates in December and then again in February”.\textsuperscript{169} The Chancellor of the Exchequer also pointed out that the UK’s levels of public debt were “lower than most of our competitors, [and] they compare well internationally”.\textsuperscript{170} On the question of whether there should have been further consolidation of the public finances during the previous years of stronger economic growth, the Chancellor of the Exchequer remarked:

The other thing I would say—and I know that many people, not so much the commentators but inside this House are now saying—‘You should have cut back at times when the economy was growing above trend’. Firstly, I do not actually remember them saying that at the time, and indeed many of them were actually calling for more spending. Also, if we had actually not borrowed when the economy was growing above trend then we would have had to cut back quite substantially into some of the investment that we have been making in our long term infrastructure, and I think that would have been to repeat all the mistakes of successive
governments—and I am not talking about the last one but other governments of different political colours over the last 30 or 40 years.\textsuperscript{171}

As we have noted already, the forecasts for the state of the public finances show further deterioration from 2008–09 onwards, and there are significant downside risks to the forecasts for economic growth. Should those risks crystallise, the Government would have extremely limited scope, under the fiscal rules as currently defined, to take further fiscal measures to support monetary policy. We expect to examine the role of the golden rule and of the sustainable investment rule in more detail in our inquiry into the 2008 Pre-Budget Report.
4 Child poverty, fuel poverty and the poverty trap

Child poverty

Background

44. In 1999, the then Prime Minister committed the Government to the goal of ending child poverty “within a generation”. The pledge was underlined by setting a series of targets and milestones to reduce child poverty on the way to eradicating it by 2020. These targets were encapsulated in the 2002 Spending Review objectives set for HM Treasury and the Department for Work and Pensions, within the framework of Public Service Agreements, to reduce the number of children in low-income households by at least a half by 2010–11 and eradicate it by 2020–21.172

Child poverty indicators and progress to date

45. The Government reiterated its commitment to halving child poverty by 2010–11 at the time of the 2007 Comprehensive Spending Review. The Government announced in that Review that it would use three indicators to measure progress against tackling child poverty in the coming years:

- Indicator 1: the number of children in absolute low-income households, defined as households with incomes of less than 60% of median income held constant in real terms from a 1998–99 baseline;

- Indicator 2: the number of children in relative low-income households, defined as households with incomes below 60% of median income. This is the indicator used for the target to reduce by a half the number of children living in poverty by 2010–11; and

- Indicator 3: the number of children in relative low-income households and in material deprivation: the introduction of a material deprivation indicator for child poverty is designed to provide a wider measure of living standards and reflects the view that tackling child poverty is about more than simply raising income levels.173

The baseline for progress against the target to halve the number of children in relative low-income households by 2010–11 was the Government’s estimate that 3.4 million children were living in relative poverty in 1998–99. This meant that child poverty levels needed to be reduced to 1.7 million in order for the Government to meet its 2010–11 target. Between 1998–99 and 2005–06, child poverty by this measure fell by 600,000, from 3.4 million to 2.8

173 HM Treasury, PSA Delivery Agreement 9: Halve the number of children in poverty by 2010–11, on the way to eradicating child poverty by 2020, October 2007
million, which meant that there would need to be a fall of 1.1 million children in relative poverty between 2005–06 and 2010–11 in order to meet the target.174

Our previous consideration

46. In November 2007, following the 2007 Comprehensive Spending Review, we expressed concern that the Spending Review was not accompanied by a clear explanation of the linkage between the Government’s target to halve child poverty by 2010–11 and the proposed deployment of resources to meet that target.175 Our Report also expressed concern that the Government might have drawn back from a whole-hearted commitment to meeting the 2010–11 child poverty target. We concluded that “a failure to meet that target would represent a conscious decision to leave hundreds of thousands of children in poverty for longer than is necessary or desirable”.176 In its response to our Report on the 2007 Comprehensive Spending Review, the Government implicitly rejected our call for a clear statement about where the resources would come from to meet the 2010–11 child poverty target. Instead it stated that “decisions on the levels of financial support provided to families will continue to be set at future Budgets and Pre-Budget Reports in the normal way”.177

Measures in the 2008 Budget

47. The 2008 Budget contained three measures intended to contribute towards meeting the Government’s child poverty targets:

- Increasing the first child rate of Child Benefit to £20 a week from April 2009;
- Increasing the child element of the Child Tax Credit by £50 a year above indexation from April 2009; and
- disregarding Child Benefit in calculating income for Housing and Council Tax Benefit from October 2009.178

The combined cost of these measures will be £870 million in 2010–11. The increase in the child element of Child Tax Credit and the Child Benefit disregard each cost £350 million whilst the increase in the first child rate of Child Benefit will cost a further £170 million.179

48. Regarding the announcement that from October 2009 Child Benefit income will be disregarded in calculating income for Housing Benefit and Council Tax Benefit purposes, the Treasury told us that, “compared to the current system, this reform amounts to an additional disregard in net incomes for Housing Benefit/Council Tax Benefit purposes up

174 Ev 59
176 Ibid.
178 Budget 2008, p 63, para 4.17
179 Ibid., p 110, Table A.1
to the value of Child Benefit for any family receiving Child Benefit”. The Treasury went on to state that, compared with the current system, this reform would lead to a genuine increase in income for any family receiving Child Benefit whose net earnings for Housing Benefit/Council Tax Benefit purposes currently exceeded their applicable amount (and who currently faced withdrawal of Housing Benefit/Council Tax Benefit). The Treasury concluded that “transferring additional resources via Housing Benefit and Council Tax Benefit ensures that gains are focussed on low income families with children, with greater gains for larger families where the risk of child poverty is greater”.\textsuperscript{180} Mr Chote noted the complexity of the disregard, telling us that “if it is understood by the people who are intended to receive this they are brighter people than I am”.\textsuperscript{181}

49. Asked about the balance in the Government’s strategy between universal and in-work benefits, Mr Chote suggested that this year’s Budget placed emphasis on incentives for work, telling us that “the changes in disregards as affecting Housing Benefit and Council Benefit … may provide a useful incentive for people to get into work in the first place”. He went on to say that:

In terms of the balance, some mixture of the two can certainly look appropriate but the difficulty is that you do not get as much bang for your buck in terms of reducing the target measure of child poverty by going for something like Child Benefit because a lot of it is spent on people who are well above the poverty line anyway.\textsuperscript{182}

Mr Chote told us that the Institute of Fiscal Studies had not yet made a projection of which groups the measures in the Budget would benefit most, but suggested that, based on past experience, it would be most likely to lift children in families already close to the 60% level above that level.\textsuperscript{183}

**Prospects for meeting the 2010–11 child poverty target**

50. The Treasury estimated that the measures in the 2008 Budget would lift up to a further 250,000 children out of poverty. The Treasury also estimated that the measures in the 2008 Budget, combined with the reforms announced in the 2007 Budget and the 2007 Pre-Budget Report and Comprehensive Spending Review, would lift a total of over 500,000 children out of poverty.\textsuperscript{184} Mr Chote told us that he broadly agreed with the Government’s assessment of the Budget measures, telling us that the Institute of Fiscal Studies had calculated that they would move 200,000 to 250,000 children out of poverty.\textsuperscript{185}

51. Mr Chote explained to us that, prior to the measures announced in this year’s Budget, the Government “would have ended up 700,000 short of where they wanted to be by 2010–

\textsuperscript{180} Ev 59–60
\textsuperscript{181} Q 66
\textsuperscript{182} Q 63
\textsuperscript{183} Q 61
\textsuperscript{184} Budget 2008, p 63, para 4.18
\textsuperscript{185} Q 61
He also said that, if the measures in the 2008 Budget reduced child poverty by 250,000, then the Government “are probably still 450,000 short of the target”. He estimated that bridging this gap would require additional expenditure of around £2.8 billion for the Government to meet its 2010–11 target. He viewed the remaining progress required as most likely to be achieved through the benefits system, stating that “it is either transfer payments or nothing at this stage”. He was sceptical about the contribution that increasing employment could make at this stage towards meeting the 2010–11 target:

It does not make much difference on the timescale for 2010. If you were to achieve the Government’s lone parent employment target it would probably cut the amount you needed to spend by about £200 million. That was the calculation we did a year or so ago. It shows basically that success on that front does not really get you very far in terms of the near-term target.

The Chancellor of the Exchequer told us that the Government remained committed to meeting its child poverty targets, telling us that “we aim to halve the number [of children] in poverty by 2010” and that the future 2020 target was also very important. He added that meeting the child poverty targets would be “difficult”, but that the targets were “well worth pursuing”. We welcome the measures in the 2008 Budget on child poverty, which will make an important contribution towards reducing child poverty. We recommend that the Government, in its response to this Report, clarify the targets that have been set relating to child poverty since the pledge to eliminate child poverty in a generation was first made and report on performance against each of those targets in each financial year. We further recommend that that response set out the Government’s estimate of the effect of each measure relating to child poverty in this year’s Budget on progress towards the 2010–11 target in each financial year from 2008–09 to 2010–11. We remain concerned that the Government has yet to provide a clear explanation of the linkage between its target to halve child poverty by 2010–11 and the proposed deployment of resources to meet that target. It is of crucial importance that the Government makes it clear that the necessary resources to meet the 2010–11 target are available and that the Government is committed to deploying those resources directly to support low-income families. It is also important that the Government sets out the policy instruments under consideration to meet this target.

Fuel poverty

In recent years, the Government has made a number of winter fuel payments and additional “one-off” payments to pensioners. The level of the winter fuel allowance,
established in 1997, has changed nine times in 12 years. In this year’s Budget statement, the Chancellor of the Exchequer announced that “further action is also now needed to help vulnerable groups deal with rising energy prices”. He announced that he would help pensioners who were facing higher energy bills by raising the winter fuel payment for over-60s from £200 to £250 and for the over-80s from £300 to £400, which would ensure that “nine million pensioner households will be better off”. The cost of the payments for Winter 2008–09 is £575 million.

54. The additional winter fuel payment for 2008–09 is a one year commitment. In coming years, the Government expects that further assistance will be available from energy supply companies. The Chancellor of the Exchequer said in his Budget statement that “energy companies currently spend around £50 million a year on social tariffs. I want to see this rising to at least £150 million a year in the period ahead.” The Treasury had targeted the energy suppliers rather than energy producers in part because the legislation that enabled the payment of social tariffs, the Energy Bill, only applied to electricity and gas suppliers. The Chancellor of the Exchequer indicated that the Government would “work with the companies to take forward further action on a voluntary and on a statutory basis to underpin this as necessary”. Treasury officials told us that “it may be necessary to have some kind of statutory underpinning to ensure a fair distribution of the contributions from the energy companies”. However, they emphasised that they were entering “into discussions with the presumption that we can achieve agreement rather than waving the stick too much”. They also told us that they were “looking for further action on bringing down the price differential between pre-payment meters, which a lot of people who fall into the fuel poor category have, and those people on direct debits or standard tariffs, and that will also obviously contribute”. The Treasury hoped to make proposals arising from the discussions with the energy supply companies for Winter 2009–10.

55. We explored with witnesses whether an increased social tariff and other measures taken with the energy industry would make good the shortfall if the increase in the winter fuel allowance were to be a one-off measure, as currently envisaged. That allowance is not means-tested and currently it is paid to all UK residents over the age of 60. As such, it is not targeted on those most in need, as Treasury officials indicated: “one of the problems there is around targeting additional spending … on people who are fuel poor, is identifying the

194 HC Deb, 12 March 2008, col 291
195 Ibid., col 298
196 Budget 2008, p 9, Table 1.2; Q 217
197 HC Deb, 12 March 2008, col 291
198 Q 366
199 HC Deb, 12 March 2008, col 291
200 Q 216
201 Q 223
202 Q 220
203 Qq 217–223
The Chancellor of the Exchequer emphasised that it was not easy to ensure that support through energy supply companies was effectively targeted:

"On the face of it, you might think: why do we not just give the electricity companies or the gas companies the names of people receiving benefits. There is a real difficulty in that there are some people who just do not want that information passed on. They have every right to have their privacy respected just as you or I have … We are discussing it within government. There ought to be a way round it because we know who people are who are likely to be fuel poor." 205

The Chancellor of the Exchequer said that the proposed social tariffs would work alongside other measures to target those suffering from fuel poverty. 206 He also explained that any decisions on the future payments of the winter fuel allowance would be taken in subsequent Budgets or Pre-Budget Reports. 207

56. A household is said to be in fuel poverty if it needs to spend more than 10% of its income on fuel to maintain a satisfactory heating regime (usually 21 degrees for the main living area, and 18 degrees for other occupied rooms). 208 The UK Fuel Poverty Strategy, published in November 2001, set out targets to eradicate fuel poverty by 2016. The Government has a target to eradicate fuel poverty in England in vulnerable households by 2010, where a vulnerable household is deemed to be one containing children, or those who are elderly, sick or disabled. 209 There is a further target that by 22 November 2016, as far as reasonably practicable, no person in England should have to live in fuel poverty. The Scottish Fuel Poverty Statement, published in August 2002, sets out Scotland’s overall objective for fuel poverty. This is to ensure that, as far as reasonably practicable, people are not living in fuel poverty in Scotland by November 2016. 210 The Welsh Assembly Government’s target is that as far as reasonably practicable, no vulnerable household in Wales should be living in fuel poverty by 2010 and no household should be living in fuel poverty by 2018. 211 Northern Ireland has the same objectives as England. 212 The Government has stated that progress on this will be monitored by an inter-ministerial group and through the UK Fuel Poverty Strategy Annual Progress Report, which is published by the Department for Business, Enterprise and Regulatory Reform in conjunction with the Department for Environment, Food and Rural Affairs. The Government has said that its primary tool in tackling fuel poverty over the period 2008–09 to 2010–11 will be the Department for Environment, Food and Rural Affairs’ Warm Front

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204 Q 216
205 Q 369
206 Q 362
207 Ibid.
211 http://wales.gov.uk/topics/housingandcommunity/housing/energyandfuel/?lang=en
212 http://www.dsdni.gov.uk/ending_fuel_poverty_-._a_strategy_for_ni.pdf
Scheme, which provides a package of heating and insulation measures to private sector households in receipt of certain benefits, and benefit entitlement checks to help maximise income. It is important that the Government continues to tackle fuel poverty through a combination of targeted and universal measures. We look forward to a constructive outcome to continuing discussions between the Treasury and the energy supply companies, particularly with regard to lowering the differential in charges between those with pre-payment meters and those making other forms of payment. In view of the importance of measures announced in Budgets and Pre-Budget Reports to the progress of the targets to eradicate fuel poverty set by the Government itself and by the devolved administrations, we recommend that the Government report in Budgets and Pre-Budget Reports on the effect of any measures announced at that time on progress towards meeting fuel poverty targets. We further recommend that, in the 2008 Pre-Budget Report, the Government report specifically on:

- the outcome of its discussions with the energy supply companies;
- any legislative measures in this area under consideration; and
- its assessment of the effectiveness of the one-off increase in the winter fuel allowance for Winter 2008–09 in terms of progress in meetings its obligations relating to fuel poverty.

We expect to examine during our inquiry into the 2008 Pre-Budget Report whether the increase in the winter fuel allowance for 2008–09 and the additional measures proposed for the Winter of 2009–10 will be effective in reducing fuel poverty in line with the Government’s targets.

Marginal deduction rates and the poverty trap

High marginal deduction rates

57. The Treasury defines the poverty trap as occurring “when those in work have limited incentives to move up the earnings ladder because it may leave them little better off”. Marginal deduction rates are used to measure how far people’s incentives to increase their income are being reduced. For instance, a marginal deduction rate of 65% means that, for every one pound of additional income earned, 65 pence of that extra pound is taken away, either by taxes or a reduction in benefits. Chart 1 shows how the Government’s policy mix has affected the distribution of marginal deduction rates over time.

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213 PSA Delivery Agreement 9: Halve the number of children in poverty by 2010–11, on the way to eradicating child poverty by 2020, p 16, para 3.33

214 Budget 2008, p 62, para 4.15
As can be seen from Chart 1, while the Government has been successful at moving people from the highest marginal deduction rates above 70%, the number of people caught by a marginal deduction rate of between 60% and 70% has increased—by around 200,000 between the tax years 2007–08 and 2008–09.

58. The Treasury stated in the Budget that that increase was “primarily due to the introduction of tax credits, which has extended financial support so that far more families benefit, including low-income working people without children.” 215 Mr John Whiting of PricewaterhouseCoopers explained that changes within the Government’s policy mix had also increased the number of people caught by marginal deduction rates at this level:

as the tax credits have become more generous … that naturally takes this level at which the claw back starts to affect people up higher. If we go back two or three years when tax credits were first introduced we would be looking at people on incomes of £12,000 to £14,000 and as the credits have become more generous that has made them more available further up the income scale but it has meant more people being subject to claw back over a wider income band than used to be the case. 216

However, Mr Whiting acknowledged that such high marginal deduction rates might be the consequence of the Government trying to achieve its social policy goals. He told us that “It
is one of the imponderables … that as soon as you give benefits and then say, ‘We want to withdraw them’, you are facing people with a significant taper”.

59. When asked why around 200,000 extra people now faced marginal deduction rates between 60% and 70%, Treasury officials told us that:

The main reason for that is partly, indeed primarily, as a result of the 2007 Budget measure that introduced extra help through tax credits from 2008. That brought more people into tax credits, the result being that more people then faced higher marginal deduction rates.

Treasury officials also acknowledged the choice faced by Government when deciding how to distribute benefits:

There is not a perfect answer. You could go for universal support, as, of course, he has done with child benefit, but in that situation you are not targeting the public resource on those who need it most and that leads inevitably to one of two consequences: either you have to spend more to provide that level of support for the poorest or on the other hand you support the poorest less, so that is universal support. You could equally go for a very steep cliff edge with very high marginal deduction rates which would leave a smaller group of people affected by high marginal deduction rates, but then you are leaving those people with a massive disincentive, or, which is what the Government has done, you can focus resource on the more needy and then gradually withdraw that through a taper.

The Chancellor of the Exchequer defended the decisions made on tax credits, and the consequences that this had had on the marginal deduction rates faced by some people. He explained that:

When you decide you want to increase people’s incomes through the tax credit system, the down side is that when they come off it there might be a disincentive there. You try and avoid that by a taper but of course the taper will then take you further up the income scale. There are ways in which you can mitigate that but I would not want to get myself into a situation where frankly I did not increase the incomes of people if I thought that was the right thing to do.

60. The increase in the number of people facing marginal deduction rates of between 60% and 70% is a direct consequence of decisions made by Government as to how the tax and benefit system will work. We acknowledge that such decisions are finely balanced between the overall cost of a benefit, and the rate at which it is withdrawn. We recommend that the Government undertake further research into how the design of the tax credit system, in conjunction with the overall tax and benefit system, is enhancing or impeding progress on the Government’s welfare to work objectives, and report on
such work in the 2008 Pre-Budget Report. We recommend that, as a basic principle, the Government ensure that high marginal deduction rates are limited wherever possible, and we will continue to keep this matter under review.

**Tax credit take-up rates**

61. High marginal deduction rates are faced by those who are already part of the tax credit and benefit system, but not all those eligible take up the tax credits owed to them. The importance of the need for higher levels of tax credit take up were highlighted when we discussed the reforms announced in the 2007 Budget, which included the abolition of the 10 pence starting rate of income tax, and a reduction in the basic rate of income tax from 22 pence to 20 pence from April 2008.\(^2\)\(^2\)\(^1\) As a result of these reforms, some low-income workers may have been potentially disadvantaged because the loss of the 10% starting rate of income tax was not outweighed by the gain from an overall lower basic rate of income tax. The Treasury provided the following evidence as to who might lose as a result of the changes in Budget 2007, and how those losses may be mitigated:

Estimates are that 0.8m single earners with income under £18,500 will see their income decrease by around £1.45 a week on average. The reforms overall, however, are of particular benefit to low income households. The reforms will lift around 200,000 children out of poverty, and analysis of the reforms by the Institute for Fiscal Studies showed the greatest gains are for households in the poorest two deciles. The maximum amount any single individual could be worse off by is £232 per year (£4.46 per week) about 3% of net income. This loss would be completely offset by increases in Working Tax Credits for those eligible to claim. For those not eligible for Working Tax Credits it is possible that households around or under the level of income achieving the maximum loss could be receiving Housing and/or Council Tax Benefits and could therefore have up to 85% of this loss offset by increases in HB/CTB. For households that are worse off, the average loss is about £2 per week.\(^2\)\(^2\)\(^2\)

The Chancellor of the Exchequer acknowledged that there were some sections of society that would be affected by the loss of the 10 pence starting rate of income tax:

There is a particular group of people, mainly women between the age of 60 and 65, who would have been paying the 10p rate who, if you look at where their incomes have come from in the last ten years, [are] better off than they were. Yes, it would affect them.\(^2\)\(^2\)\(^3\)

The Chancellor of the Exchequer was also keen to point out that “We have tried to help wherever we can through the tax credit. I have mentioned the winter fuel payment and for a lot of people their incomes will have gone up.” He also to stated that overall “the reduction to 20 pence will benefit very substantial numbers of people”.\(^2\)\(^2\)\(^4\) **Those most**
affected by the abolition of the 10 pence rate of income tax appear to be those below the age of 65 with an income under £18,500 who are in childless households. The effect is greatest on those households where no individual is above the age of 60 because the household does not then benefit from the higher winter fuel allowance. We accept that there are benefits in tax simplification and that there are merits to focus on both the needs of children and motivation to work. However, the group of main losers from the abolition of the 10 pence rate of income tax seem an unreasonable target for raising additional tax revenues to fund these and other initiatives.

62. Despite tax credits being identified as one of the ways of mitigating the loss of the 10 pence starting rate of income tax, as Treasury officials acknowledged, there has been a continuing problem of low take-up rates of working tax credits. As we noted last year, the problem of low take-up rates is especially acute among families without children, where the central estimate of the take-up rate of working tax credits was 22% for the financial year 2005–06. Treasury officials pointed out that take-up of the working tax credit, which I agree has not been as good as we would have liked, is increasing. That is also an important reality to bear in mind, and steps are being taken to draw the attention of people who can claim that tax credit to the fact that it is available, and that is having some success. More people are claiming the working tax credit.

The Chancellor of the Exchequer also acknowledged that “There are particular groups who would be eligible for the working tax credit who are not taking it up and that is something that we need to do something about”. He reiterated his desire to see further action, telling us that “where take-up is insufficient, particularly with people without children, I would like to see us do more”. We are concerned by the poor take-up rate of working tax credit among eligible families without children, especially given that working tax credits are intended to mitigate for low-income households the effect of the removal of the 10 pence starting rate of income tax. We expect the Treasury and HM Revenue & Customs to galvanise their efforts in this area in coming months and years. We recommend that the Government report regularly in Budgets and Pre-Budget Reports, starting with the 2008 Pre-Budget Report, on progress in increasing the take-up rates of working tax credits for those sections of society with particularly low take-up rates. We further recommend that the Treasury commission research into whether the withdrawal of the 10 pence income tax band and high marginal deduction rates are creating disincentives that could frustrate the Government’s welfare to work objectives.

225 Q 232
226 HM Revenue & Customs, Child Tax Credit and Working Tax Credits: Take-up rates 2005–06, p 12, Table 10; HC (2006–07) 389-I, paras 44–45
227 Q 238
228 Q 379
229 Q 380
5 Public expenditure issues

International Financial Reporting Standards

Implementation timetable

63. In last year’s Budget the Government announced that, “in order to bring benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice”, the annual financial statements of government departments and other central government bodies would be prepared using International Financial Reporting Standards (IFRS) adapted as necessary for the public sector, in place of UK Generally Accepted Accounting Principles (UK GAAP). The transition to IFRS was scheduled for 2008–09, along with the first set of Whole of Government Accounts (WGA), which would be produced on an IFRS basis.230 In this year’s Budget the Government announced that the transition to IFRS and production of the first WGA would be delayed for one year to 2009–10, because the original timetable had proven too short for some Government departments to achieve.231 Treasury officials told us that the Ministry of Defence and Department of Health, two departments with complex budgets and large numbers of assets, found the timetable “too stretching”. The Department for Communities and Local Government also had concerns about coordination with the implementation of IFRS by local authorities.232 Professor David Heald, a member of the Financial Reporting Advisory Board and a Special Adviser to this Committee, argued that the primary problem at both the Ministry of Defence and Department of Health related to the accounting treatment of Private Finance Initiative (PFI) assets: for the Ministry of Defence, it was the sheer number of PFI assets that would have to be reviewed; for the Department of Health the main issue was that funding allocations for 2008–09 had already been set, and changes to PFI accounting on the initial timetable would result in many NHS bodies breaching their statutory financial obligations.233 Mr Elwyn Eilledge, the Chairman of the Financial Reporting Advisory Board, viewed the fact that some departments were unable to move to IFRS on the original schedule as “extremely disappointing”.234

64. Several members of the Financial Reporting Advisory Board suggested to us that the Government’s original timetable for implementation had been over-optimistic. Mr Eilledge said that “the timetable was always extremely tight, of course, and these things inevitably take a long time, frustratingly so”.235 Mr Wild pointed out that the private sector had had five years to implement IFRS, and some companies had still only just managed to meet the deadline. He contrasted this timeframe with the Treasury’s initial implementation period of one year, and commented that “having watched the private sector move, I was really

230 Budget 2007, p 154, para 6.59–6.60
231 Budget 2008, p 202, para C.103; Q 289
232 Q 290
233 Ev 66; HC (2007–08) 397–i, Qq 26, 38
234 HC (2007–08) 397–i, Q 23
235 Ibid., Q 4
concerned about the [Government’s] original timetable of a year”. Mr Eilledge also noted that the private sector did not have the problem of accounting for PFI to grapple with as had the public sector. Professor Heald concluded:

Given the five-year timetable available to the private sector for IFRS conversion, together with the linkage in the public sector between accounting and the budgetary funding of organisations such as NHS bodies, the one-year timetable announced in Budget 2007 was over-ambitious.

We are disappointed that the Government has been forced to delay the implementation of International Financial Reporting Standards for the public sector until 2009–10, but not altogether surprised. The proposed timetable of one year for implementation was over-ambitious, and considerably more stretching than the five-year transition period enjoyed by the private sector. The Treasury appears to have misjudged the scale and complexity of the issues involved in the transition to International Financial Reporting Standards, in particular the issue of accounting for private finance initiative assets.

Shadow accounts

65. Members of the Financial Reporting Advisory Board told us that they had recommended that all departments that could do so should produce 2008–09 shadow resource accounts on an IFRS basis alongside their accounts on a modified UK GAAP basis. Treasury officials confirmed that those Government departments in a position to do so would produce shadow accounts from 2008–09. Professor Heald argued that these shadow accounts ought to be thoroughly reviewed by the National Audit Office, and that the Treasury should adopt a “trigger-point strategy, with clear milestones, and regularly report progress to Parliament”, arguing that otherwise there would be a severe risk of further delays. It is important that momentum towards the implementation of International Financial Reporting Standards is maintained and, in that context, we welcome the Treasury’s assurance that those departments in a position to do so will produce shadow accounts on an International Financial Reporting Standards basis from 2008–09. We recommend that the Government, in its response to this Report, state whether those shadow accounts will be reviewed by the National Audit Office and whether the opinions of the National Audit Office on those shadow accounts will be made public.

Accounting treatment of PFI assets

66. Professor Heald explained that there was wide variation in the proportion of private finance initiative (PFI) assets held off balance sheet across departments, and argued that
these differences were heavily driven by the identity of the auditor—because the National Audit Office had been stricter about balance sheet treatment than the appointed auditors of the Audit Commission—and the control framework. This inconsistency was facilitated, in Professor Heald’s view, by the scope for arbitrage between Financial Reporting Standard (FRS) 5A (published by the Accounting Standards Board) and the revised Treasury Technical Note 1 (published by the Treasury as an interpretation but which effectively became treated as a competitor standard). Mr Eilledge also referred to this arbitrage between the two different interpretations, which had led the Financial Reporting Advisory Board to push the Treasury towards removing the Technical Note. However, before a formal recommendation was made to the Treasury by the Financial Reporting Advisory Board, the 2007 Budget had announced the intended implementation of IFRS from 2008–09, which would have rendered both FRS 5A and the Technical Note obsolete. The 2008 Budget decision to delay IFRS implementation might mean that the Technical Note could still be in use until 2009–10 and arbitrage between that and FRS 5A could continue to be possible. We are concerned about the potential for arbitrage between Financial Reporting Standard 5A and the Treasury’s Technical Note 1 on accounting for private finance initiative (PFI) assets, creating the potential for different interpretations of appropriate PFI accounting treatment. We recommend that the Treasury, in consultation with the Financial Reporting Advisory Board, seek to ensure that PFI accounting under International Financial Reporting Standards is implemented across the public sector in a consistent, effective and transparent manner.

**Efficiency**

*The 2004 Spending Review efficiency programme*

67. At the time of the 2004 Spending Review, the Government established a target to achieve efficiency savings across central and local government with an annual value of £21.5 billion by 2007–08. We have examined progress against this target on several occasions during this Parliament, expressing concern about the measurement and verification of reported savings, particularly in relation to the issue of whether service standards have been maintained. In this year’s Budget, the Government announced that, by December 2007, departments and local authorities had reported delivery of efficiency savings with an annual value of over £23 billion. At the same time, the Government rejected our previously expressed doubts regarding service standards:

The Government does not accept that there are unresolved issues concerning the effects of the current Efficiency Programme on service delivery. All efficiency initiatives in the SR04 Programme have associated balancing quality measures to
monitor service output and no efficiency gain will be scored as ‘final’ until maintenance of service quality is evidenced.247

68. The Government stated that, of the savings of £23 billion reported by December 2007, 87% were already classified as ‘final’.246 Treasury officials indicated that such a classification often arose from a dialogue between individual departments and the Treasury.249 In subsequent written evidence, the Treasury said that its “challenge process looks at a range of issues including whether service quality is being robustly measured”. The Treasury confirmed that, in the case of any gains that were not robust and or where it had not been demonstrated that quality had not been affected, the gains would not be counted. The Treasury stated that it was too soon in the process to provide examples of disallowed gains.250 However, Treasury officials also said that “we will certainly make available all the evidence when we finally say that we have or have not met the targets”.251

69. In a recent Report, we examined the transfer of responsibility for oversight of the efficiency programme from the Office of Government Commerce (OGC) to the Treasury, concluding that:

we are not convinced that the Treasury’s Public Spending Directorate is suitably placed to play an effective role in supporting and challenging departmental efficiency programmes. It is not evident that a role in questioning the validity of claimed efficiency savings is compatible with the task of ensuring that public spending limits are adhered to.252

Our concern was echoed by Professor Talbot, who argued that “the shift of responsibility for overseeing the programme into HM Treasury in the name of ‘mainstreaming’ removes what was clearly a useful ‘check and balance’ in the semi-independent role which OGC played”.253 An effective oversight role is essential to the overall credibility of the programme, to which Professor Talbot also referred:

The Gershon programme probably has produced substantial savings and these are probably bigger than any similar programme in the past 20–30 years but the combination of questionable reporting and over-ambition has undermined the public credibility of the effort.254

In reporting the final outcome of the 2004 efficiency programme, it will be crucial that the Treasury provides convincing evidence that the gains reported as ‘final’ have been achieved without a diminution of service standards. The credibility of such evidence

247 HC (2007–08) 428, p 2
249 Q 294
250 Ev 62
251 Q 293
252 Treasury Committee, Seventh Report of Session 2007–08, Administration and expenditure of the Chancellor’s departments, 2006–07, HC 57, para 51
253 Ev 72
254 Ev 71
would be enhanced by the reporting of instances where savings have not been included within the final reported total because such evidence has not been provided. The completeness and transparency with which the final outcome of the programme is reported will be an important test of whether HM Treasury can perform the roles of challenge and oversight in relation to the programme previously undertaken by the Office for Government Commerce.

Measuring efficiency in the period 2008–09 to 2010–11

70. For the period from 2008–09 to 2010–11, the Government has set a target of savings with an annual value of £30.54 billion to be achieved by the last of those years. All of the savings must be cash-releasing and measured net of implementation costs, leading us to characterise the targets as “stretching and highly ambitious” in our Report last November on the 2007 Comprehensive Spending Review.\(^{255}\) In the same Report, we called for clarification of the method for calculating baselines for monetary savings.\(^{256}\) The Government response explained that each department’s baseline was “generated from their respective 2007–08 near-cash resource Departmental Expenditure Limits (DEL) plus capital DEL baselines, minus depreciation and minus any grants to local government, with minor other adjustments in some cases”. The Government stated that the efficiency target in percentage terms was calculated by multiplying the baseline by 1.03\(^3\) and then deducting the baseline total.\(^{257}\) However, the Value for Money Delivery Agreements indicated that departments are using different methods for calculating the savings achieved. For example, in the case of HM Treasury, the minimum projected savings have been calculated as the difference between projected programme expenditure and so-called “counter-factual” expenditure based on a ‘do nothing’ scenario of baseline costs increasing by general inflation.\(^{258}\) The Department for Work and Pensions has used a different method for calculating its “counter-factual spending profile”, assuming that pay will increase in line with the pay remit and that other costs will rise in line with current estimates of GDP growth.\(^{259}\)

71. Further issues relating to the measurement and classification of efficiency savings in the coming years have emerged from the recently-published Value for Money Delivery Agreements. The Ministry of Defence included within its projected “efficiency” savings spending reductions that would come from, for example, “gradual reductions in Gazelle helicopter flying hours, reflecting their lack of utility on military operations”, and from “accelerated withdrawal of the Jaguar reconnaissance aircraft from service”.\(^{260}\) The Department for Environment, Food and Rural Affairs indicated that, within the Animal Health and Welfare programme, savings of £120.88 million would be generated through a variety of mechanisms including “transfer of full or partial costs to industry where the

\(^{255}\) HC (2007–08) 55, paras 18–25

\(^{256}\) Ibid., paras 17, 21

\(^{257}\) HC (2007–08) 428, p 1

\(^{258}\) HM Treasury, Value for Money Delivery Agreement, December 2007, para 2.5

\(^{259}\) Department for Work and Pensions, 2007 CSR Value for Money Delivery Agreement, p 8, para 3.1.1

\(^{260}\) Ministry of Defence, Value for Money Delivery Agreement, p 7
activity is of clear benefit to the industry itself and charging—again for activities in these instances which are of clear benefit to the individual recipient of that service”. 261 We raised with the Chancellor of the Exchequer the question of whether the label of efficiency might be applied to what were in fact service reductions. He emphasised the primary role of individual Secretaries of State in reaching such judgements and said that each case had to be examined on merits. 262 However, he also saw a role for the Treasury as part of an “iterative” process: “You cannot leave everything entirely to a department any more than you can leave everything to the Treasury because unless the department owns the decision, in my experience, not a lot will happen”. 263 He indicated that he would be “happy to return to the subject” of how efficiency gains were measured. 264

72. Professor Talbot suggested that measurement problems in the new Value for Money Delivery Agreements seemed “acute”. 265 Our predecessors noted that the Efficiency Technical Notes that were the precursor of such Agreements were examined by the National Audit Office prior to publication against agreed criteria relating to clarity of savings, measurement methods, data quality, service continuity, and readability. 266 There are a number of unresolved measurement issues relating to the efficiency programme for the period from 2008–09 to 2010–11. We recommend that, in its response to this Report, the Government—

- set out the value for money baselines for each department;
- explain whether a consistent method is used for calculating “counter-factual” expenditure increases and, if not, why not;
- set out the circumstances in which it is appropriate to treat reductions in service as efficiency savings; and
- clarify the circumstances in which a net reduction in expenditure arising from a transfer of costs to the private sector by charging or other means constitutes an efficiency saving.

We further recommend that the Government invite the National Audit Office to examine the published Value for Money Delivery Agreements and that the Government consider the case for publishing updated and improved Agreements in the light of such examination.

The Saving Gateway

73. The Saving Gateway is a cash saving account for those on lower incomes which provides a financial incentive to save through “matching”, whereby the Government makes

261 Department of Environment, Food and Rural Affairs, Defra Value for Money Delivery Agreement, February 2008, p 4
262 Qq 387, 390
263 Qq 392, 394
264 Q 396
265 Ev 72
a specified contribution for each pound saved by the account holder up to a certain limit.\textsuperscript{267} The Saving Gateway was first proposed by the Government in April 2001. An initial pilot project ran for 18 months from August 2002. In the 2004 Pre-Budget Report, the then Chancellor of the Exchequer announced that there would be a second pilot project beginning in 2005, which ran with six variant forms between February 2005 and March 2007 in five pilot areas. In January 2005, our predecessors looked forward to “the Government moving as quickly as possible … to national availability of the Saving Gateway scheme”.\textsuperscript{268} We have considered the Saving Gateway twice in the present Parliament,\textsuperscript{269} concluding that “the introduction of a national Saving Gateway would be the most important single step towards achieving the aim of increasing the level of saving among low-income individuals and households”.\textsuperscript{270} In the 2008 Budget statement, the Chancellor of the Exchequer announced that the Saving Gateway would be launched nationally, with the first accounts available from 2010.\textsuperscript{271} He told us that “the idea of the Saving Gateway is a very important one where we help people who historically have not saved get into the savings habit”.\textsuperscript{272} When we asked him why the scheme would not be ready for national implementation prior to 2010, he identified issues both of practical implementation—stressing the potential difficulties arising from quick implementation—and affordability—“I have to make sure I have the money to pay for it”.\textsuperscript{273}

74. The overall costs of the scheme will depend crucially upon the final decision on the level of matching. The Government’s consultation document accompanying the Budget indicated that the Government had yet to come to a view on this matter.\textsuperscript{274} The first Saving Gateway pilot project was based on the simple proposition that, for each pound invested by an individual up to £25 per month over the 18–month period of the account, the Government would itself pay a pound into that account. However, the final evaluation of the second pilot project suggested that “the ideal match rate was thought to be around 50p for each £1 of matchable contribution, although the majority of participants accepted that a lower rate would be more appropriate for reasons of affordability”.\textsuperscript{275} Last year, we accepted that, on grounds of affordability as well as other grounds, a national Saving Gateway could be based on a level of matching lower than pound-for-pound, and that a lower level of matching might be effective in encouraging saving among low-income individuals and households. However, we noted that certain forms of saving by the highest income groups obtain subsidy through tax relief at an effective rate of 40%, and we


\textsuperscript{268} HC (2004–05) 138, para 77


\textsuperscript{270} HC (2006–07) 504, para 112

\textsuperscript{271} HC Deb, 12 March 2008, col 291

\textsuperscript{272} Q 357

\textsuperscript{273} Q 358

\textsuperscript{274} \textit{The Saving Gateway: operating a national scheme}, p 21, para 5.3

\textsuperscript{275} HM Treasury and Department for Education and Skills, \textit{Final Evaluation of the Saving Gateway 2 Pilot: Main Report}, May 2007, p 5
consider that the level of subsidy in percentage terms for those on the lowest incomes ought to be higher. On grounds of simplicity, we suggested that this argued for a rate of matching of 50 pence for every pound invested by the individual, although we also saw merit in the proposal that a pound-for-pound match rate might be set for saving in the initial two months of an account to encourage participation. We continue to believe that there is a strong case for matching under the Saving Gateway at the level of 50 pence for every pound invested by the individual, possibly with support for the opening months at the pound-for-pound level. We recommend that, in advance of a final decision on matching rates, the Government publish estimates of the cost of implementation based on different levels of matching and associated estimates of take-up rates.

75. The cost estimates that we have just recommended be prepared could be based in the first instance on the Government’s proposals for eligibility. The Government envisages that eligibility for the national Saving Gateway scheme “will be ‘passported’ from qualifying benefits and tax credits”. With the exception of Incapacity Benefit, all the relevant benefits are means-tested. One of the lessons that the Government drew from the evaluation of the second pilot project was that a concentration on “people on lower incomes—up to around £15,000 household income as used in the first pilot—is about the right level”. If eligibility were extended up the income scale, savings would start to be reallocated from existing savings schemes into the Saving Gateway, creating significant “deadweight” in terms of the Government subsidy. The Government confirmed that the Saving Gateway was targeted on the working population:

People who are retired will not be eligible as other forms of support are in place for those who are retired and on low incomes, such as the Pension Credit and the winter fuel allowance. Students are able to access financial support through student loans and maintenance grants.

76. However, even with regard to the working population, the use of “passporting”, while administratively convenient, excludes from eligibility significant numbers of individuals on low incomes. The Treasury enumerated such individuals, as follows:

- 0.5 million in the category of “those on low incomes, in work, aged 18–25 who do not qualify for [Working Tax Credit]”;
- 0.7 million in the category of those working 16 to 30 hours a week not eligible for Working Tax Credit; and

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276 HC (2006–07) 504, para 106
277 The Saving Gateway: operating a national scheme, Executive Summary, p 3. The qualifying benefits and tax credits are Working Tax Credits, Child Tax Credits paid at the maximum rate, Income Support, Incapacity Benefit or Employment Support Allowance, Severe Disablement Allowance and Jobseeker’s Allowance.
278 Q 75
279 HC (2006–07) 504, para 102
280 Ev 62
281 Ibid.
282 Qq 75–76, 194
- 2.7 million in the category of those “eligible for a qualifying benefit but [who] do not take it up”. 283

The Government stated that:

> to bring these groups into eligibility for the scheme it would be necessary to set a separate income and asset test for those who do not qualify through ‘passporting’ but think they have income and assets low enough to qualify … A separate income and asset test would detract from the simplicity of ‘passporting’ and may act as a further barrier to helping individuals on low incomes to save. It would also not be possible to put the necessary computer systems in place to do this in time for the introduction of the scheme in 2010. 284

The Chancellor of the Exchequer did not rule out the possible extension of the Saving Gateway. 285 We believe that, should the Saving Gateway be extended in future, the first priority should be to extend eligibility to those who would qualify initially in terms of income, but are not in receipt of a qualifying benefit or tax credit. The initial availability of the Saving Gateway only to those claiming qualifying benefits and tax credits reinforces the importance of Government efforts to increase take-up of tax credits to which we referred earlier. We recommend accordingly that the Government consider measures to link promotion of the Saving Gateway with the wider promotion of the availability of tax credits.

77. Mr Chote raised the concern that the Saving Gateway might not attract net new saving among the target group if financial providers offered to lend people money to invest in a Saving Gateway account:

> There is obviously this issue that they have to deal with in terms of rolling this out in that how do they stop people effectively borrowing, they go along to a financial provider who says, ‘Fine, we will lend you the money and you can then go and get the match for this and you can pay us back, you are better off and we are better off’, but that is not achieving what the Government wants to. 286

We recommend that the Government set out, in its response to our Report, its proposed methods for ensuring that Saving Gateway does not operate so as to provide incentives for financial providers, particularly unregulated financial providers, to lend money at high interest rates to encourage those eligible simply to borrow in order to save in Saving Gateway accounts.

78. The Government proposes that providers of Saving Gateway accounts should pay a return on balances held by savers. This return will generally be in the form of interest, although credit unions offering Saving Gateway accounts may pay a dividend unless our recommendation that credit unions be able to pay interest has been implemented by

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283  Ev 62
284  Ibid.
285  Q 357
286  Q 74
2010. Treasury officials confirmed that it was currently envisaged that interest payments would be taxable, while pointing out that many of those eligible would be below the tax threshold. The Chancellor of the Exchequer indicated that he would keep the taxation of interest on Saving Gateway accounts under review, while pointing out that the Government would be supporting those accounts through matching. Although we accept that many of those with Saving Gateway accounts will not required to pay tax on the interest earned, we believe that both the simplicity of operation and the appeal of the Saving Gateway would be assisted if it were offered on a tax-free basis. To assist the public debate on this matter, we recommend that, alongside the cost estimates that we have previously called for, the Government set out its forecasts of the total tax receipts from interest on Saving Gateway accounts.
6 Tax measures

Capital gains tax

79. The 2007 Pre-Budget Report announced proposals for a new capital gains tax (CGT) regime under which the previous structure of reliefs and allowances—principally, taper relief 290 and the indexation allowance 291—would be abolished and replaced with a single universal rate of 18%. 292 During our inquiry into last year’s Pre-Budget Report, we were told that tax simplification was the key aim of this policy. 293 We discovered that, although there had been consultation on tax simplification, there had been no discussion about the abolition of taper relief prior to its announcement in that Pre-Budget Report. We recommended that the Government clarify on which points it was prepared to consider the representations of affected parties and set out how it intended “to mitigate the effects of the withdrawal of taper relief … with especial reference to small businesses.” 294 In the two months following the announcement, the Chancellor of the Exchequer signalled that he would not change his policy on abolition of taper relief and indexation allowance. In its response to our Report on the on the 2007 Pre-Budget Report, the Government stated that it did not generally consult on changes to tax rates, but went on to state that:

following the announcement of capital gains tax changes at the Pre-Budget Report a dialogue was entered into with a wide range of interested parties. HM Revenue & Customs immediately engaged with individuals in the accounting and tax professions in order to inform the eventual legislative approach. HM Treasury received representations from a number of groups and hosted constructive discussions with representatives of the business community on different aspects of the proposed changes. 295

Following this consultation process, the Chancellor of the Exchequer made a further statement on 24 January 2008, when he announced the introduction of an “Entrepreneurs’ Relief”, designed to mitigate the negative effects of the abolition of taper relief for small businesses. 296 The Treasury explained in the 2008 Budget document that the entrepreneurs’ relief would “be available on the disposal of a trading business or shares in a trading

290 Taper relief reduces the taxable proportion of the capital gain, depending on how long the asset has been held by the seller and whether the assets are classified as “business” or “non-business” assets: see HC (2007–08) 54–I, para 34

291 The indexation allowance was introduced to reduce the taxable gain on the sale of an investment bought between 31 March 1982 and 5 April 1998. This was achieved by increasing the base cost of the asset/investment in line with inflation over the holding period. The allowance was replaced by taper relief after April 1998. Assets acquired between 1982 and 1998 would therefore have the taxable gain reduced by both the allowance and taper relief.

292 Pre-Budget Report and Comprehensive Spending Review 2007, p 90, para 5.79

293 HC (2007–08) 54–I, para 45

294 Ibid., paras 41, 56


296 HC Deb, 24 January 2008, cols 1627–1628
company … This will reduce the effective tax rate to 10% for up to the first £1 million of gains made over a lifetime.”

80. The Institute of Chartered Accountants in England and Wales (ICAEW), the Institute for Fiscal Studies and Mr Whiting all welcomed the relief, but drew attention to the problems that had been caused by the lack of consultation prior to the 2007 Pre-Budget Report and the confusion that had followed. Mr Whiting argued that the lesson to be learnt from the Budget was that “the way to do it is consult before and decide on the changes afterwards”. He went on to say that:

in the end we may have got to a reasonable result, but it has not been a very good way of managing change … we have had a variety of clients and a variety of situations wanting to know what was going to happen … and taking action before or after 5 April to make the most of the possible changes or to avoid the tax increase. So it has distorted a certain amount of business decision-making … it has accelerated deals, it has decelerated deals, it has taken people’s minds off perhaps just progressing the business they were doing.

Mr Chote added:

Clearly there was scope for consultation here. The very fact the Chancellor said there will be time for people to arrange their affairs, implies this was not something which needed to be done at 6 o’clock on the day you announced it for fear of reaction. But then to basically give people time to arrange their affairs and then within a matter of days to cave in to concern from next door and from the CBI and then to throw up uncertainty about what the system will look like, promise clarification before the end of the year, not give it until January, is not a process designed to give a good planning environment for business or indeed for anybody else.

81. As a result of these delays, there have been calls for either a postponement of the implementation of the new policy or for transitional arrangements. The ICAEW believed that “the move to a flat-rate CGT would have been assisted by improved transitional rules, either by grandfathering existing reliefs and/or providing taxpayers with a longer period to reorganise their affairs”. The Chancellor of the Exchequer rejected the case for a delay in implementation or for the establishment of transitional arrangements:

Some people said, ‘Look, put the thing off’ but a lot more were saying, ‘Whatever you do, we would like to know what the position is’. When you think about it, if you have somebody in business who wants to make plans, if we had said we would not make our mind up until March 2009 I do not think that would have been desirable.

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297 Budget 2008, p 67, para 4.42
298 Qq 100, 102
299 Q 102
300 Ev 75. See also The Green Budget 2008, pp 229–232.
301 Q 397
The entrepreneurs’ relief was intended to mitigate the unintended consequences of the abolition of taper relief on small businesses. However, as we noted in our Report on the 2007 Pre-Budget Report, there are other groups who may also be adversely affected by the changes to the CGT regime. Employee shareholders on Save As You Earn schemes were one group mentioned in our Report. The Chancellor of the Exchequer confirmed in evidence that employee shareholders would not be able to take advantage of the entrepreneurs’ relief. The Association of British Insurers (ABI) has claimed that the changes to the CGT regime will have a severe effect on sales of insurance bonds. The ABI claimed that “advisors could no longer safely propose the purchase of insurance bonds … This was due to insurance bonds being put at a real disadvantage, not just due to a problem of consumer perception.” Mr Whiting argued that this would lead to a higher tax levy for “an insurance-based product as against direct investment”. In response to such concerns, the 2008 Budget stated that “the Government does not see the need for any change to the taxation of life insurance bonds as a result of CGT reform”. When we asked the Chancellor of the Exchequer why he had listened to the concerns of small businesses but ignored other groups potentially affected by the reform of CGT he told us that:

I did not ignore it … whatever solution they came up with, whilst it might have sorted one particular category of life policies, it would have in some cases an adverse effect on others … When I looked at the amount of sales that were affected and at what was happening in the market generally, I do not think the position was quite as clear-cut. The real clincher is that what we were being asked to do could have run the risk of perhaps—and I only say perhaps—sorting one problem only to discover we opened up another problem. I think it is best to try and avoid doing that.

Another aspect of the new CGT regime that was raised with the Committee was the challenge posed by the policing of the new entrepreneurs’ relief. The main innovation of the relief is that it is limited to £1 million over the taxpayer’s lifetime, rather than applying to a particular transaction. Talking about the “lifetime” element of the relief, Mr Whiting suggested that the very interesting question … [is] how they are going to keep track of it, because we certainly see a practical problem in keeping track of where you or I in our own individual situations are on the £1 million allowance. Conceptually, it sounds easy, but there is a deal of record-keeping to be followed for this which does create an administrative burden.

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302 HC (2007–08) 54–I, paras 51–52
303 Qq 400–402
305 Association of British Insurers, Letter to the Chancellor of the Exchequer, 14 February 2008, p 1
306 Q 104
307 Budget 2008, p 67, para 4.42
308 Q 399
309 Q 103
When we put this to the Treasury officials and pointed out that this was a considerable increase on the present requirement to hold records for six years, they stated that they did not see any problems with implementing this aspect of the entrepreneurs’ relief:

The million pounds [limit] will be policed by having people who have used any part of the million pounds [keeping] a running tally of how much of the million pounds they have used … The reality in that situation is that both will keep records, the taxpayer and HM [Revenue & Customs] … [if] people who take advantage of the entrepreneur’s relief … do not use up the full million pounds the first time they use it, then they will have to keep a tab of how much of the million pounds they have used.310

We welcome the announcement of the entrepreneur’s relief, which responds to some of the concerns which we voiced in our Report on last year’s Pre-Budget Report. However, we believe that significant new record-keeping challenges could be posed by the new relief, and that it is important that HM Revenue & Customs gives full and early advice to potential beneficiaries of the relief and their advisers about these challenges. We note that the entrepreneur’s relief does not resolve all the problems created as side-effects by the changes to the capital gains tax regime. We believe that, if the Government is seeking further to simplify taxation for small businesses, it will need to undertake a broader review and consultation which examines the fundamentals of the tax regime.

The tax treatment of residence and domicile

84. In last year’s Pre-Budget Report, the Chancellor of the Exchequer announced plans for a new series of measures relating to the tax treatment of residence and domicile. These included the levy of an annual charge of £30,000 and the loss of personal tax allowances for non-domiciled taxpayers using the remittance basis on their worldwide income and gains, where those income and gains total more than £1,000 annually.311 As we noted in our Report on the 2007 Pre-Budget Report, it was somewhat unclear which areas of this policy were open to consultation and we recommended that discussion with interested parties should take place as soon as possible.312 The Government’s response to our Report stated that:

On 6 December the Government announced the launch of a consultation on the residence and domicile rules and practices that govern personal taxation … Paying a Fairer Share: A Consultation on Residence and Domicile considered whether more could be done to increase fairness without damaging competitiveness by looking at a number of approaches which would require people who have been resident in the UK for longer than ten years to make a greater contribution. The consultation closed

310 Qq 250, 252–253
311 The remittance basis is a method of paying tax on overseas earnings, available to Non-domiciled residents, whereby income and gains originating overseas are taxed only when they are remitted back to the UK in whatever form.
312 HC (2007–08) 54–I, paras 67–72
on 28 February and the Government’s response is published today [12 March 2008].

The consultation resulted in a number of changes to the initial suggested policies, including the doubling of the annual de minimis limit to £2,000, and the fixing of the annual charge at £30,000 for the duration of this Parliament and the next. The CBI welcomed the fact that the Government had

recognised and acted on several of the concerns in this area. Worthwhile changes to core aspects of the proposals include leaving alone gains and income from assets in trusts kept offshore, and pledging to avoid double taxation issues. All of this will soften the impact.

85. In looking at the revised policy on residence and domicile announced in the 2008 Budget, it is important to distinguish between the two key aspects of the change—the £30,000 annual charge and the loss of personal tax allowance. Both of these measures affect those who have over the de minimis limit of annual unremitted foreign income and gains over £2,000, but there are different qualifying periods of residence. The £30,000 charge is payable only by adults who have been resident in the UK for more than seven of the last 10 tax years and meet the de minimis limit. However, the loss of personal tax allowance affects all who meet the unremitted foreign income limit without reference to any minimum period of residence in the UK. Consequently, anyone who has unremitted foreign income and gains of over £2,000 would lose the right to a personal tax allowance on their UK earnings. The Treasury implied that the only way in which a taxpayer could breach the de minimis limit would be to have savings capital of around £40,000 overseas. However, as Mr Whiting pointed out, the limit does not only apply to interest on capital savings or investments overseas, but could also be breached from letting a property in a foreign country, or from relatively short periods of temporary work in the home country, for example, in a summer job. For those non-domiciled taxpayers who are liable to pay the £30,000 annual charge, the choice of whether to pay the charge or remit all their worldwide income to the UK—hence, paying UK tax on all their income and gains—is made each year, and their decision will be made on the basis of how much foreign income and gains they have earned during that year. Therefore, as the Chancellor of the Exchequer noted, unless the taxpayers were remitting to the UK over £85,000 a year, it would not be worth their while to pay the £30,000 charge.

86. Mr Whiting identified three separate groups of non-domiciled taxpayers who would be affected by very different issues: the extremely wealthy; the middle-income expatriate professionals often working for multinational companies; and the low-income non-
professional workers.\textsuperscript{320} For the first group, Mr Whiting argued that the £30,000 annual charge and loss of personal allowances were less likely to be a problem.\textsuperscript{321} Instead, he thought that the main issue in relation to them would be the incentive it might provide for them to leave the United Kingdom. He said:

In all honesty, nobody knows exactly how many people will leave. People are undoubtedly considering leaving and some are leaving; the volume we do not know. Undoubtedly the changes announced in the Budget have reassured a cadre of people; they have been helpful. Whether they have gone far enough to really stem any exodus remains to be seen, because … one of the impacts there has been is a loss of confidence and a feeling amongst the non-domiciled community that the UK no longer wants them in the way they once did.\textsuperscript{322}

In the case of the middle-income group, Mr Whiting was concerned that employers would bear the burden, thus making the United Kingdom a less attractive place to do business.\textsuperscript{323} The group which has received the least attention in the debate over the residence and domicile policy is that of the low-income non-professional workers characterised by Mr Whiting as “the archetypal Polish plumber or Romanian farm-worker or sandwich-bar worker”.\textsuperscript{324} Such workers are often paid wages through the PAYE system, but are not registered as non-domiciles. As such, they could be considered as “non-domiciled taxpayers” and—after 6 April 2008—may well become unwittingly in breach of the \textit{de minimis} limit. As Mr Whiting explained, this group are paying their UK taxes but probably do not even know they are non-domiciled because they do not know the term, they do not realise potentially they are about to lose their personal allowance, they certainly do not have any advisers, and if they were to go to HM Revenue & Customs—and let us be realistic we are talking about potentially millions of them—I very much doubt whether HM Revenue & Customs are the least bit geared up to help them. In other words, what we are looking at is unwitting non-compliance by a large group of people at the bottom end of the income scale.\textsuperscript{325}

Mr Whiting estimated that this group was the largest of the three cadres of non-domiciled taxpayers to which he had referred.\textsuperscript{326}

87. When we asked the Treasury how many non-domiciled taxpayers it had estimated would leave the UK, it responded that “at the time of the consultation our working assumption was that 3,000 people would leave. This is broadly still the case.”\textsuperscript{327}
Treasury also told us that not all the 3,000 non-domiciles would be wealthy individuals.\(^{328}\) When we asked Treasury officials whether HM Revenue & Customs could cope with a very large number of foreign taxpayers seeking advice, particularly in view of the language barrier, they responded that they did not doubt the ability of HM Revenue & Customs to cope.\(^{329}\) However, the Treasury subsequently stated that “Currently our data shows that around 80,000 remittance basis users have UK employment income. We expect this to stay broadly the same following the changes announced at Budget.”\(^{330}\) This contrasts markedly with Mr Whiting’s estimate of “potentially millions”, possibly due to the fact that the Treasury’s figure relates to the 80,000 remittance basis users at present, rather than the “unwitting” non-domiciled taxpayers. When we asked the Chancellor of the Exchequer about potential risks of his new residence and domicile policy he stated that:

I do not want people to leave this country, far from it. Our country’s wealth over the last few years, and especially over the last ten years or so, has been substantially enhanced by people coming from all over the world, choosing to live and work here. Some will come for a short period, and of course until you have been here for seven years this [£30,000] measure does not affect you at all and I think it would have been quite wrong to impose a charge from day one as some have proposed. These people contribute substantially.\(^{331}\)

88. We are concerned that, as a result of the focus on wealthy individual non-domiciles, there has been insufficient consideration of the possible impact of tax changes announced in the Budget on the middle and lower income groups of non-domiciled taxpayers. Due to the complex nature of the policies on domicile and residence, and the distinction between how liability is incurred for the annual £30,000 charge and the loss of personal tax allowances, we are concerned that the new policies will create a group of non-domiciled taxpayers who would be unwittingly in breach of the new law. We are also not convinced that sufficient consideration has been given to the possible further burden that the measure will place on HM Revenue & Customs. We recommend that the Government, in its response to this Report, summarise the steps being taken by HM Revenue & Customs to deal with the potentially large number of foreign workers who may be seeking tax advice, following the implementation of the new policy. We intend to monitor the tax domicile regimes now proposed to be, or actually, created in a number of other tax jurisdictions. We believe that the Government should undertake a wider review of the off-shoring of both individuals and companies.
Environmental taxation

The motives behind environmental taxation

89. The 2008 Budget reiterated the Government’s view that “Tackling climate change is the most serious and pressing global environmental challenge the world faces”.

The Budget then went on to state that it set out “new policies to reduce emissions across all major sectors of the economy”.

Mr Whiting accepted that there were a number of “good and worthy” environmental measures in the Budget, but considered:

What is lacking is a clear statement, a clear framework, by Government which says … ‘Are we raising money by environmental duties or are we changing behaviour?’ … to give business in particular the confidence that is the intention because, after all, business needs a little time to adapt and to follow what Government wants.

The CBI believed that the Government was approaching environmental taxes “in completely the wrong way”, arguing that the primary aim of environmental taxes should be to change behaviour, and not to raise revenue. Where revenues were raised as a side-effect of well-designed and objectively-justified tax reforms, continued the CBI, they should either be used specifically for environmental purposes, or balanced by offsetting tax reductions so that the overall tax burden is left unaffected. The CBI was “particularly disappointed” that the 2008 Budget measures were not revenue-neutral, and claimed that “revenue-raising appears to be a major motivating factor”.

Aviation

90. Aviation currently accounts for 6.3% of the UK’s carbon dioxide emissions, but this is projected to rise to as much as 21% by 2050. The Government has repeatedly expressed its commitment to ensuring that the aviation industry expands in an environmentally sustainable way, and that it pays the external costs of its activities, as well as contributing fairly to public services.

The 2007 Pre-Budget Report announced that air passenger duty would be replaced by a duty payable per plane, from 1 November 2009.

We welcomed this announcement, urging the Government to ensure that freight and private planes be included in the new framework, and that the new duty offers clear incentives for the aviation industry to invest in cleaner fleets.

Details of the revised duty will not be finalised until the Government’s consultation period ends on 24 April 2008, but the Treasury has already decided how much revenue it will collect when the duty is introduced in 2009. The Government announced in this year’s Budget that revenues from the duty in

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332 Budget 2008, p 89, para 6.1
333 Ibid., p 92, para 6.4
334 Q 112
335 Ev 81
336 Budget 2008, p 99, para 6.38
337 Pre-Budget Report and Comprehensive Spending Review 2007, p 123, para 7.56
the second full year of its operation would be 10% higher than had been forecast in the 2007 Pre-Budget Report “in order to strengthen the environmental signal”. Mr Chote commented that the 2007 Pre-Budget Report gave “a strangely precise amount of revenue … from what was a very vague plan at that stage, and now we have a very precise number increased by 10%, for reasons which do not seem very obvious. The CBI questioned the motives of the Government more explicitly:

the Budget announcement that tax revenue from the new duty will increase by 10% in the second full year of operation seems to confirm fears that the government sees this primarily as a revenue-raising exercise, rather than a genuine attempt to change behaviour. This increase is likely to be less obvious to the individual consumer than it would have been had the existing ‘per passenger’ tax been retained, and as such can be thought of as another element of the government’s ‘stealth tax’ agenda.

Vehicle excise duty

91. The King Review of low-carbon cars, published alongside the 2008 Budget, suggested that drivers could reduce carbon dioxide emissions and fuel bills by up to 25% by choosing the most efficient vehicle within the relevant group. The Review concluded that the technology existed to reduce the average carbon dioxide emission of new cars to 100g per km by 2020. In this year’s Budget the Government announced a reform to the structure and rates of vehicle excise duty (VED) “in order to support this target, and strengthen the environmental incentive to develop and purchase fuel-efficient cars”. By 2010–11, there will be thirteen VED bands (instead of the current seven), with rates ranging from zero for the cleanest cars to £455 per year for cars emitting more than 255g per km of CO₂. The Budget explained that the differential in VED between the most and least polluting cars would increase, so that making a small change in car emissions had a greater financial impact. Newly-registered cars will be subject to a first-year rate from 2010 which, for the cars producing the most emissions will be £950. The Budget’s rationale for this charge was “to influence purchasing choices”. Treasury officials confirmed that approximately 50% of new car buyers from 2009 would be better off, 20% of new car buyers will be neither better nor worse off and 30% would have to pay more to tax their cars. The CBI welcomed the Government’s broad approach on green taxation in relation to cars, but warned that the pace and scale of the proposed new car taxes would present “a sting in the tail” for some manufacturers. In their view, both business and the wider public would buy into the environmental agenda if ‘carrots’ as well as ‘sticks’ were used in the Government’s

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339 Budget 2008, p 99, para 6.38
340 Q 113
341 Ev 81
342 Budget 2008, p 96, para 6.27
343 Ibid., p 96, para 6.28
344 Ibid.
345 Qq 257–258
attempts to force behavioural change. Dr Weale argued that, if the Government really wanted to change people’s actions, it would simply increase road fuel duty:

I find myself asking, ‘Yes, there is some discouragement now to owning cars which use a lot of fuel’ but actually what does the Treasury, what do HM [Revenue & Customs], think the implications would have been if instead vehicle excise duty had been abolished and the revenue entirely collected through fuel duty? My guess is that that change would do a lot more to reduce carbon emissions, perhaps not in the short run but in the medium term.

Road fuel duty

92. It is the Government’s policy that “fuel duty rates should rise each year at least in line with inflation as the UK seeks to reduce polluting emissions and fund public services”. In this year’s Budget the Government announced a postponement of six months to the 2 pence per litre increase in road fuel duty scheduled for April 2008, but also announced an above-inflation increase for 2010–11. The Chancellor of the Exchequer’s reason for the delay was “quite simply because in the current circumstances when people are facing increased costs and given the fact that the price of oil is so high at the moment, I thought it was the right thing to do”. The CBI observed that the decision to delay the 2p increase in fuel duties would be a welcome relief to hauliers, businesses and other motorists, particularly in light of recent increases in fuel prices. The CBI urged the Government to keep under review the proposed further half a penny rise from 2010, and argued that “in the longer term the Government needs to level out the playing field for UK hauliers to compete with their foreign counterparts who enjoy far cheaper fuel prices”. Mr Chote did not agree that delaying the 2p increase would be of significant benefit to the economy: “The justification for delaying is that you are doing that to support the economy. But saying that in a £1.4 trillion economy whether you raise Fuel Duty by £500 million now or in October is going to make a great deal of difference seems to me at odds with experience.”

Income shifting

93. In last year’s Pre-Budget Report, the Government announced its intention to consult on draft legislation designed to prevent a person arranging “their affairs to gain a tax advantage by shifting part of their income, from dividends or partnership profits, to another person who is subject to a lower rate of tax”, a practice referred to as ‘income shifting’ or ‘income splitting’. The Government argued that the vast majority of

346 Ev 81
347 Q 108
348 Budget 2008, p 97, para 6.30
349 Q 408
350 Ev 81
351 Q 60
352 Pre-Budget Report and Comprehensive Spending Review 2007, p 93, para 5.99
individuals could not shift their income and therefore income shifting was “unfair” and ran counter to the principle of independent taxation. The legislation was intended to operate alongside the existing rules on business deductions and settlements, and would have sought to remove the tax advantage obtained from income shifting. The Government stated that the legislation was “intended to apply to two forms of income: profits from a partnership; and company distributions, most commonly dividends”. Income from employment, interest on savings and any other source would not be affected. HM Revenue & Customs estimated in the 2007 Pre-Budget Report that the introduction of income shifting rules would generate about £260 million in 2009–10.

94. The introduction of such legislation had been widely expected following the ruling of the House of Lords against HM Revenue & Customs on 25 July 2007 in the case of Arctic Systems involving Mr and Mrs Jones. HM Revenue & Customs had previously lost its case in the Court of Appeal and as a result had appealed to the House of Lords. The case concerned dividend payments made to Mrs Jones by a company through which Mr Jones provided IT consultancy services. The view of HM Revenue & Customs was that the settlements legislation deemed the dividends received by his wife to be Mr Jones’s for income tax purposes. The House of Lords, however, ruled in favour of Mr Jones. On 26 July 2007, the Exchequer Secretary to the Treasury, Angela Eagle MP, made a Written Statement to the House stating that the Arctic Systems case had “brought to light the need for the Government to ensure that there is greater clarity in the law regarding its position on the tax treatment of ‘income splitting’ … It is the Government’s view that individuals involved in these arrangements should pay tax on what is, in substance, their own income and that the legislation should clearly provide for this. The Government will therefore bring forward proposals for changes to legislation to ensure this is the case.” The Government consulted on the draft legislation between December 2007 and February 2008, receiving over 260 responses.

95. The 2007 Pre-Budget Report had announced the Government’s intention to bring into effect from 6 April 2008 legislation to prevent a tax advantage being gained from income shifting. However, the Government announced in the Budget that, following the recent consultation on this issue, it had decided to undertake a further consultation and had postponed the introduction of legislation until the 2009 Finance Bill. The delay was in order “to ensure that the legislation in this area provides clarity and certainty”. Treasury officials told us that there had been “a considerable misunderstanding as to the number of

353 HM Treasury, Income shifting: a consultation on draft legislation, December 2007, p 3, para 1.1
354 Ibid., p 13, para B.6
355 Pre-Budget Report and Comprehensive Spending Review 2007, p 93, para 5.99
356 Ibid., p 11, Table 1.2
358 HC Deb, 26 July 2007, cols 89–90WS
359 Income shifting: a consultation on draft legislation, p 9, para 2.1; Q 278
360 Budget 2008, p 126, para A.142
361 HM Treasury, Budget 2008 Press Notice No. 3: Income shifting
businesses that will actually be affected … the assumption [is] that 85,000 businesses will be affected.”

96. Mr Whiting thought that “the decision to postpone the impractical and unworkable income shifting proposals is very welcome”. He hoped that the opportunity would now be taken to have a “proper review of the principles of small business taxation. The result should be a taxation system that rests on practical, workable rules for the small business community, rather than resorting to a sticking plaster solution to the perceived problem.”

The ICAEW contended that the draft legislation had contained proposals that were “fundamentally flawed” and cautioned that “deferring the proposals for one year without a reconsideration of the underlying policy will merely defer the considerable implementation problems that will otherwise arise”. Furthermore, “the proposed legislation would have caused considerable administrative burdens upon businesses and a high level of uncertainty as to whether people were caught or not”.

97. Treasury officials believed that it was important to implement the income shifting rules correctly to ensure that “they act as a deterrent for those who are setting out to mitigate tax in a way which the Government does not intend and not as an administrative burden for ordinary small businesses”. The Chancellor of the Exchequer told us that he did not have “any problem with husbands and wives who are partners in a business and they are both working. It seems to me that it is absolutely right that we should recognise that through the tax system. Where you have the problem is where one of them is not doing any work at all.”

We were concerned that Directors in other types of business were not required to justify their salary based on the work they had undertaken and that the draft legislation appeared to place an unfair burden on family business. We asked the Chancellor of the Exchequer to explain why the draft income shifting legislation specifically targeted small family businesses, given that those wishing to avoid being affected by the new legislation could presumably shift their income to a person outside their family. The Chancellor of the Exchequer conceded that “trying to draft that legislation is difficult”. However he maintained that he could not “allow a situation to develop where more and more people can take advantage of something that is not open to the majority of people in this country, because I think that becomes unfair”. We welcome the Chancellor of the Exchequer’s decision to undertake a further consultation on the issue of income shifting. However, we are concerned that this proposed legislation would place an additional tax burden on small businesses and we note that it caused widespread concern during the previous consultation period. We recommend that the terms of the consultation be widened to

362 Q 278
363 Ev 64
364 Ev 74
365 Ibid.
366 Q 280
367 Q 416
368 Q 427
369 Ibid.
constitute a full review of the principles of small business taxation to ensure that the taxation system rests on practical, workable rules for the small business community.

**Double taxation treaties**

98. In this year’s Budget the Government announced that a measure would be introduced, with effect from 12 March 2008, to “clarify existing indefinitely retrospective legislation introduced in 1987 to counter double taxation treaty avoidance schemes. This will clarify that the wording of the UK’s double taxation treaties does not allow UK residents to avoid paying UK tax on their profits from foreign partnerships.”\(^{370}\) It was also announced that a further, more general, measure would be introduced to prevent tax avoidance through the misuse of double taxation treaties by UK residents.\(^{371}\) The double taxation treaties were designed to prevent UK residents from being taxed twice on overseas income. Mr Whiting told that abuse of these treaties had been widely known and that the practice had been popular with UK property developers who used the treaties to set up partnerships in the Isle of Man, with profits from UK developments made via the trust in order to avoid UK taxation. He told us that the abuse had “certainly been disclosed to HM Revenue & Customs” and he was surprised that HM Revenue & Customs had suddenly taken such far-reaching retrospective action to stop the abuse.\(^{372}\) He was concerned that it would set “a dangerous precedent for the integrity of the UK’s tax system”.\(^{373}\) He also told us that, if HM Revenue & Customs recovered tax on every case since 1987, the savings to the Exchequer would be in the order of “tens of millions” of pounds, but concluded that “to go back 20 years does seem to be a little too far”.\(^{374}\)

99. Treasury officials told us that:

> Following the introduction of the disclosure rules in 2004, it was disclosed that a number of individuals, particularly in the property industry, had been taking a different interpretation from that which had been announced in 1987 and were continuing, without any active presence in the Isle of Man and only having income in the UK, to be claiming that 99% of their income was effectively covered by the Isle of Man double tax treaty. The action that has been announced here is retrospective. It confirms what was set out quite clearly in 1987 and what was intended by the Isle of Man treaty when it was entered into.\(^{375}\)

We welcome steps taken by the Government to prevent tax avoidance through the misuse of double taxation treaties by UK residents. We are concerned by the suggestion that the Government has known about this abuse for some time and yet has failed to act. We recommend that the Government set out, in its response to this Report, when it was first alerted to the abuse, why action was not taken earlier and why it considers a

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370 *Budget 2008*, p 126, para A.140
371 Ibid.
372 Q 119
373 Ev 64
374 Qq 118–119
375 Q 245
21-year period of retrospection appropriate. We expect the Government to move swiftly to close future abuses of the tax system that are disclosed to them.
Conclusions and recommendations

The economy

1. We note that the lower boundaries of the Treasury’s forecasts for economic growth in 2008 and 2009 remain above the average of outside forecasters, and we are concerned that the Treasury has provided little evidence of analysis of upside or downside risk and specifically may have given insufficient weight to the risks of continued financial market turbulence and has failed to be more specific about the risks associated with such continued turbulence. The Treasury’s optimism is based on its contention that the UK economy is better placed than other OECD economies in the face of market turmoil. We remain concerned that some of the economy’s characteristics that have proven beneficial during past crises (rapidly rising residential property prices, close links with the US and an increasing reliance on the financial services industry, for example) might prove to be conduits through which the current problems in global financial markets are transmitted to the United Kingdom real economy. (Paragraph 11)

2. We note the establishment of a Working Group to examine market-led initiatives to improve liquidity in the mortgage-backed securities market. We expect to continue to monitor developments in asset-backed securities markets and their impact on housing finance. We believe that the Working Group should also consider any need for new mortgage support schemes for low-income homeowners in difficulty. We look forward to the Working Group reporting back to the Chancellor of the Exchequer in the Summer and producing a final report at the time of the 2008 Pre-Budget Report. (Paragraph 23)

3. We expect to continue to monitor endeavours by the Government and the Financial Services Authority to promote the supply of, and demand for, long-term fixed-rate mortgages. (Paragraph 24)

The public finances

4. There has been a further weakening of the Treasury’s forecasts of the current budget balance from 2008–09 onwards since last year and the latest forecasts for the fiscal position are based on forecasts for economic growth that are subject to considerable downside risks. (Paragraph 31)

5. In our previous recommendations in our Reports on the 2007 Budget and 2007 Pre-Budget Report, we argued that the Government should review the golden rule such that it becomes more forward looking and less dependent upon the dating of the economic cycle. The current inability of the Treasury to date the end of the economic cycle works against the positive attributes of a fiscal rule founded on judgements about economic cycles. We continue to believe that the golden rule should be more forward-looking, but, even on the Treasury’s own current formulation, it appears to us to be premature for the Treasury to state that it is “on course” to meet the golden rule in the next economic cycle, given the lack of an end date for the previous economic cycle. (Paragraph 34)
6. The Government has forecast that it will meet the sustainable investment rule over the period up to 2012–13. However, the margin by which it is now forecasting that it will meet the rule is extremely tight, especially considering the uncertainty surrounding the overall economic situation. (Paragraph 36)

7. It seems highly likely that, following the move to International Financial Reporting Standards for central government, the sustainable investment rule as currently defined and interpreted will be breached in 2009–10 as a result of the reclassification of PFI projects. As such, the delay announced in Budget 2008 in the implementation of International Financial Reporting Standards gives the Government a chance to announce in advance whether and how it proposes to revise the sustainable investment rule in the light of the implementation of International Financial Reporting Standards. We recommend that the Government publish in the 2008 Pre-Budget Report any proposed changes to the sustainable investment rule and its interpretation arising from classification changes resulting from International Financial Reporting Standards. (Paragraph 39)

8. We accept that Northern Rock’s inclusion within calculations of Public Sector Net Debt should not influence decision-making under the fiscal framework. It is nevertheless important that the Government reports transparently on the effects of Northern Rock in its forecasts of Public Sector Net Debt as a proportion of GDP. (Paragraph 41)

9. As we have noted already, the forecasts for the state of the public finances show further deterioration from 2008–09 onwards, and there are significant downside risks to the forecasts for economic growth. Should those risks crystallise, the Government would have extremely limited scope, under the fiscal rules as currently defined, to take further fiscal measures to support monetary policy. We expect to examine the role of the golden rule and of the sustainable investment rule in more detail in our inquiry into the 2008 Pre-Budget Report. (Paragraph 43)

**Child poverty, fuel poverty and the poverty trap**

10. We welcome the measures in the 2008 Budget on child poverty, which will make an important contribution towards reducing child poverty. We recommend that the Government, in its response to this Report, clarify the targets that have been set relating to child poverty since the pledge to eliminate child poverty in a generation was first made and report on performance against each of those targets in each financial year. We further recommend that that response set out the Government’s estimate of the effect of each measure relating to child poverty in this year’s Budget on progress towards the 2010–11 target in each financial year from 2008–09 to 2010–11. We remain concerned that the Government has yet to provide a clear explanation of the linkage between its target to halve child poverty by 2010–11 and the proposed deployment of resources to meet that target. It is of crucial importance that the Government makes it clear that the necessary resources to meet the 2010–11 target are available and that the Government is committed to deploying those resources directly to support low-income families. It is also important that the Government sets out the policy instruments under consideration to meet this target. (Paragraph 52)
11. It is important that the Government continues to tackle fuel poverty through a combination of targeted and universal measures. We look forward to a constructive outcome to continuing discussions between the Treasury and the energy supply companies, particularly with regard to lowering the differential in charges between those with pre-payment meters and those making other forms of payment. In view of the importance of measures announced in Budgets and Pre-Budget Reports to the progress of the targets to eradicate fuel poverty set by the Government itself and by the devolved administrations, we recommend that the Government report in Budgets and Pre-Budget Reports on the effect of any measures announced at that time on progress towards meeting fuel poverty targets. We further recommend that, in the 2008 Pre-Budget Report, the Government report specifically on:

- the outcome of its discussions with the energy supply companies;
- any legislative measures in this area under consideration; and
- its assessment of the effectiveness of the one-off increase in the winter fuel allowance for Winter 2008–09 in terms of progress in meetings its obligations relating to fuel poverty.

We expect to examine during our inquiry into the 2008 Pre-Budget Report whether the increase in the winter fuel allowance for 2008–09 and the additional measures proposed for the Winter of 2009–10 will be effective in reducing fuel poverty in line with the Government’s targets. (Paragraph 56)

12. The increase in the number of people facing marginal deduction rates of between 60% and 70% is a direct consequence of decisions made by Government as to how the tax and benefit system will work. We acknowledge that such decisions are finely balanced between the overall cost of a benefit, and the rate at which it is withdrawn. We recommend that the Government undertake further research into how the design of the tax credit system, in conjunction with the overall tax and benefit system, is enhancing or impeding progress on the Government’s welfare to work objectives, and report on such work in the 2008 Pre-Budget Report. We recommend that, as a basic principle, the Government ensure that high marginal deduction rates are limited wherever possible, and we will continue to keep this matter under review. (Paragraph 60)

13. Those most affected by the abolition of the 10 pence rate of income tax appear to be those below the age of 65 with an income under £18,500 who are in childless households. The effect is greatest on those households where no individual is above the age of 60 because the household does not then benefit from the higher winter fuel allowance. We accept that there are benefits in tax simplification and that there are merits to focus on both the needs of children and motivation to work. However, the group of main losers from the abolition of the 10 pence rate of income tax seem an unreasonable target for raising additional tax revenues to fund these and other initiatives. (Paragraph 61)

14. We are concerned by the poor take-up rate of working tax credit among eligible families without children, especially given that working tax credits are intended to mitigate for low-income households the effect of the removal of the 10 pence starting
rate of income tax. We expect the Treasury and HM Revenue & Customs to galvanise their efforts in this area in coming months and years. We recommend that the Government report regularly in Budgets and Pre-Budget Reports, starting with the 2008 Pre-Budget Report, on progress in increasing the take-up rates of working tax credits for those sections of society with particularly low take-up rates. We further recommend that the Treasury commission research into whether the withdrawal of the 10 pence income tax band and high marginal deduction rates are creating disincentives that could frustrate the Government’s welfare to work objectives. (Paragraph 62)

**Public expenditure issues**

15. We are disappointed that the Government has been forced to delay the implementation of International Financial Reporting Standards for the public sector until 2009–10, but not altogether surprised. The proposed timetable of one year for implementation was over-ambitious, and considerably more stretching than the five-year transition period enjoyed by the private sector. The Treasury appears to have misjudged the scale and complexity of the issues involved in the transition to International Financial Reporting Standards, in particular the issue of accounting for private finance initiative assets. (Paragraph 64)

16. It is important that momentum towards the implementation of International Financial Reporting Standards is maintained and, in that context, we welcome the Treasury’s assurance that those departments in a position to do so will produce shadow accounts on an International Financial Reporting Standards basis from 2008–09. We recommend that the Government, in its response to this Report, state whether those shadow accounts will be reviewed by the National Audit Office and whether the opinions of the National Audit Office on those shadow accounts will be made public. (Paragraph 65)

17. We are concerned about the potential for arbitrage between Financial Reporting Standard 5A and the Treasury’s Technical Note 1 on accounting for private finance initiative (PFI) assets, creating the potential for different interpretations of appropriate PFI accounting treatment. We recommend that the Treasury, in consultation with the Financial Reporting Advisory Board, seek to ensure that PFI accounting under International Financial Reporting Standards is implemented across the public sector in a consistent, effective and transparent manner. (Paragraph 66)

18. In reporting the final outcome of the 2004 efficiency programme, it will be crucial that the Treasury provides convincing evidence that the gains reported as ‘final’ have been achieved without a diminution of service standards. The credibility of such evidence would be enhanced by the reporting of instances where savings have not been included within the final reported total because such evidence has not been provided. The completeness and transparency with which the final outcome of the programme is reported will be an important test of whether HM Treasury can perform the roles of challenge and oversight in relation to the programme previously undertaken by the Office for Government Commerce. (Paragraph 69)
19. There are a number of unresolved measurement issues relating to the efficiency programme for the period from 2008–09 to 2010–11. We recommend that, in its response to this Report, the Government—

- set out the value for money baselines for each department;
- explain whether a consistent method is used for calculating “counter-factual” expenditure increases and, if not, why not;
- set out the circumstances in which it is appropriate to treat reductions in service as efficiency savings; and
- clarify the circumstances in which a net reduction in expenditure arising from a transfer of costs to the private sector by charging or other means constitutes an efficiency saving.

We further recommend that the Government invite the National Audit Office to examine the published Value for Money Delivery Agreements and that the Government consider the case for publishing updated and improved Agreements in the light of such examination. (Paragraph 72)

20. We continue to believe that there is a strong case for matching under the Saving Gateway at the level of 50 pence for every pound invested by the individual, possibly with support for the opening months at the pound-for-pound level. We recommend that, in advance of a final decision on matching rates, the Government publish estimates of the cost of implementation based on different levels of matching and associated estimates of take up rates. (Paragraph 74)

21. We believe that, should the Saving Gateway be extended in future, the first priority should be to extend eligibility to those who would qualify initially in terms of income, but are not in receipt of a qualifying benefit or tax credit. The initial availability of the Saving Gateway only to those claiming qualifying benefits and tax credits reinforces the importance of Government efforts to increase take-up of tax credits to which we referred earlier. We recommend accordingly that the Government consider measures to link promotion of the Saving Gateway with the wider promotion of the availability of tax credits. (Paragraph 76)

22. We recommend that the Government set out, in its response to our Report, its proposed methods for ensuring that Saving Gateway does not operate so as to provide incentives for financial providers, particularly unregulated financial providers, to lend money at high interest rates to encourage those eligible simply to borrow in order to save in Saving Gateway accounts. (Paragraph 77)

23. Although we accept that many of those with Saving Gateway accounts will not required to pay tax on the interest earned, we believe that both the simplicity of operation and the appeal of the Saving Gateway would be assisted if it were offered on a tax-free basis. To assist the public debate on this matter, we recommend that, alongside the cost estimates that we have previously called for, the Government set out its forecasts of the total tax receipts from interest on Saving Gateway accounts. (Paragraph 78)
Tax measures

24. We welcome the announcement of the entrepreneur’s relief, which responds to some of the concerns which we voiced in our Report on last year’s Pre-Budget Report. However, we believe that significant new record-keeping challenges could be posed by the new relief, and that it is important that HM Revenue & Customs gives full and early advice to potential beneficiaries of the relief and their advisers about these challenges. We note that the entrepreneur’s relief does not resolve all the problems created as side-effects by the changes to the capital gains tax regime. We believe that, if the Government is seeking further to simplify taxation for small businesses, it will need to undertake a broader review and consultation which examines the fundamentals of the tax regime. (Paragraph 83)

25. We are concerned that, as a result of the focus on wealthy individual non-domiciles, there has been insufficient consideration of the possible impact of tax changes announced in the Budget on the middle and lower income groups of non-domiciled taxpayers. Due to the complex nature of the policies on domicile and residence, and the distinction between how liability is incurred for the annual £30,000 charge and the loss of personal tax allowances, we are concerned that the new policies will create a group of non-domiciled taxpayers who would be unwittingly in breach of the new law. We are also not convinced that sufficient consideration has been given to the possible further burden that the measure will place on HM Revenue & Customs. We recommend that the Government, in its response to this Report, summarise the steps being taken by HM Revenue & Customs to deal with the potentially large number of foreign workers who may be seeking tax advice, following the implementation of the new policy. We intend to monitor the tax domicile regimes now proposed to be, or actually, created in a number of other tax jurisdictions. We believe that the Government should undertake a wider review of the off-shoring of both individuals and companies. (Paragraph 88)

26. We welcome the Chancellor of the Exchequer’s decision to undertake a further consultation on the issue of income shifting. However, we are concerned that this proposed legislation would place an additional tax burden on small businesses and we note that it caused widespread concern during the previous consultation period. We recommend that the terms of the consultation be widened to constitute a full review of the principles of small business taxation to ensure that the taxation system rests on practical, workable rules for the small business community. (Paragraph 97)

27. We welcome steps taken by the Government to prevent tax avoidance through the misuse of double taxation treaties by UK residents. We are concerned by the suggestion that the Government has known about this abuse for some time and yet has failed to act. We recommend that the Government set out, in its response to this Report, when it was first alerted to the abuse, why action was not taken earlier and why it considers a 21-year period of retrospection appropriate. We expect the Government to move swiftly to close future abuses of the tax system that are disclosed to them. (Paragraph 99)
Formal minutes

Tuesday 1 April 2008

Members present:

John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Mr Colin Breed
Jim Cousins
Mr Philip Dunne
Mr Michael Fallon

Ms Sally Keeble
Mr George Mudie
Mr Siôn Simon
John Thurso
Mark Todd

The 2008 Budget

Draft Report (The 2008 Budget), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 10 read and agreed to.

Paragraphs 11 and 12 read, amended and agreed to.

Paragraphs 13 to 21 read and agreed to.

Paragraphs 22 and 23 read, amended and agreed to.

Paragraphs 24 to 42 read and agreed to.

Paragraph 43 read, amended and agreed to.

Paragraphs 44 to 49 read and agreed to.

Paragraph 50 read, amended and agreed to.

Paragraph 51 read and agreed to.

Paragraphs 52 and 53 read, amended and agreed to.

Paragraph 54 read and agreed to.

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

Paragraphs 56 to 58 (now paragraphs 57 to 59) read and agreed to.

Paragraph 59 (now paragraph 60) read, amended and agreed to.

Paragraph 60 read, amended, divided and agreed to (now paragraphs 61 and 62).
Paragraphs 61 to 77 (now paragraphs 63 to 79) read and agreed to.

Paragraph 78 (now paragraph 80) read, amended and agreed to.

Paragraphs 79 and 80 (now paragraph 81 and 82) read and agreed to.

Paragraph 81 (now paragraph 83) read, amended and agreed to.

Paragraphs 82 to 85 (now paragraphs 84 to 87) read and agreed to.

Paragraph 86 (now paragraph 88) read, amended and agreed to.

Paragraphs 87 to 90 (now paragraphs 89 to 92) read and agreed to.

Paragraphs 91 to 93 (now paragraphs 93 to 95) read, amended and agreed to.

Paragraphs 94 to 97 (now paragraphs 96 to 99) read and agreed to.

Summary amended and agreed to.

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

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

Written evidence was ordered to be reported to the House for printing with the Report.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 22 April at 9.30 am.]
Witnesses

Monday 17 March 2008

Mr David Miles, Morgan Stanley, Dr Martin Weale, National Institute for Economic and Social Research (NIESR), Mr Robert Chote, Institute for Fiscal Studies (IFS), and Ms Bridget Rosewell, Volterra Consulting

Mr John Whiting, PriceWaterhouseCoopers, Dr Martin Weale, NIESR, and Mr Robert Chote, IFS

Tuesday 18 March 2008

Mr Dave Ramsden, Managing Director, Macroeconomic and Fiscal Policy, Mr Mike Williams, Director, Personal Tax and Welfare Reform, Mr Edward Troup, Director, Business and Indirect Tax, Ms Sarah Mullen, Joint Director, Public Spending, Mr Chris Martin, Director, Public Services, and Mr Simon Gallagher, Team Leader, Financial Services, HM Treasury

Wednesday 19 March 2008

Rt Hon Alistair Darling MP, Chancellor of the Exchequer, Mr Dave Ramsden, Managing Director, Macroeconomic and Fiscal Policy, Mr Mike Williams, Director, Personal Tax and Welfare Reform, Mr Edward Troup, Director, Business and Indirect Tax, and Mr Simon Gallagher, Team Leader, Financial Services, HM Treasury

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1 Supplementary memorandum from HM Treasury Ev 59
2 Memorandum from Mr John Whiting, PriceWaterhouseCoopers LLP (with input from the Chartered Institute of Taxation and Low Incomes Tax Reform Group) Ev 63
3 Memorandum by Professor David Heald, Specialist Adviser to the Committee Ev 65
4 Memorandum from Professor Colin Talbot, Specialist Adviser to the Committee Ev 71
5 Memorandum from the Institute of Chartered Accountants in England and Wales Ev 73
6 Memorandum from the CBI Ev 77
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Oral evidence

Taken before the Treasury Committee

on Monday 17 March 2008

Members present
John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Mr Philip Dunne
Mr Michael Fallon
Ms Sally Keeble
Mr Andrew Love
Mr George Mudie
John Thurso
Mr Mark Todd
Peter Viggers

Witnesses: 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, gave evidence.

Q1 Chairman: Welcome to our first session on the 2008 Budget. Could you introduce yourselves for the shorthand writer, please?

Ms Rosewell: Bridget Rosewell, Volterra Consulting.
Mr Chote: Robert Chote, Institute for Fiscal Studies.
Dr Weale: Martin Weale, National Institute for Economic and Social Research.

Q2 Chairman: I will introduce David Miles, in his absence, from Morgan Stanley; he will come along shortly. Treasury growth forecasts appear optimistic compared to the range of independent forecasts detailed in the Budget. Why do you think the Treasury have been over-optimistic?

Ms Rosewell: I think that if they had been less optimistic then the strains in the public finances would have shown up rather more obviously than is the case here. I think that it is quite odd that the forecasts should be as optimistic as they are, particularly as the consensus itself is continuing to fall, and indeed is likely to fall still further in the light of most recent events. Of course if there is weaker growth then there are weaker tax revenues and that makes it even more difficult to sustain the public finances, which are already running £6 billion ahead of where they were estimated to be even six months ago.

Q3 Chairman: Martin, you usually have something to say.

Dr Weale: The Budget forecast seems remarkably like the forecast that we produced in January and that was slightly more optimistic than the consensus, but justifiably, so on that basis the Treasury is optimistic but not over-optimistic. I think that what has been happening since then is that the financial crisis seems to be intensifying. Obviously the latest sign of that has come after the forecast was prepared and indeed after the Budget, but I think that what the document could have made much more of, or could have made something of, was of the significant downside risk that a prolonged financial squeeze will create and the implications of that. Once again it is a document that says very little about how things might go wrong.

Q4 Chairman: Robert, to what extent is the Treasury’s overall view dependent on its outlook about the duration of the credit crunch? A number of economic commentators have said there is a benign approach by the Treasury on this in that they see the credit crunch having a bit of an effect just now but we will sail into 2009 and onwards and forget all about it.

Mr Chote: As you say, the revision downward to growth is relatively modest in both of the next two years and given what you say about that relative to the independent consensus we would certainly have some concerns there. As regards the impact on the public finances, it is also worth noting that at the same time that they have revised down real GDP growth they have also revised up whole economy inflation, the GDP deflator. So in fact the profile for money GDP through the five years of the forecast period is very little changed from the pre-Budget Report and that, in a sense, masks what you would otherwise see as a bigger temporary deterioration in the public finances.

Ms Rosewell: The particular form of optimism that I find most disturbing was not that overall headline number, where even the bottom end of the range is above the current consensus, which seems odd, but also the discussion about the UK’s resilience to economic shocks and how this is expected to have increased. It was the complacency surrounding that which I found particularly disturbing. We know for example in the dot-com collapse in early 2001 that we had quite a sharp fall in output and it was only stopped from being sharper by the fact of increases in spending going through at that particular time which buttressed that. Indeed London, which is more exposed to private sector developments, did go briefly into recession in 2001. I think the fact you have been resilient over the last couple of occasions, it needs to be shown why that means you are going to be more resilient in the future. Given the scale of
things that are going on at the moment, indeed were going on before Alistair Darling stood up, I found that particularly worrying.

**Dr Weale:** Could I add to that I do not understand the argument about the resilience of the UK economy. The UK economy is considerably more geared than some of its neighbours, perhaps most notably Germany where over the last ten years debt income ratios have been falling rather than showing the sharp rise that we have had. We are not as exposed by that measure as Spain and the Irish Republic, we are slightly more exposed than the United States, and of course we have had a house price bubble even more pronounced than that of the United States, so the fact that things have not gone too badly wrong in the past one would hope could be reassuring, but it certainly would not be something that you would grasp at without thinking of all the sorts of risks that the economy does face.

**Q5 Chairman:** The Treasury argues that inflation will fall back to 2.5% by the end of 2008 and return to target in 2009 and thereafter. Again there has been quite a bit of comment from commentators that that is a bit optimistic. Who agrees with the Treasury’s forecast?

**Dr Weale:** I do largely agree with it to the extent that a few percentage points do not matter too much. I think that, yes, we do have the prospect, as the Governor of the Bank of England has said, of a further rise in the inflation rate at the moment, but I think there is a reasonable basis for expecting that to fall back towards target. Of course that is on the assumption that the Bank of England does maintain a relatively tight monetary stance and also that we do not see a large collapse in demand. If we do see a marked collapse in demand then inflation may fall below target eventually next year.

**Ms Rosewell:** I think I would agree with that. The Treasury has simply taken the view that the Bank of England will meet its target and will be committed to meeting its target, and all the evidence suggests that is indeed what they are committed to doing, and they will move interest rates to enable that to happen, so that seems a perfectly plausible view for the Treasury to take.

**Chairman:** Fine. George?

**Mr Mudie:** The Treasury is assuming that credit conditions will start to ease during the second half of this year and normalise by mid-1990, this seems optimistic. Do you think it is optimistic?

**Chairman:** We asked them that George!

**Mr Mudie:** I asked it better than you though and probably we were not satisfied with the answers! Can I just ask something on that then because my follow-up was going to be—which the Chairman did not ask—there is a disagreement in terms of some people view the ability to lower interest rates as being a useful tool in achieving that and other people think because of inflation that will not allow the interest rate to be used in that way. How much do you think the Chancellor has factored into his growth projections interest rate cuts? You did not ask that, did you?

**Q6 Chairman:** No.

**Ms Rosewell:** Given that he essentially seems to have factored in the view being taken by the Bank that they will hit their inflation target, that would suggest, on the basis of what we are seeing currently coming out of the Bank, that there is probably limited scope for rate cuts, and indeed that would be more or less consistent with what the market is expecting, which is another two cuts this year. In fact, I think things are contingent on a number of additional factors which are going to be quite hard to balance out. On the one hand, we still have considerable pressure on some of the underlying cost increases coming through from, for example, oil and other commodity prices. Supply difficulties in a number of those areas suggest that there is going to be continued if not increased upward pressure at least nudging at those. Oil prices are still rising, over $110 in some markets, so that is going to limit the ability to do that. However, against that, there is the fact that the market interest rates that people are actually having to borrow at have moved away from base rate, and indeed that has happened again in the last couple of days, so cutting interest rates does not necessarily cut the borrowing rates that people are actually faced with and so how that interest rate is working through into the market place is quite a hard call for the Bank currently to make. They may feel that they need to cut rates even though that will not necessarily make much difference to the cost of borrowing, it may stop it increasing too much, so there is a conundrum there. The third thing is that if we are right, as most of us seem to be thinking that the Treasury is optimistic about growth, then as growth declines that may actually mean that the Bank is more willing to see it break its inflation target in order to try and maintain some pace of growth if things look particularly bad, and we have yet to see that.

**Q7 Mr Mudie:** In the States we have seen the sub-prime stuff move across to the mainstream with very, very worrying consequences. If an intensification of the credit squeeze happened here, what do you see the effect on the UK economy?

**Professor Miles:** I think it has the potential to be serious. The UK economy is like the US economy in the sense that the household sector has borrowed a great deal of money, we have a very low savings rate, and there is a lot of debt out there. And if we were to see the cost of debt to households and to some extent to companies rise—and we have not seen much of a rise yet but there is obviously the potential for it to play out that way—that has quite an impact on the disposable income of many households. It would affect the growth forecast. So far the thing that has not happened in the UK (but it clearly has happened and will continue to happen in the US) is that there really is no firm and strong evidence of sharp rises in defaults on mortgages. As yet in the UK although people are very worried about that we have not seen a very significant deterioration and we are still in a position where bad debts and arrears on mortgages and repossessions of property are still running historically at a really rather low level. So it
is a risk as opposed to the situation in the US something that really is already playing out in front of our eyes.

Q8 Mr Mudie: Going off the housing side, that has repercussions for the rest of the financial economy and that would be more likely to hit us first rather than what you say in the mortgage field. Could you see that happening here? Are you worried about the developments in the last week in the States? Martin, you were going to answer the question before I suppose!

Dr Weale: Yes, I am afraid I was. Obviously the effect of a credit crunch depends how tight the crunch is but, for what it is worth, our estimates are that if rates to borrowers were pushed up by four percentage points for one year that would take 1.3 percentage points off GDP, so that would turn us into a state where there was very little year-on-year growth. It would effectively mean, depending what definition people adopt, a recession, so a tight credit squeeze does very much have the power to deliver that, and it could do it here as well as in the United States.

Q9 Mr Mudie: Back to Mr Miles, David, if you wanted a massive injection of liquidity by the Bank of England or the creation of an emergency state mortgage lending agency, you would be overwhelmed to see that the Government has set up a working group to examine market-led initiatives. Could you give us your view on how you think they will work?

Professor Miles: I think a couple of things have happened. Firstly, and not related to the Budget, the Bank of England did announce last week, I think it was, that they would continue the practice of lending for relatively long horizons—three months—against a broader range of collateral than in their normal operations. They will have an auction, I believe it is tomorrow, of £10 billion: that follows two unusual auctions that they did in December of last year and January of this year and they have announced they are going to do that again in this month, March, and again in April. So there has been some action by the Bank of England and, who knows, we may see more announcements by the Bank of England in due course. In terms of the working group that was set up, and that was announced in the Budget, its aim is to make the mortgage-backed securities market work a bit better. To be honest, I think it was probably the most sensible thing because there were some rumours that perhaps the Government was going to announce a rather prescriptive regime—a so-called kite mark regime or gold standard for mortgages such that mortgages that had certain characteristics would be given some kind of official seal of approval. That was mooted, at least in public, as being maybe the way the Government was going. Relative to that, which was a rather dangerous strategy. I was rather pleased they have gone down the road of looking for a market-based solution and getting the input from practitioners in the market. I would say that I think the actions of the Bank of England have gone in the direction that I thought was helpful and necessary at the time I wrote a short piece in the Financial Times a month or so back.

Ms Rosewell: I would support that because I very much agree with David that producing some sort of kite mark for the mortgages that everybody knew were all right was not actually going to make any difference one way or the other. What is much more at issue here is the mechanisms by which banks finance themselves and each other and the inability to get longer term finance when in fact nothing much had changed in the market-place, even for institutions which were largely only issuing these kinds of debt, and that was because the money being wiped off other banks’ balance sheets was reverberating through the system so that people normally doing business were just not doing that business because they were finding it hard themselves to get finance. That is the circular nature of banking after all. That is why this move by the Bank of England to continue a slightly—three months is not long, I have to say, in term but it is certainly better than overnight—longer term auction enabling people to pick up some at least medium-term funds in a more normal basis than they have been able to do recently is quite important while this disruption is going on.

Dr Weale: I think it is important to understand, is not particularly because there is much toxic debt in the UK housing system (there may be overextension in a number of places but I do not think it is anything like it was in the States) it is because of the way that individual banks in other institutions who have been exposed to that have had to write money off and therefore have much less ability to generate further normal “business as usual” finance, so there is some exposure but a lot of it is just as much about the ability to do business as usual.

Ms Rosewell: I think the difficulty we have is that in the short term we probably—more than probably—want to see more mortgages becoming more readily available. The restriction in mortgages we have seen is likely to be a problem for the economy but in the longer term we do want to move to a situation where mortgage finance is less readily available than it was in, say, July of last year and excessive availability of mortgage finance has been fundamentally the cause of these difficulties.

Q10 Mr Mudie: That is a controversial statement, Martin, but there we are. Back to David, what about the Government’s preoccupation with long-term fixed rate mortgages; how successful do you think the Budget will be in moving on that debate?

Professor Miles: Well, first of all I think there is a good reason for the Government to continue to be concerned about this area. Part of the problem we may see playing out in the UK economy over the next few years is that people may be faced with mortgages that are more expensive than they thought when they borrowed money two or three years ago. And that would not be because the Bank of England has increased interest rates very sharply. It is another risk, which is that mortgage lenders may feel they need to charge more even
though the Bank of England may be cutting base rate. That just emphasises there are many risks that people take on with variable rate mortgages. It is not just about what is the rate of inflation and what the Bank of England will do; it is about the whole operation of the financial market, and I think that is one reason why the Government quite rightly remains concerned in this area. In some sense I think the Government’s focus in what they announced at the Budget always was going to be somewhat narrow because it was very much on the wholesale funding of mortgages; it was not so much, in fact it was not at all about the way in which mortgages are sold—the information people are given, their understanding of risks. That set of concerns is very much in the area of the Financial Services Authority in its regulation of mortgage sales. That regulation is an on-going process. The FSA is reviewing its current way of regulating mortgages, seeing how well it works. I think the Government focus in this Budget and the announcements they have made and the consideration they will give when they come back at the Pre-Budget Report to the issues, are very much on the funding side, where to my mind the issues are probably to some extent less significant than where I think the real issues in the mortgage market are. That is about consumer understanding, about information, about people’s ability to understand risks and the incentives of lenders and intermediaries. That set of issues really is not part of the process that the Government is looking at right now.

**Q11 Mr Mudie:** With the problem in mortgage markets and the threat of falling house prices, is it a sensible time to be pushing? It seems to be a preoccupation.

**Professor Miles:** I think it is a preoccupation for a good reason, which is that we have a mortgage market in which because house prices are very high in the UK people are borrowing a great deal relative to their incomes. It remains the case that the cost of variable rate mortgages is very difficult to predict. I have got very little confidence where mortgage rates will be six or nine months from now. It depends on a whole range of factors, many of which are nothing to do with what goes on in the UK economy. Thinking about the type of debt people take on and their understanding of risk and their ability to handle unexpected movements in the cost of debt, one can see why the Government remains of the view that this is very important and I think they are right.

**Ms Rosewell:** But long-term mortgages are not cheap.

**Q12 John Thurso:** I would like to follow up on the question that George Mudie asked about the effect of America. Can I quickly get a handle; how many of you think that America will go into recession in 2008 and what level of severity might you be anticipating?

**Ms Rosewell:** I think it probably is in recession.

**Q13 John Thurso:** Is that a fairly consensus view?

**Dr Weale:** Whether it is in recession or not depends on how you measure recession. I think it depends on whether the financial crisis does persist or whether things do start to ease up fairly quickly. If things do start to ease up fairly quickly I think we could have year-on-year growth of 1% or more than 1% this year compared with last year in America, and that may still mean two quarters of falling output, which some people use to define a recession.

**Q14 John Thurso:** So your view would be that it is not going to be severe, it is not going to be a repeat of the early 1990s for example?

**Ms Rosewell:** I do not think we are really in a position yet to know quite the answer to that. It is not about 2008; it is about 2009. It is clearly getting worse at the moment. As Martin says, if the economy recovers and business as usual returns in the back end of this year, then the American economy is very flexible and it could bounce back in 2009, and you would have a picture much like the end of the dot-com boom, for example, a sharp decline and then a bounce back. If the sorts of things we have been hearing in the last couple of days go on then 2009 we will not be in that kind of position. I think it is quite finely balanced at the moment.

**Q15 John Thurso:** Two questions wrapped up as one really, people always used to say that when the States sneezes everybody else catches a cold. What is that going to mean for the UK? How do you see that impacting on the UK? There has been of course tremendous development in the Asian economies which are no longer as linked as they used to be, so how do you see that impacting on us?

**Ms Rosewell:** I do not really believe we have decoupled from the United States as much as some people have suggested. It is still the largest single economy in the world and although China may be growing very fast, certainly from the UK perspective we do not do that much business with China and certainly in terms of exports we do not do that much business with China. If you look at what is happening to the European economies, they are trundling along but again they look slightly vulnerable to what is going on. German banks in particular have been struggling with the consequences of the American sub-prime debacle. Japan has also moved down quite sharply. It is quite hard to see that the ramifications of this current global financial business do not go right across the whole world.

**Dr Weale:** I think the point is that although the UK has other export markets and the United States is an appreciably smaller share of the world economy than it was, the sort of financial crunch that we are seeing is inevitably international and it is hard to imagine that it could not be, so if the United States simply sneezes because people decide to save more, then the rest of the world could probably cope with that, but if the cause of the disease is a credit crunch, then I think the rest of the world will be affected and
if it does persist into next year in the United States then the United Kingdom will be affected in the sort of way that I indicated.

Q16 John Thurso: The Treasury expects euro area GDP growth to slow to below trend rates in 2008 but returning to trend in 2009. Does anybody not share that view?

Dr Weale: I think again that view is contingent upon how you expect the credit crisis to play itself out. It is entirely coherent with the view in the Budget document and the fault is not that they have that view, it is they do not give enough attention to alternatives, or any attention to alternatives.

Ms Rosewell: Hear hear.

Q17 John Thurso: I have a huge sense of déjá vu from having run a business through the 1993 period where everybody went on talking about how there might be a soft landing and it was all going to be all right on the night and then before you knew it we were into negative equity and businesses were struggling to survive. The déjá vu feeling that I have is everybody is trying to talk themselves into a reasonable outcome and every day we get worse news.

Dr Weale: That is fair enough but one can also remember occasions when everyone was trying to talk themselves into recessions that did not happen, for example 1998 and the Asian crisis when you could have made exactly the same comments as have been made now about the Treasury forecast being optimistic but actually the projection was lower than things turned out. What that does is demonstrate the uncertainty.

Ms Rosewell: The Governor of the Bank of England is always coming in front of you to talk about uncertainty and the role that it plays, but that is precisely why I agree with Martin, that the failure to discuss some of the risks which are in this Budget Report at this particular time seems to be so complacent.

Q18 John Thurso: Let me turn to one of those risks; how many of you are concerned that the UK’s current account deficit is now at its highest level since records began in 1955?

Dr Weale: It is important to remember that the current account deficit measures the difference between saving and investment. Compared with three or four years ago we have had two things going on and contributing in roughly equal proportions. One is that we have had an increase in investment as a proportion of GDP, and that may be explained by the surge in immigration that we have had because if you suddenly have a lot of workers that you were not expecting then it is sensible to import the means of finance of the capital that they use to work with, and that increase in borrowing does not worry me enormously and that has accounted for roughly two percentage points of GDP. However, we have also had a two percentage point decline in the savings rate and that is simply people spending money that they have not got. To be quite frank, I am surprised that the Government has in its Budget documents over the last two or three years paid absolutely no attention to that.

Q19 John Thurso: Do you think that the drop in savings is a critical problem?

Dr Weale: I think the United Kingdom has a long-term problem of undersaving. For what it is worth, work that I have done suggests that if each cohort paid its own way consumption would be about 8% lower than it is. In other words, we are relying on being supported by someone else at some point and either our descendents will have to pay or be disappointed, one of the two. I think the United Kingdom does have a particular problem in that respect and it is something that the Government has approached piecemeal but it has no overall strategy about what it thinks we ought to be saving and why and how to achieve it.

John Thurso: Are any of you particularly concerned by the possible inflationary impact of continuing falls in sterling?

Q20 Chairman: Could one of you answer that and then we have got to move on, John.

Professor Miles: I think that it is a question of time horizons. I have no doubt that we need a lower exchange rate in the UK. It is the natural market reaction to a current account deficit that is probably unsustainable. You may need ultimately a rather large depreciation of sterling. If it all happened in the space of two or three months it would be very unpleasant because it would generate a lot of inflation six or 12 months down the road. Ideally what one would want is a rather prolonged but steady and gradual decline in sterling. The problem is that it is impossible to try and manufacture such a thing.

Q21 Peter Viggers: Returning to the key issue of stability and resilience, the Institute for Fiscal Studies, Professor Miles, said that the economy was less able to weather an economic shock than it was a few years ago. Of course the Treasury has produced a paper on resilience and the Chancellor of the Exchequer made a key point of resilience. Are you persuaded by his arguments?

Professor Miles: I think on some measures the UK is not very well-placed to suffer a sharp downturn. Clearly there is not much margin of error left if the Government is to meet its fiscal rules and in that sense you would not want to start from here. If there had been more of a buffer or more of a margin, then it would have been easier to offset some weakness with a relaxation in fiscal policy. That is much more difficult given that you start from here so in that sense the Chancellor’s claim does not quite add up. I guess there is another sense in which there is something to it though, which is that what we have achieved over the course of the last ten years with Bank of England independence is a pretty credible anti-inflation regime. And even though we have seen oil prices rise very, very sharply, food prices go up, and inflation a little bit above the Bank of England’s target (and it will probably move a bit further)
nonetheless, expectations about where inflation will go remain pretty well controlled. Certainly if you look in the government bond market the yields on government bonds have stayed at an exceptionally low level which suggests to me that most people believe inflation will stay very low in the UK. We have avoided what would have been arguably a catastrophic situation. Had we been going into a very difficult period for the economy and at the same time people had lost faith that inflation would stay low, then I think we would have seen a toxic combination of much higher nominal interest rates as the shocks hit the financial system. I think that would have been a truly terrible situation to be in. So there is something to be said for what the Chancellor would have been a truly terrible situation to be in. Had we been going into a very difficult period for the economy and at the same time people had lost faith that inflation would stay low, then I think we would have seen a toxic combination of much higher nominal interest rates as the shocks hit the financial system. I think that would have been a truly terrible situation to be in. So there is something to be said for what the Chancellor was talking about, but it does not quite read across very well in terms of where you start from with fiscal policy.

Q22 Peter Viggers: Dr Weale, you referred to the Asian crisis and our resilience as we came through that. Do you think that the unusually fast growth of public expenditure was a determining factor in carrying us through that?

Dr Weale: I do not think so at that point. As Bridget Rosewell mentioned, that was a factor in the resilience after the dot-com boom but I think it was simply that the Asian crisis was resolved more quickly than people feared or was less damaging than people had feared.

Ms Rosewell: In some senses there are some parallels between the Asian crisis and what we have been experiencing recently, but it was much more corralled in the sense that there were serious financial consequences, not in Western economies but for the Asian economies, and there were some knock-ons into things like the Russian debt and long term capital management and so on and there were some bailouts but they were more corralled and they are less pushed over into lots of different financial institutions, so there was not that kind of fear as to where the difficulties were. Everybody was reasonably clear where those difficulties were and if there was a bailout it was in a more restricted area than the things we have been experiencing more recently.

Q23 Peter Viggers: The Treasury document on resilience seeks to show with a diagram that the estimated root mean squared error of shocks is lower in the United Kingdom than most other countries, but of course we have been buoyed up recently by our relationship with the United States, by the relevance and importance of our financial services industry and by the housing boom. Are you more concerned about the latter which look forward rather than the statistics which look backwards?

Dr Weale: I am concerned about the way in which the growth has been sustained because essentially it has been sustained by, you have described it as a housing boom, a land price boom, and we are now in a situation where in the short term to alleviate our problems we want prices to stay up, we want people to go further into debt or the government to go further into debt on their behalf, but in the longer term that is actually what really got us into the difficulties that we face, so I think there can be a real concern that the stability that we have enjoyed has in some sense been an illusion and based on a fool’s paradise of essentially wealth appearing in people’s balance sheets through rising house prices.

Q24 Peter Viggers: The Treasury seems confident that there will be a rebalancing of the economy during the remainder of 2008 with consumption and business investment slowing and external demand receiving a boost from the depreciating pound. Does that correspond with your own thinking?

Dr Weale: Again it corresponds with my view of the circumstances that give rise to the Treasury forecast. I mentioned earlier that it was very similar to our January forecast and that had the same sort of rebalancing with exports benefiting from the fall of the exchange rate, so once again if the credit crunch persists and intensifies then we may find that exports are also weaker than we would like, but it is a coherent view of the world.

Q25 Ms Keeble: I want to ask some questions about unemployment. Does the increased flexibility of the UK labour market mean that employment will be more resilient to an economic slowdown than previously?

Dr Weale: I think it probably does. It is unclear because the slowdown may be of a nature that we have not had for a while and it may be that things like the minimum wage do significantly reduce the flexibility. On the other hand, when you have had significant numbers of migrant workers coming into the country, and possibly in this case not bringing their families with them, then the experience of other countries is that in downturns they may tend to leave, so what we may see is a reduction in the number of people employed without a sharp increase in unemployment.

Q26 Ms Keeble: There are two particular points following on from there. Is there any study done of the impact of slowdowns on, for example, overtime rates and such like which potentially by impacting on household incomes can have a very substantial impact on housing repossessions, child poverty, and the like, whereas those figures do not necessarily appear in an unemployment claimant count. Do you take my point?

Dr Weale: Yes I do and I am afraid my answer is I do not know.

Q27 Ms Keeble: Does anyone else know?

Ms Rosewell: I do not know of any study. We certainly know that when there is a slowdown that things like overtime rates and so on are hit first. Of course there are large numbers of people for whom there are no such things as overtime rates so not all of those would come through in that kind of way. The point on flexibility is also one of the things you notice, if there is a severe downturn at any rate, then you get rising self-employment, you get people going into part-time work and so on and so forth, and it
requires the ability to be able to do that. With part-Time and temporary workers increasingly being treated as if they are permanent workers, people may be less willing to offer that kind of employment flexibility in the future. I think we have yet to see that because a lot of the regulation in that area has changed quite a lot in the last few years, so I do not think we quite know how that would perform in a downturn compared to previously.

Q28 Ms Keeble: I also wanted to ask about the impact on migrant labour because, Martin, you set out if there is a slowdown then migrant labour is probably displaced first. Would you want to expand on that? You are talking about them leaving but are they not more likely to be made unemployed or is there a possibility that perhaps because they are prepared to undercut that it is the non-migrant who might be disproportionately affected?

Dr Weale: That is obviously possible. I think the experience in Continental countries going back 30 years and so on has been that there is flexibility and some migrants have tended to return home, particularly when they are migrants from not too far away, but what you suggest is also a possibility, that they will be available for working though possibly illegally at below the minimum wage or something like that and it may lead to undercutting; we do not know.

Ms Rosewell: Also there is a big difference between different kinds of migrant groups. We are already beginning to get anecdotal evidence, not to be statistically relied on, that some of the big groups are now seeing that there are more opportunities back in their own economies, Eastern European countries, in particular Poland, than maybe they are now thinking the UK can offer. It is a pull factor, “I can now do better at home”, rather than there is a pull factor to stay or a push factor to come here. Refugee groups is obviously a very different proposition and the way that they behave and the way that wage rates operate are also quite different. It is really hard to give a blanket answer to this kind of question.

Dr Weale: Except that the number of refugees is rather small compared with the number of people who have come from Central and Eastern Europe.

Q29 Ms Keeble: Has anyone else got a view on the impact on labour market flexibility and migration? No. Going on to issues about the housing market, do any of you think that the downside risks for the UK housing market are greater than the Treasury have suggested?

Professor Miles: I am not quite sure how they quantified how big the risks were. I think in some sense the risks are great but in a deeper sense there is an opportunity as well, which sounds a strange thing to say so let me briefly describe what I mean. It seems to me not at implausible that we will go through a possibly prolonged period where house prices move lower. Maybe they drift lower and month on month prices are down on average 1% or so for a long period, or maybe we see something that will be a little sharper than that. It seems to me that the probability of this happening is quite substantial.

Q28 Ms Keeble: Could I turn it round the other way. House prices are linked presumably to wages but they are also linked to supply. Is there any evidence that people who have been holding land are going to not build because of a perception that the prices might be going down? There is then a risk that prices do not go down and there is real pressure on lower income house families in trying to afford housing.

Professor Miles: If you have got land with planning permission, then given the cost of building a house and the cost of selling a house with the land, then even if house prices were to be rather significantly lower, I would imagine for the great majority of people who have got planning permission on land it still remains commercially viable, to actually build the house. The difference between the value of a plot of land when you can build a house on it and building a house and selling it, and the value just left as non-residential land is so enormous that I think there is a lot of scope for incentives to build even if prices were to move lower.

Ms Rosewell: There is an issue however for some of the companies concerned who might otherwise be building houses in that at the moment they have not got any cash. It depends on the mix of things that they might be building so there is a number of banks and building societies who are restricting further loans on apartments and flats for example, new builds of all kinds, at this moment in time, so they may not be able to afford to.

Q30 Ms Keeble: There has been an assumed read-across from the problems in the US housing market to the UK market. Do you actually think there are similarities and do you see our housing market vulnerable to the same kind of problems that afflict the US?

Professor Miles: There are similarities in the sense that we are one of the few mortgage markets outside the US that has something recognisable as a sub-prime mortgage market. It has been possible for people in the UK with impaired credit histories and county court judgments against them to borrow. That is not true in the majority of other countries in Europe. Clearly it is true in the US, so in that sense the UK mortgage market looks more like the US than almost any other mortgage market in Europe, which in itself sounds quite a worrying proposition.
I think the good news here though is that the kind of toxic mortgage product that really has caused a lot of the problems in the US, where people were given mortgage debt with very little prospect they could repay it even at the current rate, but then with a built-in feature that the interest rate would re-set a year or two years down the road dramatically higher, that kind of product really does not have a UK counterpart. So I am a little bit more optimistic than some that we can avoid the worst aspects of what is playing out in the US.

Q32 Andrew Love: In the IFS Green Budget, Mr Miles, you forecast that there was a one-in-three prospect of there being a recession. I cannot remember whether that was a technical recession or not. If you were writing that report today would you change your mind?

Professor Miles: One in three was what we thought a couple of months ago. I guess the world looks a marginally more risky place this morning than it did back then at the end of January. I might put that probability a little bit higher. Of course that is the probability of what we call a technical recession, that is two quarters in which GDP does not rise; it might fall by a small amount. I remain of the view that the most likely outcome is that we will miss even that. That remains the more likely outcome; even if we do go into a technical recession there are technical recessions that are so mild that if you look back at them in years to come they hardly show up as much of a blip. So although one in three (and maybe the chances are a little higher than that) sounds very worrying, it is perfectly possible to have a short, shallow, temporary recession and therefore the risks of something really bad happening to the UK are in a sense exaggerated by looking at a one-in-three chance or something like that.

Q33 Andrew Love: Dr Weale, there has been quite a lot of comment that the Government are being for too optimistic in terms of the credit crunch disappearing. In the light of recent events in the United States, would that be a reasonable assumption to make? Are we fully taking into account the likely longevity of the credit difficulties we are facing?

Dr Weale: The credit difficulties do seem to me worse and therefore I think probably also more likely to be sustained for at least the major part of this year than I would have said.

Q34 Andrew Love: Do you think it will go into next year, 2009?

Dr Weale: I really do not know. I would be very surprised if we see a return next year to the situation we had before the beginning of these problems in the summer of last year. In that sense, I think we have seen a permanent change, but I think one way or another, and it may involve more in the United States than here, the taxpayer will be taking over liabilities that they were hoping not to pick up. I suspect that American taxpayers are going to have to dip fairly deeply into their pockets to pay for the past success of their financial system. The question will be how long it takes the authorities to come to grips with that, and of course the fact that there is an election in the United States this year and the President does not take office until January of next year may mean that it is harder to come to a political solution than would have been the case in three or four years.

Ms Rosewell: I think you have got to distinguish between two different things going on here. One is the semi-permanent change, since all things go in cycles of some length or another, which is the end to cheap money. It came to a head in 2005–06 really when interest rates were extremely low and people could borrow for almost anything because there was also a huge amount of lending and the impact of Japanese carry trade, borrow cheap and move it over to another jurisdiction. I think the events we have had now mean that at least for the next five or six years interest rates will for all sorts of purposes—corporate purposes, personal purposes, you name it—be higher and the cost of doing that kind of business will be higher. If you like, the credit crunch is therefore permanent in that sense. That is not the same as talking about the credit crunch crisis and the sorts of things that we have been seeing over the weekend with banks getting into severe difficulty and having to be bailed out. That is the bit that we should hope will come to an end in the next few months because if it does not come to an end in the next few months we really are for the high jump.

Q35 Andrew Love: I do not want to get onto the issue about whether boosting liquidity is going to address the real fundamental problem that we face, but since you talked about higher interest rates and the impact on the corporate sector, the Government is suggesting that there will be a decline in business investment, are they being too optimistic? You were all mentioning earlier this important word “uncertainty”. How large a part is uncertainty going to play in business decisions about investment?

Ms Rosewell: I think it is partly an investment question but it is also a working capital question not just investment. One of the things that I am observing around the place is that banks are coming along to corporate clients and shortening credit lines, raising the price, just on ordinary working capital, and that is one of the things that increases uncertainty and makes businesses more cautious about any kind of activity, even if it is going out into the market for investment funds, which is the big investment that people tend to think about. A lot of investment is quite small scale, for example taking on a couple of people, and we know that investment in intangibles—and the Treasury has done some interesting stuff around that—is much more important than it used to be, so a lot of investment may not be measured. Nonetheless, I think that general tightening, maybe a screw not very much tightened but just making it that much more difficult to do business, will in general increase people’s caution. I do think they may be being too optimistic about investment, although that is the measured investment bit which I do not think is the whole story.
Q36 Mr Love: One final question, we have just been talking about the constraints on business investment; will it be the availability or the price of credit that will be the more important constraint?

Dr Weale: The business sector as a whole is fairly flush with funds at the moment, so it is difficult to say. For some businesses—

Q37 Mr Love: The Bank of England characterised it in their recent report as there are successful companies where profitability is good, they have got money in the bank, if I can say that, and they do not have a problem, but then there is another part of the business sector that is in a much worse position and I think the concern is about that other part of the business sector which may have more difficulty and real problems in both availability but also price. Which is going to be more important or are both going to play a factor in business investment decisions?

Dr Weale: I think both are going to play a factor. If you have not got the cash and cannot borrow it all you obviously will not be rushing to invest particularly as the equity market is weak and, therefore, rights issues are not terribly attractive. Equally, I think businesses will be having to pay more for credit. Sorry, to reiterate the point: if that premium persists for a substantial period, as indeed it did in Germany in the first half of this decade, then investment undoubtedly will be rather weak.

Chairman: I think we will have to move on.

Q38 Mr Brady: How much scope was there in the Budget to use fiscal policy to support monetary policy?

Ms Rosewell: Not a lot.

Dr Weale: It depends what you mean. If you take the view that is what you should be doing with fiscal policy when the country is in difficulties then there was quite a lot of scope because, after all, the limits that the Government set on its borrowing are just arbitrary. On the other hand, if the Government wanted to maintain, I suppose, the letter as they define it of the fiscal rules, because I think they have given up on the spirit of them, the letter as spelt out by the Treasury then, as Bridget has said, I do not think there was room to support monetary policy.

Q39 Mr Brady: Is it just the fiscal rules that limit that?

Dr Weale: Yes, I think it is.

Ms Rosewell: Clearly the Government could go out and borrow; there is nothing to stop it going out into the market, although it might have to pay a bit more. If you ask for more money you might have to pay a bit more, but it is a triple-A rated institution and it can go out and raise funds. Indeed, there are increases in borrowing put into this. The self-imposed constraints are clearly very serious indeed. In fact, the only reason this current Budget works at all in terms of its forward planning is by effectively saying the cycle has ended and will not start again, so we are at the zero point and it is going to stay there, which seems quite an unlikely outcome to emerge. Certainly in itself it is an imposed constraint. I suppose the next question is would it be better if a more relaxed attitude had been taken to fiscal policy. Given the background to where we are I think it would be quite difficult for a government to take the sort of view that has been taken in the US simply because of the scale of the deficit which exists in what has been a high growth period. It is quite hard then to say, “We are just going to have to push it further” as a deliberate thing rather than as would happen if the economy slowed down where borrowing would increase because spending would increase on unemployment benefit, etc.

Q40 Mr Brady: Is that a consensus view or is there anybody who would have liked to have seen fiscal policy used more actively?

Mr Chote: I think one of the difficulties with the way the current framework is set up is that at the moment, with having the Bank of England given an inflation target, it is the Bank of England that is the second mover and essentially decides how much aggregate spending it is safe to have in the economy. If you were to do something much more expansionary on fiscal policy and the Bank thought that was over-egging it, the sort of discussions we have had before, then they would offset that, and similarly if they went in the other direction. In a sense, the Treasury is only able to affect the policy mix. The Bank of England decides how much overall expansion or contraction is appropriate and, as you discussed earlier, at the moment they are caught between the desire to shallow out the downturn and at the same time not wishing to see the short-term inflation boost get into wage settlements. So I think there is a broader issue, about the way in which responsibilities are given, leaving aside the fiscal rules.

Q41 Mr Brady: Are there places that you could have targeted fiscal changes that would have avoided that policy response from the Bank of England?

Dr Weale: The solution is to have joint policy setting and not to have an independent Bank of England but to manage monetary and fiscal policy jointly. Independence has worked much better certainly than I had expected when it was introduced ten years ago but, at the same time, there may be some circumstances, and perhaps we are seeing that now, when co-operation rather than independence is more suitable.

Mr Chote: You would certainly hope that we would have discussions going on, say, in the run-up to a Budget in which the Treasury came to the Monetary Policy Committee, or at least some subset of the Monetary Policy Committee, and said, “These are the things which we believe may be necessary for the medium-term health of the public finances. Is that going to make your life more or less difficult or no difference at all?” They at least need to understand how the other party will react to decisions even if there is not a formal getting together and coming up with a joint view.
Q42 Mr Brady: Can I move on to the question of the Government’s forecast and in particular the Government has had to move its forecast back a year for when it believes the Budget will be coming back into surplus. How likely is it to beat that forecast?

Mr Chote: This is pretty much the seventh budget forecasting record that the Government has for its own debt, how credible is it that it will achieve the sustainable investment rule in the forecast period?

Ms Rosewell: On what definition?

Dr Weale: 50/50 on their forecast.

Mr Chote: Exactly, 50/50 on their forecast assuming that the chances of them being overly optimistic and overly pessimistic are in line with the long run average rather than the recent years in which it has all been in one direction. The headroom below the sustainable investment rule is now £2.8 billion, that is a couple of years out, and the average forecasting error for the budget deficit one year ahead is about £13–14 billion, so 50/50 would seem a pretty good stab at it.

Q43 Mr Brady: Just looking at the question of inflation and its effects on the public finances, obviously inflation affects tax receipts but also makes it harder to meet spending obligations if there are fixed plans. On balance, is higher than expected inflation beneficial or detrimental to the Government’s fiscal position?

Mr Chote: I do not think that comes out easily from this. It depends partly on how you respond in terms of the spending. If you are holding to the cash spending numbers then that is giving you some element of constraint. It looks as though the Treasury has pushed up its spending forecast reflecting the impact of higher inflation on higher benefit and tax credit costs so, therefore, you are getting a smaller cut in spending as a share of national income over Comprehensive Spending Review 2007 than they had originally intended, which I think is part of the reason why they are not putting in this even tighter squeeze in Spending Review 2009 to make the numbers all stack up.

Ms Rosewell: It all excludes Northern Rock?

Mr Chote: Yes, because Northern Rock effectively has added 7% of GDP so you are through it already on that definition.

Ms Rosewell: Or the treatment of PFIs for that matter.

Q44 Mr Dunne: A couple of questions about the sustainable investment rule that you have just touched on with Mr Brady. Given the poor forecasting record that the Government has for its own debt, how credible is it that it will achieve the sustainable investment rule in the forecast period?

Q45 Mr Dunne: That all excludes Northern Rock?

Mr Chote: Yes, because Northern Rock effectively has added 7% of GDP so you are through it already on that definition.

Ms Rosewell: Or the treatment of PFIs for that matter.

Q46 Mr Dunne: Indeed. If you take Northern Rock first, do you think the Government’s approach to excluding Northern Rock from the public finances for the purposes of their fiscal rules or the sustainable investment rule adds credibility or retracts credibility from the rules?

Dr Weale: I must say what I would have done is to say the 40% is a target, the nature of the world is that things happen that you do not expect and we have exceeded the target, but on this occasion we think we do not need to do anything about it because crossing the target has come about because we have taken over Northern Rock and unless it appears that the taxpayer is going to suffer financial loss as a consequence we can simply wait for Northern Rock to be taken off the balance sheet again. Presentationally it has been very bad but the conclusion that they have come to is correct.

Q47 Mr Dunne: Is that view shared, Bridget?

Ms Rosewell: Yes.

Q48 Mr Dunne: In relation to the IFRS changes, those have been put off a year and when they get taken into account in the public finances is that the time to rewrite the rules do you believe?

Dr Weale: There you are not seeing something that you can say is a temporary factor. You have taken evidence on this recently and I do not know whether you were given a firm indication of what the likely magnitude is going to be, but it seems hard to imagine that this is not going to have an impact greater than £2.8 billion.

Q49 Mr Dunne: More like 10-fold 2.8 billion.

Mr Chote: The maximum you end up with is something like £30 billion if everything goes on that is currently off. I am not clear what proportion of that that would be. The 40% target was always an arbitrary number to start with. The difficulty, of course, was that when the Treasury embarked on this years ago they thought they would be so far away from it, at worst, that you could have these sorts of definitional changes, which do take place from time to time, and that would not have been an
issue. But, of course, as the room for manoeuvre has been progressively removed, you are now very close. So either some definitional change like this or, indeed, some mildly weaker outlook for the economy or suddenly deciding that yet again the one-off winter fuel allowance is not going to be one-off puts you in that sort of difficulty. This is coming back to the point Martin made earlier on, that at the moment the Treasury is still sticking with this: “We are below 40%, what is the issue?” There is no discussion of, “If for a variety of reasons that might not be the case, what is the sensible approach? Are we going to change the rules? Do we think we have breached this, but we just explain the circumstances”. The worst thing you can do is basically say, “There is no problem. There is no problem. There is no problem” and then just move the goalposts at exactly the point at which you would cross it, which was what happened with the Golden Rule and it looks like they are setting themselves up for exactly the same thing with the sustainable investment rule.

**Q50 Chairman:** Given the problems that the Government had in defining when the economic cycle ends, how useful is the Golden Rule?

**Mr Chote:** There is no harm in saying again that this approach of identifying a fixed end to the cycle seems to be ever more absurd with every passing year. I would point you to the entertaining chart on page 154 where the Treasury has concluded that after the current negative output gap—the little downturn we are having at the moment—growth is only fractionally above trend and therefore it takes four years in order to get the output gap back to zero. There may be a modelling approach which explains now why they believe that this output gap is going to be closed very, very gradually over this period. Cynics, if there are any among you, may say the advantage of having a long attenuated recovery like that until you close the cycle is that it gives you more years of fiscal drag to get the underlying position to improve and, surprise, surprise, if you have either a six year cycle or you bolt six years on to the previous definition of the cycle, surprisingly enough we happen to meet the Golden Rule on both those timescales.

**Dr Weale:** Could I say that the Golden Rule should be replaced by a prospective rule about the state of the public finances in the medium term and because there is uncertainty about the future it should be done by an independent assessment, perhaps by Parliament and this Committee.

**Chairman:** We have mentioned this ourselves in the past. I wanted to ask that question to see if your minds were still alert!

**Q51 Mr Mudie:** Robert, if we are that close in the definition of change that might push us over there is obviously a political argument against phasing public expenditure differently, but is there an economic argument against doing that?

**Mr Chote:** Do you mean against the argument for reducing spending in the out years?

**Q52 Mr Mudie:** Yes. If you are that close and the circumstances are almost unique, if the Chancellor went to the spending departments and said, “I am going to re-phase some of your stuff”—

**Ms Rosewell:** That would only be the case if you really thought this limit meant something less than an arbitrary number.

**Q53 Mr Mudie:** Politically that is an answer but I am—

**Ms Rosewell:** Economically it might give us an arbitrary number.

**Q54 Mr Mudie:** Is there an economic case for spending this money at the moment rather than a political or even social case?

**Dr Weale:** Economists tend to assume that people like their consumption, not only spending out of our own pockets but also the services that are provided to them by the Government, to evolve fairly smoothly so that we do not get large step changes, cuts one year followed by increases the next year.

**Chairman:** Thank you very much for that. We will go on to the next session.

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**Witnesses:** Mr John Whiting, PricewaterhouseCoopers & The Chartered Institute of Taxation, Dr Martin Weale, National Institute for Social and Economic Research, and Mr Robert Chote, Institute for Fiscal Studies, gave evidence.

**Q55 Chairman:** Welcome to the second session. Professor Colin Talbot has sent his apologies, he is unwell today. We have Mr John Whiting, who will introduce himself and his colleagues for the shorthand writer.

**Mr Whiting:** John Whiting. I am from PricewaterhouseCoopers and the Chartered Institute of Taxation.

**Mr Chote:** Robert Chote of the Institute for Fiscal Studies.

**Dr Weale:** Martin Weale, National Institute for Economic and Social Research.

**Q56 Chairman:** The Budget has been described as a bit boring with no shocks. Is that the case or are there some shocks? Somewhere deep inside the many pages is there something that should jump out at us?

**Mr Whiting:** I do not think there are any shocks beyond the ones we knew were coming. If I can put it that way, Chairman. Indeed, I might almost say that is a virtue seeing as we had quite a plethora of tax changes from last year’s Budget and, of course, the Pre-Budget Report. So in many ways from a tax point of view what we wanted was a consolidation Budget, a chance to take stock and work out the
detail, we did not want any more major changes. Despite that, I was able to point out to Robert last Wednesday that I think for the first time ever my volume of press releases was greater than his volume of Red Book, which is quite an interesting measure if a fairly arbitrary one.

Q57 Chairman: Tell us how many press releases HMRC had?
Mr Whiting: 107.

Q58 Chairman: With an opinion from American lawyers.
Mr Whiting: Indeed, plus an opinion from American lawyers.

Q59 Chairman: Which is unique.
Mr Whiting: Which I think is unique. I am sure you would also be aware, Chairman, that that is before you get into all the various other documents that accompany the Budget. There is still a lot of detail and paperwork to get through. To go back to the nub of your question, no, I do not think there is a dramatic new bombshell, if you want that term, within this package.

Q60 Chairman: Do others share that view?
Dr Weale: Could I say that in some ways the surprise is the sort of thing that should not have been a surprise. In the chapter on an environmentally sustainable world you read in the third bullet point, “The planned increase in Fuel Duty has been delayed” and a mix of measures, which with respect to motor vehicles are likely to be less successful than using Fuel Duty as a means of promoting an environmentally sustainable world.

Mr Chote: To be honest, there was more on child poverty than I would have expected, more progress made there. Less attractively, there was another collection of one-off measures that we will wait to see how one-off they are and, as Martin says, the Fuel Duty delay. The justification for delaying is that you are doing that to support the economy. But saying that in a £1.4 trillion economy whether you raise Fuel Duty by £500 million now or in October is going to make a great deal of difference seems to me at odds with experience.

Chairman: On that point of child poverty, that is a cue for Sally and George.

Q61 Ms Keeble: Do you agree with the Government’s assessment that the measures in the Budget will lift an extra quarter of a million children out of poverty? Do you think it will be the seriously poor or the marginally poor who will be lifted out?
Mr Chote: I think on the 250,000 number—we would end up with 200,000 to 250,000. Given the uncertainties around this, that looks okay. We have not done a projection comparing the impact on, say, below 40% or below 60% so I could not give you a judgment on that, but my guess would be that as with the pattern recently you are likely to see more people moving from relatively close below 60 to above it rather than much change in the number below 40, but that is based on the past.

Q62 Ms Keeble: Will you be doing a study on that? Could you give us a note? That is quite key in terms of potentially meeting the longer term targets, is it not?
Mr Chote: The next time we will look at it is when the next set of HBAI numbers come out, which we are expecting in the next few weeks, and it will be interesting to see whether the pattern of the past has been repeated, in other words more movement around the 60% line than around 40%. As you know, the difficulty is that the further down the poverty scale you get the more ropey the numbers become.

Q63 Ms Keeble: The emphasis is on splitting the improvements between universal and in-work benefits, targeting in-work benefits. Do you think they have got the balance right and what impact do you think the measures will have on incentives to work?
Mr Chote: This is a Budget that probably does more for the incentive to enter work than to advance in the labour market. It is the unemployment trap versus the poverty trap. You are talking about the changes in disregards as affecting Housing Benefit and Council Benefit that may provide a useful incentive for people to get into work in the first place. More generous Child Tax Credits, being means-tested, probably does less for the incentives to work a little bit harder and earn a little bit more. Arguably it is probably doing more at the margin at which the Government can have greater effect, the extensive margin of getting people into work, than it does on getting people to advance a little further in the labour market. In terms of the balance, some mixture of the two can certainly look appropriate but the difficulty is that you do not get as much bang for your buck in terms of reducing the target measure of child poverty by going for something like Child Benefit because a lot of it is spent on people who are well above the poverty line anyway. If you were then to think about what more might still need to be done to get you to the 2010 target, throwing it all on to the child element of the Child Tax Credit would probably create more difficulties with work incentives, so you might want to think of a package which included some money there but also some money on the family element, say for larger families which are more prone to poverty, so a mixture of the two is appropriate.

Q64 Ms Keeble: Just on the point of the disregard. You mentioned that in terms of it being an incentive for people to get into work and I wonder if you could expand on that. I have to say, I was a bit taken aback when I went to a primary school to talk to the mothers about this and said, “Isn’t it wonderful this is happening”; they said, “Oh, but they disregard it anyway”, which completely threw me. I wonder if you could just say exactly what the rules are now and how this ends up being an incentive to people to get into work because it just provides them with more money in their hand.

Mr Chote: How exactly this works would be stretching beyond my feeble capabilities. You are right in the sense that there is already a disregard,
but for people who are hitting the 16 hours of work it is effectively to give an extra income disregard equal to the amount of Child Benefit that you are getting.

Q65 Ms Keeble: There is already a disregard?
Mr Chote: There is already a disregard, so it is like giving a disregard twice.

Q66 Ms Keeble: So it is an extra disregard?
Mr Chote: Yes, but it is linked to the amount you are getting in Child Benefit. If it is understood by the people who are intended to receive this they are brighter people than I am, I have to say.

Q67 Ms Keeble: I have to say it shocked me a bit because I had not spotted it. You said what more would be needed to reach the 2010 target. What is the bottom line for the Treasury in how much that will cost and how should it be split between in-work benefits or more simple cash transfers?
Mr Chote: One way of hitting the 2010 target, our best guess would be that if you were to increase the child element of the Child Tax Credits, the means-tested element, by £7.50 a week and then give a new payment of £12.50 a week for the third and subsequent child through the family element, which is obviously not means-tested away until much higher up the income distribution, so you are limiting the increase in the marginal rate at that point, that would cost £2.8 billion. That gives you some sense of how much more money there is to find. If you think that they have reduced child poverty by 200,000 to 250,000, let us say 250,000, they are probably still 450,000 short of the target. So you would be needing to do another 2.8 billion or so, so two or three similar sorts of steps to the ones we have seen in this Budget taken in the remaining Budgets and Pre-Budget Reports before the target date.

Q68 Ms Keeble: We have talked about this before, but how about going into work as a solution to child poverty, particularly given the prospects of increased unemployment?
Mr Chote: It does not make much difference on the timescale for 2010. If you were to achieve the Government’s lone parent employment target it would probably cut the amount you needed to spend by about 200 million. That was the calculation we did a year or so ago. It shows basically that success on that front does not really get you very far in terms of the near-term target, so it is either transfer payments or nothing at this stage.

Q69 Mr Mudie: Robert, can I ask you to brief me before I have my annual joust with the Treasury over this. You have just shocked me by saying with the present measures there is only 450,000 left. Tell me where you think we are with child poverty. First of all, let us see the target. The target is 1.7 million by 2010–11 and it started off with 3.4 million and my maths say it is 1.7.

Mr Chote: Our view was that before yesterday on current policies they would have ended up 700,000 short of where they wanted to be by 2010–11. I do not have the precise number on me.

Q70 Mr Mudie: In the Budget book they say considerable progress has already been made of some 600,000 children. I do not think that includes the 200,000 from the 2007 Budget, so if we add that, that is to 800,000. If you add 250,000 on for this Budget that just takes you over the million and that means there are 700,000 children short of target.
Mr Chote: The latest numbers we have are for 2005–06. We will get the 2006–07 numbers this coming—

Q71 Mr Mudie: You do not trust the Government’s Budget book?
Mr Chote: You just have to remember we always have to take account of the fact that we know there was a relatively ungenerous year of benefit increases to be reflected in the next set of child poverty numbers.

Q72 Mr Mudie: What was the quarter target, 2004–05? I calculate, and Colin calculates, that it would be 850,000 children. Was that a quarter target. Do you know how many they did?
Mr Chote: I do not have that on me. They missed it and they moved further away from it in 2005–06 by 100,000.

Q73 Mr Mudie: Your organisation reviewed one of the two pilot schemes, if not both pilot schemes, on the saving gateway. How do you view the proposals against your organisation’s review?
Mr Chote: There are a number of decisions they still have to take on how to go ahead with this. The lesson that emerged from the pilots, which I think the Government has accepted, is this is more effective to the people on lower incomes than higher incomes, the lower half of the income range over which it was piloted than the higher half of the income range. There was some evidence for the people who did show an effect that they did increase the amount of money they had in liquid financial savings, they did appear to be spending less but, confusing matters, if you asked them whether there had been an increase in their overall stock of assets they said “no”. It may be that is asking a set of complicated questions of people and the third one is the one they are most likely to get wrong. It may be there is some evidence that this has at least a short-term effect on the amount of saving that the target group does. We do not have evidence on whether that effect will persist and the policy is being rolled out before we will.

Q74 Mr Mudie: Out of your review was there an obvious choice for a matched rate? Is the coyness of leaving it out simply because they do not want to put the figure in the book in terms of their expenditure?
Mr Chote: Of the matched rates that were tested—20, 50 and a pound—20 did not seem to get much response at all, so I would have thought that 50
looks the most sensible of the three. There is obviously this issue that they have to deal with in terms of rolling this out in that how do they stop people effectively borrowing, they go along to a financial provider who says, “Fine, we will lend you the money and you can then go and get the match for this and you can pay us back, you are better off and we are better off”, but that is not achieving what the Government wants to.

Q75 Mr Mudie: We have been having some discussion about the criteria that they have defined. It seems heavily weighted in terms of being on benefit, so that is the passport. Does that leave out any group of low income people who might not be claiming benefit for a given reason?

Mr Chote: Quite possibly it does. This is a way of identifying the people on relatively low incomes. All but one of the passported benefits and tax credits we are talking about are means-tested. There is Incapacity Benefit where arguably that may be paid but one of the passported benefits and tax credits we are means-tested. There is Incapacity Benefit where arguably that may be paid to a partner in a household that is better off than the target group that they are looking at. You are certainly right in the sense that if there are people who are deserving but not achieving that passport then that is a problem, but they have to make—

Q76 Mr Mudie: That is the point. Do you think there is a considerable group of people who because it has been passported at benefits are going to be left out, although the criteria for the pilots were low income?

Mr Chote: I do not know in terms of the magnitude of people but clearly there is the possibility that there are people not taking up those benefits and tax credits to which they are entitled and therefore might be.

Mr Whiting: One possible group is obviously young workers who are just starting out who do not qualify for Working Tax Credits, who are on low incomes, and it is a moot point whether those are the ones you want to encourage but in principle they would not be in this broad criteria.

Dr Weale: Chairman, it seems to me that the underlying issue is the relationship between the saving gateway and personal accounts. Even with the criteria as they are defined here there will be some people who, to say the least, may be confused as to whether they should be putting their savings into a saving gateway product or whether they should be opening a personal account. Maybe the Government hopes they would do both but we are talking about people on low incomes who are unlikely to want to do both, so even with the situation as it is defined the Government needs to be clearer and have a view about whom it is hoping will participate with personal accounts and whom it is aiming the saving gateway at.

Q77 Nick Ainger: Apologies for not being here earlier, I had a Statutory Instrument that I had to be on until now. Crude oil prices have gone from $30 a barrel to the end of 2004 to over $100 a barrel now. Oil companies’ profits are at record levels: Exxon Mobil made over £40 billion profit last year; Shell $27 billion. The Budget is putting pressure on the energy supply companies to provide a uniform social tariff for all its customers that are on low income or in need. Should the Treasury also be looking at a contribution from the oil industry, not just the energy suppliers?

Dr Weale: First of all, on the question of the social tariff, there are questions about how competitive the market is because if the market were competitive then you would not expect the suppliers to be providing the social tariff, you would expect the costs of needy people’s fuel bills to be met out of State benefit. The situation we have is inherently a bit peculiar, but it may be a reflection of the fact that everyone recognises that the retail fuel market is not terribly competitive. A separate issue is the taxation of oil companies and, of course, in the past when oil prices have been very high we have seen windfall taxes. That takes you into the broader question of whether for domestic production the royalty taxation structure is appropriate to ensure that the revenues generated by very high oil prices are evenly split, and I suspect out of the oil produced in Britain the Government could be doing a bit better and the taxpayer doing a bit less well, so there may be a case for a windfall tax but logically it is separate from the issue of a social tariff and how you support people who have difficulty with their fuel bills.

Q78 Nick Ainger: I had a meeting a few weeks ago with a representative from SWALEC who were complaining that they offered what they believed to be a decent social tariff but very few of their competitors did. I cannot remember which chief executive of which energy supply industry it was, but before the Budget he said that he felt there should be a statutory social tariff agreed so that there is a level playing field for all energy suppliers rather than some being, as SWALEC believe, generous and others not doing anything. Do you think that the social tariff should be on a statutory basis as a specific requirement for all energy suppliers?

Dr Weale: In networks we do typically have people having social obligations and this is a case where because the market does not work in the way that a competitive market would be expected to, the particular people we are talking about maybe finding it particularly difficult to shop around for their most competitive supplier, so there is a case for putting it on some sort of statutory basis but I still think the issue is distinct from the fact that prices happen to be particularly high at the moment.

Q79 Nick Ainger: One of the problems which applying a social tariff has is in identifying those people who should be receiving it. Again, from the discussion I had with this gentleman from SWALEC the problem is that central and local government do not want to give energy supply companies a list of people who are in receipt of Pension Credit or on Income Support or Disability Benefits, so they cannot actually target them and you are left with those people who may be least capable saying, “I do qualify for the social tariff” actually not claiming it. They feel that it should be the other way round, they should be given those households which are in...
receipt of certain benefits so they can identify them and make sure they do get the social tariff. Do you think that should be happening?  

**Dr Weale:** Well, the reality is people may come across special issues like that, but in general they are terribly sensitive about personal information being dispersed widely and in Britain, perhaps more so than in some other countries, people are terribly worried about privacy and you cannot have both.  

**Mr Whiting:** Can I add a couple of brief points. Certainly I would echo Martin’s point about the difficulty of the administrative burden that might be created if there is a great deal of tying up to be done, which is one of the concerns electricity companies would have. Also, reverting to your first point on oil companies, if you look at it they are some of the biggest taxpayers in the country at the moment because as the oil price goes up they are paying more and more in Corporation Tax, oil taxation, etc. From research my own firm has done, we see them as the UK’s biggest taxpayers at the moment. They are certainly paying a very substantial amount into the Exchequer.

**Q80 Nick Ainger:** I am sure they are, there is no dispute about that, but in terms of a social tariff, which in effect is a levy rather than a windfall tax on the energy suppliers, it seems to me to be bizarre that we are looking at the energy suppliers to provide the resources for the social tariff but the oil companies which are in the main supplying the gas and heating oil, for example, which has gone through the roof compared with mains gas supplies, get away with nothing. There is no social tariff for somebody who lives in a rural area having a heating oil or LPG supply, for example.  

**Mr Whiting:** I understand the point absolutely and I am quite sure it is a subject that needs to be looked at if only to find an efficient way of doing it because, as I say, one of the big concerns is we end up with a very administratively burdensome system all round.

**Q81 Mr Fallon:** Could we turn to marginal tax rates. Robert Chote, help me with the table on page 62 where the increase in those facing a 60% deduction is over a million since 1998. Who are these people?  

**Mr Chote:** This is basically the introduction of tax credits and the increase in the generosity of those tax credits in an attempt to get child poverty down. What you are seeing is increased payments at the bottom and then more people being on the taper to get those removed.  

**Q82 Mr Fallon:** But who are the extra million who are being hit by this 60% marginal rate?  

**Mr Whiting:** At a guess on figures, they can be people on incomes of around £20,000 quite easily, so there can be quite significant incomes, with a number of children, to have this credit then clawed back from them.

**Q83 Mr Fallon:** Is that right? When we drew the Government’s attention to this in our report on the 2006 Pre-Budget Report the Government said: “published HMRC tax credits statistics show they are most likely to be families with children who have incomes under £20,000”. Is that right?  

**Mr Chote:** I do not know.

**Q84 Mr Fallon:** You do not know who these million people are?  

**Mr Whiting:** It is incomes up to about that level. My point was that as the tax credits have become more generous, as Robert alluded to, that naturally takes this level at which the claw back starts to affect people up higher. If we go back two or three years when tax credits were first introduced we would be looking at people on incomes of £12,000 to £14,000 and as the credits have become more generous that has made them more available further up the income scale but it has meant more people being subject to claw back over a wider income band than used to be the case.

**Q85 Mr Fallon:** Are these typically people with or without children?  

**Mr Whiting:** Typically people with children because we are talking about people with children and, therefore, eligible for the Child Tax Credit.

**Q86 Mr Fallon:** To what extent can the Government tackle these people and still achieve its social policy goals without altering the tax take-up?  

**Mr Whiting:** It is one of the imponderables and to a certain extent it goes back to Ms Keeble’s earlier point on benefits, that as soon as you give benefits and then say, “We want to withdraw them”, you are facing people with a significant taper. To give another example, I have just come from discussing the impact on the elderly of the income withdrawal of the higher personal allowances and we are going to see considerably more people subject to a higher rate for the over-65s because as the personal allowances become more generous, as they do from three weeks’ time, that will naturally mean more people suffering a greater claw back.

**Q87 Mr Fallon:** They will pay higher National Insurance contributions and presumably they will be losing out because of the abolition of the 10p rate as well.  

**Mr Whiting:** Yes.  

**Q88 Mr Fallon:** Why is the Government clobbering these people?  

**Mr Whiting:** There is quite a deal of complexity in the way that the tax rates are moving. You are right, the 10p rate goes and this has the greatest impact on those who are under £18,000 of income roughly because, very broadly, they lose out. There is  

1 **Note by witness:** Yes, many will lose out through the abolition of the 10p rate, depending on their income level. On National Insurance, those on incomes above about £35,000 will pay increased amounts; once the full increase in NIC upper earnings limit comes through from April 2009, those earning above £43,000 effectively lose on the NIC swing almost all they have gained on the income tax roundabout. However, if you are thinking about those aged 65+, they do not pay NICs of course.
compensation for them with the higher 65-plus personal allowance or with Working Tax Credits but some will be losing out.

Q89 Mr Fallon: The table does not show the figure for the current year, what is that figure? It shows the figure before 1998 and the figure for 2008–09.
Mr Chote: You mean 2007–08?

Q90 Mr Fallon: Yes. What will the figure be for the over 60%, Robert?
Mr Chote: It has gone up 200,000, I think.

Q91 Mr Fallon: So it is 1.6 million.
Mr Chote: I do not have it with me. From memory, Budget 2007 had 1.6 million. I think it is 200,000.2

Q92 Mr Todd: The spending programme for the next three years has efficiency assumptions within it which are challenging, more challenging than those in the previous round. There appears to be some evidence that departments are producing methods for reaching that which include the termination of certain programmes or services early or charging for services to particular recipients of them. Do you think that is a reasonable definition of a saving? It is clearly a saving but is it an efficiency saving?
Dr Weale: Yes. Witnesses to this Committee have said in the past that many of the supposed efficiency savings were structured in rather odd ways. It is very imperfect but the best sense of what is happening to efficiency, I think, can be formed from looking at the national accounts and productivity in the education industry, productivity in the health industry and so on, and on the figures that the ONS has produced, and admittedly this is looking ahead and those are always looking behind, to date performance has been poor. We will have to wait and see whether things turn up, but I cannot say I have any great confidence looking at the best, albeit imperfect, measures that we have that things will.

Q93 Mr Todd: We also have some discrepancies in the way in which departments measure their baselines it seems with some inflating by GDP growth and some by general inflation. Does this suggest that having some robust central control over this process is required, that leaving these matters in the hands of departments is not an adequate mechanism for ensuring some consistency of approach in efficiency savings?
Dr Weale: What happens as of 1 April is we have the Statistics Authority and the National Statistician setting out how the statistics should be produced. What I would hope is the figures used to look at performance prospectively would be entirely consistent with those. I think those would probably be deflating neither by general inflation nor by the GDP deflator but looking at measures like productivity. This might be something for the Statistics Authority to address.

Q94 Mr Todd: I am not sure that is going to lie within their ambit, but yes. This Committee has suggested before that we should have some sort of quality audit process as well to balance any efficiency programme. Have you seen any sign in the Budget papers of addressing that other than the assertion that something like that might be attempted?
Dr Weale: As far as I know progress with measuring the quality of public services remains at an extremely early stage. Going back to your earlier point, a measure of efficiency should take account of what has happened to quality otherwise it is not a measure of efficiency at all.
Mr Chote: Certainly as the ONS’s UK Centre for the Measurement of Government Activities has been going through looking at a series of areas, we have seen, for example, on areas like health and education the introduction of different sets of output measures looking at different ways of assessing quality and those are being refined and whittled down as you go along. All of which adds up to the picture Martin paints of more inputs going in and obviously a less than proportionate quantity of quality adjusted outputs coming out, but to some extent diminishing returns to what you put in is not necessarily surprising.

Q95 Mr Love: How strong is the link between the public sector wage restraint of 2% and the Government’s inflation target, Mr Chote?
Mr Chote: Not very, I would have said. Inflation is driven more by the balance between overall demand and supply in the economy. If you have a set of public expenditure plans laid out in cash or real terms then in part the choice about what wage levels are appropriate there is what appropriate mix of spending between money on labour versus other factors will deliver you the best sorts of outcomes. It is certainly not the case, as sometimes seems to be suggested, that in order to be consistent with the inflation target you need to have the earnings growing in the public sector at the same rate as prices are expected to be growing across the whole economy, leaving aside what is happening to productivity in the appropriate sectors. Over time you would expect the wages of public sector workers to have to reflect productivity improvements across the wider economy because labour can go between the public and the private sectors.
Dr Weale: Could I just add to that?

Q96 Mr Love: Add to this as well as giving that answer. Is there any link, no matter how weak, between public sector wage restraint and awards in the private sector? Is there any evidence of that at all?
Dr Weale: My first point is that people do not buy the output of the public sector and what appears in the inflation measure is what people buy in the shops, so there is no first round impact at all. That said, movement in wages in the public sector can from time to time affect notions of a going rate, and the connection which the Chancellor has to be relying on is that if people are getting a 2% settlement in the public sector then in the private

2 Note by witness: The actual figure is indeed a 200k rise from 1.68m to 1.88m.
sector they will be more willing to accept 3.3% than they would be if the public sector were getting 6%. There probably is some substance to that.

Q97 Mr Love: The first round of three-year pay deals seems to suggest actually they are going to be greater; although the Government has set a target of 2% in each of the years, it looks likely they may not actually live up to that especially in the later years. Will that have any impact on the public finances?

Mr Chote: Not unless they end up pushing up the overall spending envelope. If that is contained within the overall spending envelope, that should not make a difference to the public finances. It will show up arguably in the changes in quality of the outputs of those services, depending on whether that is money well spent or not. You could make the case that having those higher increases may help to retain, motivate public sector workers and deliver higher quality output, but unless you breach the overall spending total it is not going to affect the public finances.

Q98 Mr Love: The Financial Times reported just after the Budget that the Comprehensive Spending Review total for education was £500 million adrift from that which appeared last autumn, and I believe there may have been other changes which came with the Budget documents. Do you know why that has happened? Is there any implication for it? Can I also ask you a slightly wider question as well, will any under-spends at the end of this financial year go back to the Treasury or will they be left with the Departments?

Mr Chote: On the specifics of the education figures, as I understand it, it was the revision to the 2010–11 numbers you are referring to?

Q99 Mr Love: Yes.

Mr Chote: My understanding is that that reflects the fact that the Treasury now has information on the spending plans of the devolved administrations which it did not have at the time of the PBR. So, roughly speaking, the Treasury previously estimated there would be more education spending by the devolved administrations than they now think is likely and that is what has led to that revision. On the broader question, I presume end-year flexibility will apply, so if there are under-spends then in principle the Departments can go back to the Treasury and can claim for spending that in future years.

Q100 Mr Dunne: Turning to the capital gains tax changes, the announcement of the initial proposals in the Pre-Budget Report without prior consultation, the re-think, the subsequent delay of the announcement of the re-think, and then the confirmation of the arrangements in the Budget we have just had, what impact do you think that series of events has on the confidence and economic competence of the Chancellor amongst tax professionals?

Mr Whiting: I can only comment in terms of how best to handle the tax changes, and I would always argue that the way to do it is consult before and decide on the changes afterwards. It would have been easy enough, surely, to announce the intention was to simplify—which, let’s not lose sight of it, is a very good product, if we do have simplification of a ludicrously over-complex tax—to say, “This is the direction we intend to go”, consult about the details, debate those and then come out with a final product over a good time frame which did not worry people too much. In the end, we may have got to a reasonable result, but it has not been a very good way of managing change. I am afraid you also have to say that if you look at income shifting and residence and domicile, you could apply the same sort of issues—“Could we please have consultation first and decisions on the direction afterwards”.

None of that precludes, of course, the Chancellor announcing that there is to be a change in a certain direction; that is what Governments can do, but can we then have consultation about how that should be taken through.

Q101 Mr Dunne: There has been some criticism that this amounts to retrospection in the way the changes have come about. Do you think that is a valid criticism or does that not matter?

Mr Whiting: Dare I say it, it depends on your definition of retrospection. We do have one prime example in the Budget of retrospection, where there seems to be a change going back 20 years potentially affecting past tax bills. Of course this, to slightly split hairs, is retro-active in a certain way, that people were expecting something and that expectation has been altered. Our tax system is always prone to alteration. Was it reasonable expectation? Well, of course, people had anticipated that capital gains tax would be levied at 10% in certain circumstances, or even less, or that they would get an indexation allowance on a long-held asset. That is no longer the case. You could argue, they have had a few months of warning, but undoubtedly I think it is a fair criticism that a certain amount of reasonable expectation has been taken away from them. Is that retrospection? Strictly, no.

Q102 Mr Dunne: Do you think it has impacted business decision-making during this period which may have impacts on the economic prospects?

Mr Whiting: I can certainly comment from our own client base that, hardly surprisingly, we have had a variety of clients and a variety of situations wanting to know what was going to happen, what was likely to change, and taking action before or after 5 April to make the most of the possible changes or to avoid the tax increase. So it has distorted a certain amount of business decision-making. At the end of the day, it has not made a major impact because there have not been vast numbers of people doing something just for the sake of it, but it has accelerated deals, it has decelerated deals, it has taken people’s minds off perhaps just progressing the business they were doing.

Mr Chote: The process here is key. Clearly there was scope for consultation here. The very fact that the Chancellor said there will be time for people to arrange their affairs, implies this was not something
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which needed to be done at 6 o’clock on the day you announced it for fear of reaction. But then to basically give people time to arrange their affairs and then within a matter of days to cave in to concern from next door and from the CBI and then to throw up uncertainty about what the system will look like, promise clarification before the end of the year, not give it until January, is not a process designed to give a good planning environment for business or indeed for anybody else.

Dr Weale: I think it is also important to remember that when the Pre-Budget Report was introduced, it was intended to be a means of consulting, and so if the Chancellor had not wanted to consult you might have thought he could have introduced it in the Budget.

Q103 Mr Dunne: On the simplification measure, do you think the life-time entrepreneur’s relief of £1 million is something which will be practical and easy for the Government to keep tabs on?

Mr Whiting: That would be a very interesting question for you to ask the officials from the Revenue and Treasury tomorrow, how they are going to keep track of it, because we certainly see a practical problem in keeping track of where you or I in our own individual situations are on the £1 million allowance. Conceptually it sounds easy but there is a deal of record-keeping to be followed for this which does create an administrative burden.

Q104 Mr Dunne: There has also been some criticism from the life insurance industry, that a lot of their products are now going to become uncompetitive. Do you think they have some validity?

Mr Whiting: They have some validity because what has been introduced—and it was something which was not spotted when the first announcement was made, not until some digging was done—is that now, rather than having a broadly level playing field for investment, you now have a different higher tax levy coming out for an insurance-based product as against direct investment. That may or may not be what the Government wants to encourage but it is seemingly an unlooked-for consequence of the changes.

Q105 Peter Viggers: Turning to the taxation of those who are non-domiciled, how much of an exodus can we expect to see and what will the impact be on taxation?

Mr Whiting: That, if I may say so, is a sort of $64 billion question, is it not? In all honesty, nobody knows exactly how many people will leave. People are undoubtedly considering leaving and some are leaving; the volume we do not know. Undoubtedly the changes announced in the Budget have reassured a cadre of people; they have been helpful. Whether they have gone far enough to really stem any exodus remains to be seen, because a bit like the point Mr Dunne was alluding to, one of the impacts there has been is a loss of confidence and a feeling amongst the non-domiciled community that the UK no longer wants them in the way they once did. Here we are talking about various levels: we are not just focusing on the very wealthy entrepreneur who feels he or she might be taxed more heavily, we are also thinking in terms of the American or other bank or finance house which employs a lot of expatriates and can suddenly see their salary bill going up because of the niggling little provision to deny the personal allowance to such people in many situations. So it is not giving a very good message to the non-domiciled community and the employers of those people, that the UK is as welcoming as it once was.

Q106 Peter Viggers: Discussing this at lunch time with a range of people, including bankers and others, the most vehement commentator was an academic. Have you come across that point?

Mr Whiting: I have certainly come across it. There is a surprising number of academics, if this is what you are alluding to, who are non-domiciled and who feel badly treated by this. I think it is in part because there has been a great deal of focus on this £30,000 fee, if I can use that as a shorthand, for very wealthy people, and what has perhaps been missed—or it has not had quite the same focus—is that there is a much larger cadre of employed people, be they in the city or in academia, for whom £30,000 is a huge amount of money. Or, again to reiterate the point, the simple loss of personal allowances is an unpleasant little extra cost to them.

Q107 Peter Viggers: Can I ask you to comment on the practical issues of implementing and enforcing taxation and the impact of the increased administrative burden?

Mr Whiting: I think it is going to be an extremely difficult measure to run. Again, the very wealthy who have their advisers will make sure they comply and they will pay the £30,000 on a self-assessment basis. The middle rank, very often employed, will be dealt with in many cases by their employer who is going to have to shoulder the burden of asking, “Have you made an election? You do realise you have to sort out whether you are actually now non-domiciled, on a remittance basis, whatever” and then start amending the PAYE code or reimbursing, so there is a huge burden there for the employer. Then the biggest cadre of non-domiciles are those who many of us see every day—the archetypal Polish plumber or the Romanian farm worker or the sandwich bar worker—who are employed, paying their UK taxes but probably do not even know they are non-domiciled because they do not know the term, they do not realise potentially they are about to lose their personal allowance, they certainly do not have any advisers, and if they were to go to HM Revenue & Customs—and let us be realistic we are talking about potentially millions of them—I very much doubt whether HM Revenue & Customs are the least bit geared up to help them. In other words, what we are looking at is unwitting non-compliance by a large group of people at the bottom end of the income scale.
Q108 John Thurso: The Budget is full of green rhetoric but I think from your comments at the beginning you were somewhat underwhelmed by the actuality. Is that a fair assessment?

Dr Weale: I certainly have that view, that things like auctioning a carbon allowance and so on is a very good idea but looking at the particular issues over road use and road fuel use, I find myself asking, “Yes, there is some discouragement now to owning cars which use a lot of fuel” but actually what does the Treasury, what do HMRC, think the implications would have been if instead vehicle excise duty had been abolished and the revenue entirely collected through fuel duty? My guess is that that change would do a lot more to reduce carbon emissions, perhaps not in the short run but in the medium term.

Q109 John Thurso: I wanted to ask you about that because I saw your first, second best comment. That holds true if what you are seeking to do is actually change behaviour, and what you want is people to say, “Gosh, this is expensive, therefore I am going to get on a bus or a tube”. You made the point, if I remember rightly, that what you do is you alleviate income tax so you help the poor by having less income tax which alleviated the burden?

Dr Weale: Yes.

Q110 John Thurso: But is there not a different problem which is the rural/metropolitan divide, which is that there are large swathes of the UK which are highly rural and have no public transport and people rely on their vehicles and therefore end up paying a lot more and they tend to be the rural poor. How would you deal with that aspect?

Dr Weale: I think that would still be something that the policy towards the countryside would be something that the Government—

Q111 John Thurso: So you would need an opt-out in there?

Dr Weale: The Government needs to address it on environmental grounds. If it is the case that people who live in the countryside do more damage to the environment because they drive around a lot, is it something we collectively want to put up with because we like the idea of the countryside not becoming completely depopulated? Once again the first best would still be, if there are people in particular circumstances who you thought deserved to be protected from the income consequences of the change, then you would try and do something to improve their income, perhaps by having council tax rebates in rural areas or something like that, to recognise people who chose to live there need to use more fuel. But the approach we have seen I do not think is in any sense first best and probably will not be very effective.

Mr Chote: One issue is, as well as the imbalance, I think we have seen a sort of tentative resuscitation of road pricing raised as a possibility. Clearly the issue then about fuel duty being quite a good tax aimed at emissions depends on the extent to which you think the issue is more of congestion. A balance of getting more money through road pricing and less fuel duty might be a more appropriate response to the fact there are different sorts of externalities—

Q112 John Thurso: Road pricing must the long term. Mr Chote: --- and that presumably has a different impact rural/urban to the current mix we have at the moment.

Mr Whiting: If I can just add, within this package there is a number of good and worthy environmentally orientated measures. I continue to feel that what is lacking is a clear statement, a clear framework, by Government which says, almost going back to your own point, “Are we raising money by environmental duties or are we changing behaviour?”—to really set a framework and to give business in particular the confidence that is the intention because, after all, business needs a little time to adapt and to follow what Government wants.

Dr Weale: Could I come back on the question of road pricing, because the measures, as I understood them, would be likely to support rather local road pricing schemes, and the idea that it might all be done by satellite monitoring is not finding the favour that it did, so it is not clear how far that will actually work to achieve the affects that Robert was describing. I concede with satellite-tracking it could be done.

Q113 John Thurso: You do not actually need a satellite but I will not go there because I could bore for Britain on road pricing. Can I move to aviation tax instead? One of the things which everybody I think is agreed upon is that aviation needs to externalise its environmental costs. We are coming up to the point where we are moving from APD to a per plane duty. Firstly, should freight aircraft be included and should private aircraft be included? Do you think there is anything of great importance that we have to get in, now the consultation is nearly over? What are the key points to get that right? Given that we have got most things wrong, how do we get that one right?

Mr Chote: One attraction of the per plane method is that does make incorporating freight an easier proposition. Given the amount of freight-only flights there are, it does not make a huge difference to the magnitudes we are talking about here. One interesting issue is that when this was first mooted there seemed to be a strangely precise amount of revenue expected from this from what was a very vague plan at that stage, and now we have a very precise number increased by 10%, for reasons which do not seem very obvious. Clearly in terms of the structure of this, there are issues about the fact that aviation like road transport has different sorts of undesirable externalities and you need to get the tax to work in a way which addresses that. There is a local noise externality versus emissions, so what is the charge? Do you change the charge depending which airport we are talking about? How much of it is a per mile element as well? So there are those issues
Q114 Chairman: I have a few tax avoidance questions for you. The Government amended stamp duty three years ago amid concern that people opting for Sharia-compliant mortgages were paying stamp duty twice. It has been reported that commercial property developers were quick to exploit the legislation which allowed them to escape stamp duty altogether. How long has the industry been aware of this loophole and how much do you estimate this has cost the taxpayer?

Mr Whiting: I do not think it is something which will have cost the taxpayer very much. It has been an issue not just in the context of stamp duty but in the general development of Sharia-compliant financing models which has been looked at, both by the industry and by HM Revenue & Customs, very carefully, because of course one cannot just make these applicable on a religious basis, they have to be open. So there has been very good consultation and discussion about these. The idea that the particular stamp duty thing could suddenly be generating a loophole is something which has become, I think, aware of in the last year, so it is a pretty quick move to stop it, so I do not think there has been any particular loss.

Q115 Chairman: The Chartered Institute of Taxation describe the income shifting rules as “a sticking plaster solution which did not address the real structural problems inherent in the ways that small businesses are currently taxed.” Do you agree with this assessment? Should the Government widen the consultation on income shifting to address these concerns?

Mr Whiting: I confess I wrote that phrase—

Q116 Mr Fallon: So you agree with it!

Mr Whiting: It does not automatically follow I agree with it!

Q117 Chairman: Two seconds to change your mind!

Mr Whiting: No, I will stick with it! Our preference would undoubtedly be that there is a good consultation to take the opportunity to have a wide-ranging review of how a small business activity, whether you are carrying it on as self-employed, small partnership, or small company, is taxed. You might also sweep into this a read-across to employees because a lot of it just comes from the structural differences that you have, and to put an income shifting sticking plaster on to something we do not really know what we are aiming for is surely not the right way forward; better to have a proper review.

Q118 Chairman: HMRC has introduced a measure to stop the abuse of double taxation treaties, an agreement which prevents UK residents from being taxed twice on overseas income. What do you think of that measure?

Mr Whiting: The actual change to prevent the abuse of double tax treaties is no problem at all. The problem I have is that it does seem to be, I believe, clarifying—to quote the press release—a change which took place in 1987 and is supposedly acting back to 1987. For all that it is changing something which has apparently been abused and is an anti-avoidance measure, to go back 20 years does seem to be a little too far.

Q119 Chairman: That practice was popular with UK property developers who used it to set up partnerships in the Isle of Man, with profits from UK developments made via the trust in order to avoid UK taxation. Will HMRC be able to tax every such developer on the income which arose? Can you give us an estimation of the savings?

Mr Whiting: I have seen various estimates of how much money is involved and I think we are into the tens of millions certainly. Will HMRC be able to access the amounts, well I assume they think they will be able to because we are talking about people who are resident in the UK. It is undoubtedly an avoidance technique which has been there. What is interesting is that it has been known about for some years and it seems strange it has only been moved against now. Not only has it been known about but it has certainly been disclosed to HM Revenue & Customs, and one of the concerning factors, whatever one says about avoidance and unacceptable avoidance, it is something which has been known about for long enough, it has been referred to in seminars and talked about quite openly, and suddenly we get a move against it after some years and is very retrospective.

Q120 Chairman: Is this a scramble to find money from anywhere?

Mr Whiting: It is a good question. Not only here but in a number of the anti-avoidance measures there are some quite impressive figures which, certainly looking at it as a tax adviser, I have to say those are quite rich figures and you do wonder whether those anti-avoidance measures will deliver the amounts which are pencilled in for them.

Chairman: John, Robert, Martin, thanks very much for your time. It has been very helpful for us in our preparation for the Chancellor on Wednesday.
Tuesday 18 March 2008

Members present

John McFall, in the Chair

Witnesses: Mr Dave Ramsden, Managing Director, Macroeconomic and Fiscal Policy, Mr Mike Williams, Director, Personal Tax and Welfare Reform, Mr Edward Troup, Director, Business and Indirect Tax, Ms Sarah Mullen, Joint Director, Public Spending, Mr Chris Martin, Director, Public Services, and Mr Simon Gallagher, Team Leader, Financial Services, HM Treasury, gave evidence.

Q121 Chairman: Good morning. Welcome to our session on the 2008 Budget. Mr Ramsden, a warm welcome to you and your colleagues. Can you introduce them for the shorthand writer, please?

Mr Ramsden: I can, Chairman. On my far right is Chris Martin, a Director in the Public Services and Growth Directorate who has particular responsibility for the environment, next to him is Edward Troup, Director of Business Tax in the Treasury, next to him is Mike Williams, Director of Personal Tax in the Treasury, and on my far left is Simon Gallagher, a Team Leader in the International and Finance Directorate, he works in Financial Services, and Sarah Mullen, Director of Public Spending. I am the Managing Director for Macroeconomic and Fiscal Policy.

Q122 Chairman: What factors explain the divergence between the Treasury and most outside forecasters regarding growth?

Mr Ramsden: In putting together our Budget forecasts we have had to take account of what is an incredibly challenging global environment. We have long-term challenges such as climate change which we have tried to emphasise in this Budget. More immediately and what has been a particular focus of this Committee, we are dealing with a period of exceptional uncertainty in the global financial markets. You wrote a very valuable report on this at the end of February. We have also had within the UK the events around Northern Rock where there has been a written statement made this morning. The uncertainty is unlike anything I have seen in the last 15 years that I have been working in the Treasury. That is the backdrop to our forecasts. Two particular aspects impinge on the forecasts. One is the judgment about how long these extremely unusual credit conditions are going to last. The second, which is really the key issue for the forecast, is the impact on the real economy. This is central to the judgment that we and all other forecasters have made. What we have tried to do in forming our judgments—and this is where we may differ from some outside forecasters—is look at the data on the real economy and whether that has been developing as we expected at Pre-Budget Report time. Also, which has been picked up by a lot of the comment on this Budget, we have attempted to put the current position in a longer-term context, looking at the performance of the UK economy and how it has dealt with past shocks, it is what we have described as its resilience. Where that leaves us is with a forecast, which I think is a very realistic forecast, of growth of 1.75 to 2.25% this year and growth of 2.25 to 2.75% in 2009. We produce these forecasts to frame our fiscal judgments and our assessment of the fiscal position and, as you know, to do that we take the bottom end of the range of our forecasts to drive our fiscal forecast. Our fiscal forecast is running off a forecast for growth in 2008 which is 1.75%, which is actually in line with the independent average for 2008. In 2009 our forecast is running off a bottom end of the range which is 2.25%. Why do we think growth will pick up in 2009? It is partly this analysis of resilience. It is also that there are some upside risks to the growth forecasts even for 2008. There is a lot of momentum from 2007, ie the business surveys have stayed strong and the labour market remains resilient. Those would be the points I would highlight to distinguish us from independent forecasters.

Q123 Chairman: The experts that we had before us yesterday and quite a number of the submissions have suggested that the Treasury forecast regarding the credit conditions is pretty optimistic. It has been suggested that you may not be living in the real world.

Mr Ramsden: I think we are very much living in the real world. I was a little bit surprised by some of the comments you had from the external experts last night. They did not think we had done justice to the risks in the forecast. If you read Chapter B, as I am sure you all have, there is extensive discussion of some of the issues that you have raised at this Committee, the issues around housing and around the impact of the credit position. On the credit position, what we have assumed is a normalisation of conditions by the middle of 2009 and with a start in that normalisation from the end of this year. By the middle of 2009 we will have had two years of not normal credit conditions. When we talk about normalisation we are not saying that we think the interest rate spread over the bank rate will go back to...
the conditions that it was at last May or June when it was unusually low, but we do think it is going to go back from the very heightened levels for the spread that we see at the moment. That is a judgment that we have made. We have been very clear about that. I think that shows that we are having, like all forecasters, to make judgments based on our analysis of both the real economy and what is going on in the financial sector and the interaction and we think those forecasts are realistic.

Q124 Chairman: In a way we do not really know where we are at the moment, do we?
Mr Ramsden: As I said a moment ago, this is a period of exceptional uncertainty. We do not even have complete data for 2007 yet. We have financial market data which is changing every day. All forecasts are based on a judgment. What we have tried to do with ours is set out clearly the basis for that judgment.

Q125 Mr Mudie: You have just repeated that this is a time of exceptional uncertainty. They say a week is a long time in politics. Is a week a long time in Budget making? Would it be the same Budget if you were delivering it tomorrow in view of the past few days?
Mr Ramsden: My advice in terms of the forecasts and the assessment that I would make would not change a week on. If you look at the data that has been published since the Budget and I would particularly draw the Committee’s attention to the inflation figures that were published this morning, those show, as we were expecting, a rise in the CPI measure of inflation, but RPI inflation is flat in February.

Q126 Mr Mudie: Is that not a sideshow to the main events that are happening in the States that look as though they could very well move over here? Do you think the data on inflation is more important than Bear Stearns?
Mr Ramsden: No, I did not say that.

Q127 Mr Mudie: Tell us how you think the Budget, if it had been delivered tomorrow, would not have changed because of Bear Stearns?
Mr Ramsden: The reason I drew attention to the inflation number this morning was because it is a critical number for the Bank of England and it is a critical number for us in our assessment of what is going on in the economy. We have drawn attention to the risks from the financial sector and the risks from the short-term increase in inflation. Inflation actually came in, as published this morning, very much as we were expecting. I thought it was useful information to pass on. I was not making an assessment of Bear Stearns relative to inflation; I was just trying to draw attention to the real economy data that came out. Bear Stearns has happened.

Q128 Mr Mudie: Is the Tripartite Committee meeting at principal level?

Mr Ramsden: What has happened over the last few days, as has happened over the whole period since last August, is that there has been intensive contact between the tripartite authorities.

Q129 Mr Mudie: Is the Tripartite Committee meeting at principal level?
Mr Ramsden: The tripartite principals have been in intense contact over this weekend.

Q130 Mr Mudie: In a tripartite formally constituted group? I would expect the Governor, the Chancellor and the FSA to speak to one another daily. Has there been a formally constituted Tripartite Committee meeting at principal level?
Mr Ramsden: There may well have been but I cannot confirm that now.

Q131 Mr Mudie: In the last few days? You do not know?
Mr Ramsden: There may well have been.

Q132 Mr Mudie: Do you think you could send someone out to phone the Treasury and tell us?
Mr Ramsden: Yes, we can do that.

Q133 Mr Mudie: Has the Treasury been a party to recent decisions to put this liquidity into the market?
Mr Ramsden: Action like that is the responsibility of the Bank of England but they keep us informed.

Q134 John Thurso: I would like to return to the link with the United States. It is clear that the sub-prime virus has infected Britain heavily through the financial markets, perhaps more heavily than people thought it might six months or so ago. The consensus this morning by most commentators on the news was that the US was already in recession; it was just a question of how long and how deep it would be. How much of an effect is that going to have on the UK given that we are still so strongly coupled in so many ways to the US economy?
Mr Ramsden: It will have an effect on the UK. To go back to Mr Mudie’s question, I think it is clear that the position of the US is considerably weaker than we were expecting at PBR time. I was certainly not trying to downgrade the impact of the problems in the US housing market and in the wider financial sector the US has had on the US economy. 16% of our exports are to the US so there will be an impact on the UK. Also, as you describe it, because of the interconnectedness of global financial markets we can expect that the credit problems that have spread out across the world financial sector are going to have more of an impact on us than we thought at PBR time. We already marked them down significantly at PBR time for 2008, that is why we have marked them down further and why, therefore, by the second half of this year, when we think the credit conditions will be having their most significant impact, our forecast for growth in the UK is down 1.5 to 2% on a year earlier. So we have a real deceleration in the UK economy which is reflecting these conditions, but that is still growth even at that
weakest point of 1.5 to 2%. We think that because of
the underlying resilience of the UK it will then start
to grow again. Our forecasts for next year for
growth, that is 2009, are compared with the bounce
back we have seen in the UK economy from
previous periods of below trend growth such as in
2005 and 2001–02. Those were followed by years of
growth at 3%. We are not forecasting anything like
that for next year. I really want to get across to this
Committee that we are not under-estimating the
impact of the di

Q135 John Thurso: Turning to the eurozone, there
has been quite a lot of press comment more or less
suggesting that the eurozone has not su
has been quite a lot of press comment more or less
normalise to lead to that forecast judgment.
both the latest data and our expectations of how the
moment, but we have made judgments based on
both the latest data and our expectations of how the
credit market positions are going to unfold and
normalise to lead to that forecast judgment.

Mr Ramsden: If you look at our main forecasts, we
have revised down growth in the euro area for 2008,
so we have growth slowing from 2.5% in 2007 to
1.75% in 2008. We do think credit conditions will
have an impact on the euro area and that matters to
us because the euro area accounts for three times as
much trade as the US does for the UK. I think it is
fair to say that if you contrast it with the US, the US
is probably a source of downside risk to our growth
forecast and the euro area is potentially a source of
upside risk to our forecast. If you look at the central
forecast of 1.75% for 2008, that is below trend,
whereas the euro area has been growing significantly
above trend in the last two years. The latest data on
industrial production for the euro area in January
was actually quite strong and that was the
second successive month. There have been
encouraging business surveys in Germany. It is
important to keep these issues in perspective. There
are these very difficult credit conditions which
potentially are going to impact, we have made
judgments that they will impact, but then there is
also an assessment of the real economy and how
these credit conditions will play out into the real
economy.

Q136 John Thurso: How concerned are you that the
UK’s current account deficit is now at its highest
level as a proportion of GDP since quarterly records
began in 1955?

Mr Ramsden: Could I just answer the previous
question that I was unable to be clear on at that
point about the Tripartite Committee? The
Chancellor, the Governor and the Chairman of the
FSA have been in very close contact over the
weekend. The Chancellor has been talking, as have
others, to Hank Paulson. Yesterday evening there
was a formally constituted tripartite principals’
meeting as opposed to those kinds of informal
discussions. Apologies for the fact I could not give
you a clear answer earlier.

Q137 John Thurso: The current account deficit is
now at its highest level as a proportion of GDP since
records began. How concerned are you?

Mr Ramsden: I think that the current account, as we
tried to set out in Chapter B of the Budget
document, is a forecast and an economic
consideration. I will not go through the definition of
what the current account is telling us, but it certainly
contains information and we look closely at it. If you
look at what happened with the numbers that were
published for 2007, on the trade side, trade in goods
and service, that has not changed really very much at
all compared with previous estimates for 2007. That
deficit has picked up a bit since 2005, but you would
expect that during a period of above trend growth
for the UK economy. Some data that came out on
Budget Day revised down the estimate of the trade
deficit in 2007 from 3.7% to 3.5%. I am not
underplaying that that trade deficit is still at 3.5%,
but that just shows how the data can change. The
real change on the current account for 2007 was the
estimates produced by the ONS for investment
income which was revised down very significantly, as
we set out in a box B8 in the Budget document. That
investment income balance, as we have tried to
emphasise in the Budget document, is a very difficult
ting to estimate. It is based on a survey of inward
investment and it is based on estimates of the asset
and liability position of the UK economy that we set
out in Chart B. So you can see that that net income
balance, as set out in Chart A of box B8, has moved
down very significantly. We think that there are
issues there that we need to keep a close eye on as to
what is driving that, but there are also data issues
around that. These are very difficult things to
estimate. What is clear is that the current account
position is sustainable to ensure the balance of
payments.

Q138 John Thurso: Could I just ask about sterling
and, in particular, to what extent you might be
concerned that the continuing depreciation of
sterling will place the inflation target under stress?
What are the risks there?

Mr Ramsden: As you have almost emphasised in
your question, starting in 1992 but formalised since
1997, the Government has had an approach to
macroeconomic stability based around targeting
inflation, so there is no exchange rate consideration
which actually feeds into that policy, it is an inflation
targeting policy. If there is depreciation in sterling,
as there has been since the PBR, as of Budget Day
the depreciation was 7%, as we drew attention to in
the Budget document, that runs a risk of imported
inflation.

Q139 John Thurso: This morning sterling is at its
lowest level since pre-1997. Is that a matter of
concern?
Mr Ramsden: The exchange rate for sterling is determined in the markets. There is a risk of imported inflation and it will depend how in the production pipeline those factors are taken into account. As we stress in other parts of the Budget document, over recent years there have been real squeezes on margins throughout the pipeline which has meant that inflation has not picked up in the UK. On the other hand, we do think that the position of the UK economy in terms of the contribution from exports and net trade will improve as a result of that exchange rate depreciation. You have those two factors that you have to take into account.

Q140 Peter Viggers: The Chancellor of the Exchequer led on the issue of resilience in his Budget by making the proud statement, “This resilience puts the UK in a strong position to deal with the current global economic uncertainties,” and yet the Institute of Fiscal Studies and other commentators have said that the UK is in a less good position to deal with shocks and strains than it was some years ago and in a less good position than it was compared with other OECD countries. How can they get it so wrong?

Mr Ramsden: I think it is a characteristic of economists that they do not necessarily always agree on everything. I think what I would say on our assessment of resilience is that it builds on work that has been done by the OECD and that has been done by the IMF on the performance of the UK economy. That work looks at two sets of issues. What we are trying to do with this resilience work is link up what has been going on at the micro level in markets in the UK economy not just over the last decade, but how markets at the micro level have performed in the UK economy and then how is that supported at the macro level by the policy framework. The conclusion of people like the IMF and the OECD is that the combination of a long-term agenda on microeconomic reform, starting with the labour market reforms that were instituted in the 1980s and feeding right through to the present day, has over time improved the working of the UK as a market economy. At a macro level particularly the reforms instituted since 1997 where you have seen a monetary policy framework and a fiscal policy framework which enables you to support and encourage stability has led to this position where the UK has had very, very stable outcomes in terms of a growth in inflation. The fact that we have had 62 quarters of successive growth sounds like a sound bite, but when you contrast that with Germany, which has been under technical recessions this decade, Italy, which has had technical recessions this decade, and France that has seen quarters of falling output, we have not seen any of that in the UK going back to 1992. We think that that resilience is still there today.

Q141 Peter Viggers: I appreciate your implied tribute to my colleague Ken Clarke in terms of the timing. The work that has been done on resilience by the Treasury is highly financially articulate but it does look backwards, whereas if you look forwards, the things that we have been so successful in and the things that have helped to move the British economy forwards have been links with the United States, success in the financial services industry and a property boom and those looking forward do not look so good. Would you agree with that?

Mr Ramsden: No, I would not agree with that. If you are trying to make a judgment about the future you typically do focus on the track record of the recent past. The UK’s track record right up to the current time delivered growth in employment of 300,000, that is 1% in the year to 2007 Q4 and that is up to and after the period when the financial turbulence started. When you look at the position on UK inflation where it came back to target, as we were forecasting a year ago and as some people queried, when you look at the stability in this budget from fiscal policy, where fiscal policies have the flexibility to support the economy, I think that that means that we can look forward and think that the resilience that we have had will stand us in good stead. The issues you draw attention to are also considerations. Our links with the euro area in terms of trade are three times greater than our links with the US. I do not think our economic success has been tied to the US. I think our economic success has been tied to a flexible, open economy that is well placed in the global economy.

Q142 Peter Viggers: You forecast a rebalancing of the economy during the remainder of 2008 with consumption and business investments slowing and external demand receiving a boost from the depreciating pound. How sensitive is this forecast to a further weakening of the world economy, in particular the UK’s key trading partners with the United States and Europe?

Mr Ramsden: Our key trading partner is very much the euro area which accounts for at least 50% of our trade. If you look at the forecasts, really what is driving this rebalancing is a quite significant slowdown in private consumption growth. We also have a slowdown based on the latest data for business investment. When I look at the path in the official data for business investment, the fact that it barely grew in 2007 in Q4 on a year earlier I find a little bit puzzling. It does not accord with business surveys for business investment. I know that is an issue that this Committee has been interested in in the past. We always run off the official data and business investment is therefore forecast to see relatively low growth in 2008 after two very strong years. If the euro area were to slow significantly more than we forecast then yes, there would likely be an impact, but as I have said, I think there is an upside risk from the euro area forecast.

Q143 Mr Love: You have made a strong case for the resilience of the British economy. What impact is that likely to have on employment going forward? Will it be a better impact than in the past slowdowns?
Mr Ramsden: Our judgments on the labour market are very much framed by the recent performance which has been strong. When I was analysing the labour market back in the early 1990s one of the surprising things about labour market performance then was how it did not follow the performance in the 1980s. Unemployment started to fall relatively quickly from its peak in the early Nineties. What do we expect to happen going forward? The business surveys suggest a bit of softness compared to the recent strength in employment. I think it is fair to say that I would be surprised if we were still having the kind of growth rates of 300,000 in employment that we saw a year earlier in 2007 Q4, in 2008 Q4. In going through a period where we are forecasting a slowdown in the UK economy you would not expect from an economic perspective the sort of growth rates we have seen in employment, which I think have surprised many people on the upside, to be sustained. But what we do think is that the resilience of the UK labour market means that you would not expect anything more worrying in the UK labour market other than a slowdown in employment growth.

Q144 Mr Love: Are you expecting a reduction in inward migration going forward and what impact will that have on wage pressures in the economy?

Mr Ramsden: As we briefed this Committee on back at PBR 2006 when we revised up our trend growth assumptions, those largely reflected an upwards revision to our medium term projection for net inward migration to about 190,000 a year. Since we made that judgment and briefed you and others on that the ONS has come out with their medium term migration estimates which are actually slightly stronger in the medium term than the ones on which our forecasts are based. That is our projection. We do not produce a forecast for migration, but there are a number of factors that actually will depend on economic factors, but I have no reason to think that our projections post-PBR 2006, which have served us well over the last year and a half, will not continue. We would expect still strong inward migration of around 190,000, which is a bit below the ONS projections.

Q145 Mr Love: You might have noticed reports this morning that the CAB are having a massive increase in enquiries in relation to mortgage difficulties. Are you expecting house prices to crash as a result of recent market activity?

Mr Ramsden: Our forecast for house prices at PBR time was that house price growth would slow down quite a bit from the double digit rates we were seeing. If anything—and we set this out in a chart in the supplementary tables that we publish—we expect a little bit more of a fall in the house price to earnings ratio. We are not forecasting a fall in house prices, but we are expecting them to be a little bit weaker in the short term than we thought they were going to be at PBR time.

Q146 Mr Love: As I understand it the figures at the moment show house prices are falling everywhere apart from Scotland and London.

Mr Ramsden: Scotland and London are quite big places. House prices are rising about 2.25% on a year earlier compared with double digit growth rates. The house prices rising a little bit less than earnings means the house price to earnings ratio falls a little bit. It fell a little bit in 2005. We are certainly not forecasting anything more significant in the housing market for the kind of reasons I went into in detail at the PBR with you as to why we think the UK housing market is different from the US housing market in terms of the structural differences.

Q147 Mr Love: Let me just pursue that for a second because yesterday some of our experts told us that the United Kingdom was really the only housing market that had major similarities to the US market. There is a healthy debate going on about how similar they are. Why do you think that with very similar housing markets we will not experience the same dramatic fall that has happened in the US?

Mr Ramsden: I might as well put it on the record again that I do not think they are very similar to the US for three reasons. One, the UK has had this long-term problem with housing supply. That is why the UK is just about the only developed country over a 30-year history that has had sustained real increases in house prices. When you bring that up to the present time, we do not have the kind of supply overhang that the US has, we have nothing like it. On the demand side, we have increasing demand. We were talking about migration and about increased numbers of households. When you look on the regulatory side, I think we have a very different structure for regulating mortgages and in a sense the lessons have been learned over the years in the UK that the US is now learning. In the RICS European housing review for 2008 they say “The UK housing market looks much better placed than many others in Europe. Interest cuts are likely to stabilise prices”.

Q148 Mr Love: Let me ask you about the link between house price inflation and consumption. Do you think there is a direct link? If house prices do start to decline will we see a more dramatic impact on consumption than perhaps you are forecasting at the present time?

Mr Ramsden: We were conscious that we had not done justice to this issue at the PBR and I think you raised it in your report on the PBR and we tried to remedy that by putting a box into the Budget document, box B7, which sets out the range of issues around this potential link. I think the conclusion I would draw is that in the past when there has been an apparent link between house prices and consumption that has been more the result of third factors such as a wider instability or a wider weakness in the labour market. The wider instability would mean high interest rates. I do not see those conditions now. We have the conditions for stability in the UK economy and, as I have said, I think we
have a strong and resilient labour market. Just as we conclude in box B7, we would recognise that if in the UK there were to turn out to be a collateral effect, so it was harder to borrow on the back of a lower evaluation of housing assets, then there may be some impact there, but we are factoring in quite a significant slowdown in consumption already. I think we have made a realistic assessment of that issue.

Q149 Mr Love: Let me add two things, one of which you have already talked about, which is the continuing impact of the credit crunch on the provision of mortgages and the cost of debt, but also the personal debt problem that we have in this country which is very significant for quite a large percentage of the population. If we assume that the credit crunch will last rather longer than I suspect the Treasury is assuming the consequences of that could be quite serious for consumption and therefore quite serious for the economy.

Mr Ramsden: The balance sheet is pretty clear on this at the macro level. The net assets in the UK for the household sector are £7 trillion. There is £1 trillion of debt but there is £8 trillion of assets, £4 trillion of non-financial, mainly housing, and £4 trillion of financial. We recognise that there are particular issues for particular groups and the Government has policies to try and address those. As to this being a widespread issue across the whole economy, no, we do not think that this is a significant risk.

Q150 Mr Fallon: Let us turn now to the public finances and perhaps give you a rest, Mr Ramsden, and bring in Sarah Mullen on public spending. This is the seventh time you have postponed the year in which the current budget will be in surplus. In Budget 2003 you said we would be in surplus in 2005. We are now told you will not be in surplus until 2010–11, five years later. Is this sloppy Treasury forecasting or is it incompetent political budget making?

Mr Ramsden: I am afraid I am going to have to start answering those questions, if that is okay and my colleagues may want to come in and support me. We have been quite open with you about the challenges that we have had in forecasting the public finances in recent years after a run of years where we were over-optimistic about the public finances. In the early years of this decade we have been over-optimistic. As I explained to you at PBR, we managed to break that trend in 2006, at least in the year ahead forecast where with the year ahead forecast in 2006 for the current deficit of about £7.5 billion actually the outturn was more like £4.5 billion.

Q151 Mr Fallon: I asked you when we were going to get into surplus. It would help the Committee if you gave us some answers. You have been wrong seven times in a row now. Why should we believe this new forecast that you will not be in surplus until 2010–11 if you have been wrong every year since 2003?

Mr Ramsden: Compared with the forecasts that I was discussing with you at the time of the PBR for 2007–08 both on the net borrowing measure and on the current balance, our latest estimates are below the forecasts which we discussed with you at PBR. This is not one-way traffic in terms of how we produce the forecasts.

Q152 Mr Fallon: Are you telling me you have not postponed it by a year?

Mr Ramsden: No.

Q153 Mr Fallon: The Red Book says you have postponed the Budget surplus year from 2009–10 to 2010–11. Why are you denying that?

Mr Ramsden: I am not denying that. I am trying to put that in context. Since Budget 2007 and since the PBR, as we have been discussing, the credit shock that has hit the global economy and the UK economy has intensified. We are in a position where we can allow the public finances to be flexible to support the economy. That explains why we have significant increases in borrowing over the early years of the forecast period and why the year in which we go back into surplus goes back a year. As the Chancellor said in his Budget speech, that is the right thing to do in these circumstances.

Q154 Mr Fallon: The credit crunch did not start in 2003. This forecast has gone back every single year for the last five years. Why has it always been forecast the wrong way and why should we believe the new forecast?

Mr Ramsden: I am trying to explain the factors that underlie the new forecast to you and our judgments. If you go back to 2005, we had a problem that emerged with MTIC fraud and VAT. We made mistakes, as we have admitted to you, in terms of how we forecasted the North Sea oil revenues. Now we are being hit by this credit shock. These impact on our forecasts, but we try and set out to you as transparently as we can the assumptions underlying these forecasts. I think these fiscal forecasts are very realistic.

Q155 Mr Fallon: Could you just confirm the figures? In Budget 2003 you said in the year that is just ending in a couple of weeks’ time we would have a surplus of £9 billion. In the Budget this year you told us that would be a deficit of £7.9 billion. That is right, is it not?

Mr Ramsden: I am afraid I have only got the Budget 2008 document in front of me so I cannot confirm earlier years, but I will happily talk about what has happened and the fact that we have higher borrowing in Budget 2008.

Q156 Mr Fallon: I just want to be clear about the figures. Five years ago you said this year we would be in surplus by £9 billion. In fact, the outturn is minus £7.9 billion. That is a swing round, a deterioration of £17 billion. That is about half the defence budget that you got wrong, is it not?
Mr Ramsden: I have no reason to doubt your numbers. I have tried to explain to you the things that have happened in the economy which have impacted on the public finances over that period.

Q157 Mr Brady: Can I turn to the question of capital programmes and look at what the Government’s plans are to change or adjust capital programmes in the light of current economic circumstances.

Mr Ramsden: The position on capital is that for 2007–08 we are forecasting that public sector net investment will be well on track to be 2.25% of GDP, which is three times up on the ratio of public sector net investment to GDP at the start of this cycle back in the 1990s. What we have seen are sustained increases in public sector net investment. One of the purposes of the fiscal framework has been by setting a Golden Rule you focus on current borrowing. It enables you, as long as you do not threaten sustainability, to protect capital investment and that is what we have seen over this period. If you look at the 2007–08 number, it is a little bit down on what we were previously forecasting, a little bit over £1 billion.

Q158 Mr Brady: Why is it down?

Mr Ramsden: Because we have new data and we have new estimates. There is an AME capital margin that has not been used up. It has gone up in previous years. If you look over the last five years, public sector net investment overall is a little bit higher in nominal terms than we were thinking it was going to be at PBR time.

Q159 Mr Brady: So it is still policy to increase the level of policy expenditure in capital programmes?

Mr Ramsden: Absolutely, up to 2.25% of GDP and that is set out clearly both in the CSR figuring and then also in the figuring for the later two years of the forecast period.

Q160 Mr Brady: And that is not affected by the level of growth forecasts? So even if it is way ahead of the level of growth you are forecasting—

Mr Ramsden: The level of growth in the economy?

Q161 Mr Brady: Yes.

Mr Ramsden: Hopefully it will feed back on to it. If this public sector net investment is productive then it might help the level of growth in the economy.

Q162 Mr Brady: I think public expenditure as a percentage of GDP has increased by 5.4% since 1999. How much of that is fixed expenditure and how much is variable? If you wanted to vary the level of public expenditure, how much scope do you have there?

Mr Ramsden: If you look in the historical tables at the back of the Red Book, they give you a run of both public sector current expenditure as a percentage of GDP and public sector net investment as a percentage of GDP. That enables you to look at how they have evolved over time. That is where you get the information that shows that the ratio of PSNI (Public Sector Net Investment) to GDP is going to go up to 2.25%. It is now 2% and it was about 0.75 of a per cent at the beginning of this cycle in 1997–98.

Q163 Mr Brady: Could you give me any idea what that would be as a proportion of that increase in public expenditure?

Mr Ramsden: Public sector current expenditure has gone up from 38.3% in 1996–97 and is 38.3% in 2006–07, so the ratio of public sector current expenditure to GDP is unchanged whereas public sector net investment has gone up from 0.7% to 1.9%. The increases have been in investment.

Q164 Mr Brady: I think you will be aware that the think-tank Reform has published a paper recently that suggests that since 1999 29% of GDP growth can be ascribed to the growth of the public sector. I would be interested in your comments on that.

Mr Ramsden: I will look at that analysis because it sounds worthwhile. What we try and set out in each Budget is the contribution that different sectors make. We were talking about this in the context of rebalancing of the economy earlier.

Q165 Mr Brady: In terms of your current forecasts for the economy, how much of the growth you are forecasting at the moment is attributable to continuing growth in the public sector?

Mr Ramsden: In Table B4 you will see the Government contributed three-quarters of a per cent to growth on average from 2000–04. That is three quarters of a per cent to total growth of 2.75%, total growth which is significantly up on the UK’s previous experience. It has fallen to 0.5% in recent years and it is forecast to remain at 0.5% over the forecast period.

Q166 Mr Brady: So that will be 0.5% of 1.5, 1.7 or whatever?

Mr Ramsden: The forecast figures I was giving you earlier. When we have the economy returning to trend of 2.5 to 3% from 2010 onwards and the Government is contributing 0.5%.

Q167 Mr Dunne: How can you tell that you are on track to meet the Golden Rule in the next cycle when you have not decided when the current cycle will come to an end?

Mr Ramsden: Because we have an average surplus over the whole period from 1997. What we say is that we have an average surplus over the whole period from 1997–98, which was the start of the last cycle and what we say is that we are over the forecast period meeting the Golden Rule. We do not say over the next cycle.

Q168 Mr Dunne: You can determine the starting point but you seem to be incapable of determining an end point to a cycle. Is there any purpose to it any longer as a fiscal rule?

Mr Ramsden: I do not think it is that we are incapable. It is just that we are in the middle of this period of real uncertainty. There is also uncertainty...
over the evolution of the data. We are very much looking forward to when the ONS produce their Blue Book national accounts figures, as they are planning to this summer, which we think will give us a clearer idea of what has been happening to growth. In a sense because we are still over the forecast period meeting the Golden Rule I do not think it is making it any more difficult to assess the fiscal framework and frame a fiscal judgment.

Q169 Mr Dunne: Turning to the sustainable investment rule, you have a margin of 0.2%, which we heard yesterday is 2.8 billion of headroom under the sustainable investment rule in 2010-11. Given the average forecasting error that we have heard about is £13-14 billion, do you think that that is enough headroom given the present uncertainties over the economy?

Mr Ramsden: It is very much because of the present uncertainties over the economy and in thinking about the operation and the purpose of the fiscal rules to support monetary policy and stabilise the economy that we are seeing increased borrowing and actually that the margin on the sustainable investment rule has gone down from the kind of levels we had at PBR time. Since the alternative would have been to tighten policy during a period when the economy is forecast to operate below trend, looking at the way the fiscal framework gives flexibility, we thought it was the right thing to do to allow current borrowing to increase and to continue to borrow to invest. That is why we have got closer to the sustainable investment rule margin. We see this as a strict rule. In a sense the fact that we are below 40% ensures that it remains strict. If you look at where our net debt started from, it is significantly lower than countries like Germany. That again suggests that we have sustainable public finances.

Q170 Mr Dunne: What is the chance of breaching the rule?

Mr Ramsden: We do not do our forecasts in that way.

Q171 Mr Dunne: Would you comment on the 50:50 chance that commentators said about yesterday?

Mr Ramsden: We have set out very clearly that the changes to IFRS.

Q172 Mr Dunne: That excludes Northern Rock and the changes to IFRS.

Mr Ramsden: The kind of commentary you got yesterday suggested that this is all one way. As we set out in the Budget document, they are forecasts based on cautious assumptions. They are also based on the data as we have it now. As we set out in the Budget book, we are expecting the ONS to be making changes to the denominator for the sustainable investment rule calculation. They have said they are going to introduce this thing called FISIM, which is Financial Intermediation Services Indirectly Measured, which, other things equal, will increase the level of money GDP and we will have to factor that into our calculations as well. I do not think the specialists you had before you yesterday mentioned that. There are factors moving in both directions.

Q173 Mr Dunne: You do not use this Budget as an opportunity to discuss what might happen in the event that you were to have breached the rules? Do we take it that there is an absolute determination not to breach the rules because otherwise you should presumably start to lay out the policy framework in case that was a real risk?

Mr Ramsden: I think we set out very fully throughout the document the risk to the forecasts and the assumptions on which it has been based and the fiscal judgments that have been made on the basis of those assumptions.

Q174 Mr Dunne: But you do not begin a debate about the sustainable investment rule in the event that you were to breach it?

Mr Ramsden: There is a debate that this Committee has led on issues around the fiscal rules. I think in the document, in the way we have tried to set out in two boxes the purpose of the rules and as I have tried to explain to you today, we are trying to emphasise that they are trying to support monetary policy in stabilising the economy, ensure sustainability and protect Government investment. So I think we are contributing to the debate in that sense.

Q175 Mr Dunne: You decided to exclude Northern Rock from the public finances on the basis of the Code for Fiscal Stability. This refers specifically to temporary operating rules. What time period do you think is covered by the Code of Fiscal Stability to allow you to use the temporary definition to keep Northern Rock off the public finances?

Mr Ramsden: Just on the question of us deciding, the Chancellor set out when he made a statement on Northern Rock in January our position on the treatment of Northern Rock and why we thought it did not make economic and fiscal sense to include it in our fiscal framework. I think all the experts you talked to last night broadly agreed with the assessment that we had made. What we are always trying to do is to ensure the credibility of our fiscal framework and the fiscal framework through the Code of Conduct allows us, as you have said, to approach considerations like Northern Rock in the way that we have. There has been a statement by the Northern Rock Board today and a written statement by the Chancellor on the back of that which sets out their initial thinking in terms of where they think Northern Rock is going and that is also on the back of the state aid notification that we made last night. It is in that context that you should be thinking about the definition of temporary.

Q176 Mr Dunne: We have not had the benefit of seeing the statement.

Mr Ramsden: I apologise for that. It was only issued at 9.30.
Q177 Mr Mudie: You said earlier that you had seen the experts so you know the questions I am going to ask on child poverty and I presume I will get specific answers. What was the target when we set out? Was it 3.4 million children?

Mr Ramsden: If it is appropriate and if it is okay with the Committee I will hand over to Mike Williams to answer that.

Q178 Mr Mudie: Was it 3.4 million?

Mr Williams: 3.4 million is broadly right, yes.

Q179 Mr Mudie: The first target in 2004–05 was you were going to do a quarter which I calculate to be 850,000 children. What figure did you actually finalise on because you did not meet your target for the quarter if I recall?

Mr Williams: If I remember rightly, Mr Mudie, I think we got to 23%, not 25% on that figure.

Q180 Mr Mudie: Tell me how many children that is.

Mr Williams: We would have missed by some tens of thousands on that.

Q181 Mr Mudie: It is more than tens of thousands. 23% on 850,000 children sounds more than tens of thousands.

Mr Williams: What I was saying, Mr Mudie, is that we achieved approximately 23%, not that it was 23% of 800,000.

Q182 Mr Mudie: Can you just give me a figure? You must have a figure for 2004–05, the first target. We were going to take 850,000 children out of poverty. What number do we officially acknowledge we took out of poverty by that review?

Mr Williams: This was a Spending Review 2002 target. On that child poverty fell 23% before housing costs and 17% after housing costs.

Q183 Mr Mudie: Mr Williams, just give me a figure. Translate that. It must be in front of you and you saw the testimony yesterday, so you knew I was going to ask it. What was the figure?

Mr Williams: The 23% figure would be just over 700,000 and the 17% figure—

Q184 Mr Mudie: I am sorry, Mr Williams. Give me that figure.

Mr Williams: The 23% figure, which is the figure before housing costs, would be just over 700,000.

Q185 Mr Mudie: So why in the Budget Book 2008 are we referring to having taken out 600,000, four years later? That is why I am trying to put on the record figures we can judge performance against.

Mr Williams: The difficulty in this whole area, Mr Mudie, is with the way the numbers work. We are not looking at a static thing and that is where the difficulties arise. What we are looking at is a projection against figures, if I could explain that. The best data that we currently have are data from 2005–06, so what we are having to do is project figures and the projection depends on a range of factors. First, and a very important factor, is parental employment rate, especially the rate of employment for lone parents.

Q186 Mr Mudie: Mr Williams, do me a favour. If you can send the Committee a report with a detailed explanation that would be useful, but are we still putting the figure for the 2010–11 halfway target at 1.7 million?

Mr Williams: Yes.

Q187 Mr Mudie: What do you think we are at now?

Mr Williams: Taking into account the measures announced in the Budget we feel that now we are just over 1.1 million.

Q188 Mr Mudie: And how much do you think it will cost to get to 1.7 million?

Mr Williams: That is really quite difficult to assess. It depends on, for example,—

Q189 Mr Mudie: Robert Chote said 2.8 million yesterday.

Mr Williams: That is his figure, but I think it depends, crucially, on the assumptions you make on things like earnings growth in the area which gives you the poverty definition, which is 60% of the median.

Q190 Mr Mudie: What is in the Comprehensive Spending Review on this item? It finishes at 2010–11.

Mr Williams: The Comprehensive Spending Review committed to the 2010 target of halving child poverty.

Q191 Mr Mudie: I am just asking what financial figures are in there to indicate that the Government is going to put the money in to meet the target.

Mr Williams: In the PBR further money was put into this.

Chairman: We will maybe get a letter from you, if possible before tomorrow when the Chancellor comes, and we know there is a moving target, but what we can gather against the 700,000 to get out of poverty by 2010. The latest measures have roughly tackled about 200,000, so there are about half a million left over two Budgets, so if you could explain that in simple terms it would help.1

Q192 Mr Mudie: It really depends because that is why I am anxious to get you to put figures on the table. If it is 1.7 million and you are at 1.1 million you are 600,000 short, not 450,000, so that is why we would welcome a figure. The Saving Gateway—who is dealing with this?

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Mr Williams: That is me as well.

Q193 Mr Mudie: Are you ready?
Mr Williams: Yes, go on.

Q194 Mr Mudie: Good. We were concerned that it seemed to be targeted at only those on benefit. Are there any people on low incomes who will be excluded from applying?
Mr Williams: It is targeted on people on a range of benefits and also some people on low incomes that get, for example, the working tax credit. Inevitably there will be some people on low incomes who will not qualify because they are not on—

Q195 Mr Mudie: Can you give us a note as to those individuals and which income levels will not be eligible and their numbers?2 Thanks. When I looked at your past documents you seemed to be very generously putting some holidays in so people could miss three payments a year, but when I looked at the documents there were no voluntary payment holidays. The maximum target you could get was minus those three. If you set the figure at £25 that would allow them to do £300 a year; yes? No—over two years, £300 over two years.
Mr Williams: With the £25 you get you would be able to put in £300 in a year.

Q196 Mr Mudie: So that would be £600?
Mr Williams: Yes.

Q197 Mr Mudie: Thank you, Mr Williams. Is this scheme envisaged to allow them to do the maximum, 24 times the payment level agreed, unlike the pilots that took the holidays out?
Mr Williams: That is the proposition, that you can put in £25 a month for two years, yes.

Q198 Mr Mudie: Lovely. The last thing is tax. ISAs are tax-free. There is no reference in the consultation document to the interest paid on these accounts being tax-free. Has that been decided already or is that a decision that we have taken at one stage, that the interest on the accounts would be tax-free?
Mr Williams: In general many of these people will not be within the tax net in any event.

Q199 Mr Mudie: Is that no decision? You have not decided or you will decide at the time?
Mr Williams: As of the current law, Mr Mudie, people who are within the tax net would have to pay tax.

Q200 Mr Mudie: Accept that. If someone perchance managed to go into paying tax are they going to be tax-free like ISAs, specifically tax-free like ISAs, or does it depend on their income whether they are too low?

Mr Williams: It will depend on their income.

Q201 Mr Mudie: Has any discussion taken place before the document was put out for consultation or was that point not specifically addressed?
Mr Williams: A key point that was addressed was whether the account should be interest bearing or not and we decided that, like other accounts for savings, it was important that they should be interest bearing.

Q202 Ms Keeble: I want to ask in particular about the third of the main measures for dealing with child poverty, which is the disregard of child benefit for purposes of housing benefit and council tax benefit. Both the women I spoke to at the school gates on Friday and the experts yesterday said that there already is a disregard and I just wonder if you could explain exactly what this disregard amounts to.
Mr Williams: What there is in the current system, which is admittedly rather complex to explain, is that child benefit is taken into account but then there is also a credit. What this does—

Q203 Ms Keeble: Can you just talk it through because it might be complicated but clearly all the women that I spoke to understood it perfectly well?
Mr Williams: As things stand at the moment, although there is what is called a disregard, it is also the case at the moment that if you get child benefit when you are on housing benefit or council tax benefit the amount of the child benefit is taken into account.

Q204 Mr Mudie: What is the disregard though? Clearly people are under the impression that they already have a disregard, so what is the disregard?
Mr Williams: What there is at the moment is a form of credit that some people call a disregard. What this will do—

Q205 Ms Keeble: Can you just say what it is? What I am trying to work out is how much better off people actually are and how it is going to work, because for the people who are on benefits it is crucial and they will understand the fine print of it perfectly well.
Mr Williams: The amount that people will benefit by is the amount—

Q206 Ms Keeble: No; what I want to know is how much is the current disregard or the credit and then how this one will operate, presumably to supersede that credit and replace it with a simpler system.
Mr Williams: All this does is that at the moment if you receive child benefit that is included in the calculation of your income.

Q207 Ms Keeble: But then you get a credit. What is a credit?
Mr Williams: That then adjusts for that.

Q208 Ms Keeble: What adjusts for that?
Mr Williams: The computation—

Q209 Ms Keeble: Is this how it works?
Mr Williams: In terms of how the credit works it would be best, I think, if I sent the Committee a paper, but the absolutely key point is that at the moment if you receive child benefit then that amount of child benefit is taken into account.

Q210 Ms Keeble: All of it?
Mr Williams: As at present. Under this new system it will be disregarded for the purpose of the—

Q211 Ms Keeble: Completely?
Mr Williams: Yes, and I think that is absolutely the key point and why it is effective as a means of lifting people out of poverty.

Q212 Ms Keeble: How much is this credit worth?
You said that it is taken into account but then it is a credit. How much is the credit currently?
Mr Williams: That reflects the existing level of child benefit, and, given the difficulty over the credit and how that fits with the disregard, it will be best if we cover that in the paper.3

Q213 Ms Keeble: There are three strands to helping families who are poor to overcome child poverty. Everyone can understand the increase in child benefit and the increase in child tax credit, but in terms of this third one the women who are in this situation say, “That is not going to make any difference because we already get it”, so unless there is a very clear explanation of how this works and how it is more effective than the disregard they have already got they think that they are not getting anything and that is quite a major issue in terms of them calculating their income and also in working out whether it is better to apply for housing benefit or how you would manage your housing.

Mr Williams: I very much agree that it is important that this disregard is properly explained to the people who benefit from it. In Jobcentre Plus they have calculations of Better Off in Work which will factor this in, for example. The key reason for adopting this third measure, which I agree is less straightforward than the first two, is that—

Q214 Ms Keeble: It is very straightforward.
Mr Williams:— it is particularly well focused on families with children living in poverty and on that basis it does help to lift a significant number of children out of poverty.
Ms Keeble: I am not quite clear whether you cannot explain it or if there is some other catch, but certainly these women understood it perfectly well and were very clear that it was not all it was cracked up to be.

Q215 Chairman: Could you write to us again on that and try and get it to us before tomorrow?
Mr Williams: Yes, certainly, but I can assure you it is as it is described: it does create a disregard and I hope that will be clear from the paper.

Q216 Nick Ainger: In the last four years domestic electricity prices have gone up about 60%, gas has gone up about 50%, domestic heating oil has gone up over 100%, and that has had a direct influence on the increase of the number of people in fuel poverty. The Budget announced the additional £50 for the over-sixties and £100 for the over-eighties in the winter fuel allowance. It is a one-off payment. Is that intended to allow you the time to negotiate with the energy suppliers to address the social tariff issues or is it likely to be renewed and what will be the cost of that?
Mr Ramsden: Chairman, if it is okay I will pass that question on to Mr Martin.
Mr Martin: On the discussions with the energy companies, we certainly hope that we will be able to bring something forward for the winter following the winter coming. I would not want to anticipate those discussions or anticipate what the Chancellor’s decisions might be in the event that we do not conclude the discussions, but we have been very clear that we are willing, if necessary, to take statutory powers to conclude those discussions. We hope and expect that we will be able to reach an agreement on a voluntary basis. It may be necessary to have some kind of statutory underpinning to ensure a fair distribution of the contributions from the energy companies but it is something we would anticipate coming forward from winter 2009–10 and going onwards.

Q217 Nick Ainger: So in terms of this additional £50 for the over-sixties and £100 for the over-eighties, how much is that costing, because the Chancellor announced that he wanted to see an extra £100 million going into the social tariff? I would estimate that for the over-sixties and the over-eighties their additional £50 and £100 is far more than an extra £100 million, is it not?
Mr Martin: I might just have to get one of my colleagues to come in on the actual costing of the payments. Just while they are doing that, the social tariff, of course, is not the only element of the package we are looking to negotiate. The other important thing is that we are looking for further action on bringing down the price differential between pre-payment meters, which a lot of people who fall into the fuel poor category have, and those people on direct debits or standard tariffs, and that will also obviously contribute. In addition to that we have a range of measures, both government-funded and company-funded, to improve insulation and energy efficiency in homes, and from this April coming this new SERT arrangement starts which will approximately double the amount of spending over the next four to five years, and all that will

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Mr Martin: We are confident, because we had a very positive response from the supply companies, that they see the need to do more in this area, that we will be able to reach that agreement. We have said that if necessary we will legislate but at the point at which we are going into discussions we want to go into discussions with the presumption that we can achieve agreement rather than waving the stick too much at the moment.

Q224 Nick Ainger: Finally, on the £570 million which is going to be spent from October of this year with the winter fuel allowance, are you saying that the energy companies for October 2009 would first of all be required to find £570 million to substitute for the money that the Treasury will withdraw from the winter fuel allowance?

Mr Martin: The payment this year is a one-off, as the Chancellor made clear. We are expecting from the following winter to be in a position where there is this trebling in the support from the supplier companies, plus we have additional measures and we want those measures to be very focused on the fuel poor. We want to make sure we design a scheme that does that with the ultimate ambition of making sure we achieve our targets on fuel poverty.

Q225 Nick Ainger: So many pensioners are likely to see their winter fuel allowance fall in 2009?

Mr Martin: The decision about what happens in 2009 will be for the Chancellor to make in his Budget next year.

Q226 Mr Fallon: Mr Williams, can we come back to the poverty trap? Can you turn to page 62 of the Red Book and explain to me why table 4.2 conceals the increase of 200,000 people now facing a marginal tax rate of 60%?

Mr Williams: The table shows the number of people who face deduction rates of over 60% in 2008–09.

Q227 Mr Fallon: Yes. Why does it conceal the increase of 200,000 over the current year?

Mr Williams: I do not think it does conceal anything, Mr Fallon. What it does is set it out in conformity with what we have set out in previous tables. If you look to the 2007 Budget document there are the figures there for 2007–08.

Q228 Mr Fallon: Will you confirm that the increase in the number of people facing a marginal deduction rate is of the order of 200,000?

Mr Williams: Yes.

Q229 Mr Fallon: Why is that?

Mr Williams: The main reason for that is partly, indeed primarily, as a result of the 2007 Budget measure that introduced extra help through tax credits from 2008. That brought more people into tax credits, the result being that more people then faced higher marginal deduction rates.
Q230 Mr Fallon: So it was a decision? It is deliberately clobbering another 200,000 people? This is deliberate?
Mr Williams: It is certainly a consequence that follows from the fact that more people were given access to tax credits.

Q231 Jim Cousins: I wonder if you think you can achieve your broader social policy goals with these very high marginal tax benefit deduction rates.
Mr Williams: I think, Mr Cousins, that there are important trade-offs that you have to consider in this area and we cannot pretend that there is a perfect answer. There is not a perfect answer. You could go for universal support, as, of course, has been done with child benefit, but in that situation you are not targeting the public resource on those who need it most and that leads inevitably to one of two consequences: either you have to spend more to provide that level of support for the poorest or on the other hand you support the poorest less, so that is universal support. You could equally go for a very steep cliff edge with very high marginal deduction rates which would leave a smaller group of people affected by high marginal deduction rates, but then you are leaving those people with a massive disincentive, or, which is what the Government has done, you can focus resource on the more needy and then gradually withdraw that through a taper.

Q232 Jim Cousins: What estimate do you have of the number of childless couples or single people who would be eligible for a working tax credit on income grounds but who do not actually claim it?
Mr Williams: The best estimate we have for that, I think, is from 2005–06 where there are a significant number of those, but if I recall correctly that number fell then by six percentage points, so the position is not as good as we would like it to be but is improving.

Q233 Jim Cousins: That significant number that you have referred to was four out of five people entitled to the working tax credit without children who are eligible but not claiming it. Four out of five did not claim it. That is the significant figure you are referring to, is it not?
Mr Williams: I would need to check that, Mr Cousins. Certainly there is less claimed in those circumstances than, for example, with the child tax credit.

Q234 Jim Cousins: Mr Williams, taking the various elements of policy together, the withdrawal of the 10% tax band, the income tax changes, the changes to tax credits and child benefits, and, of course, the large numbers of people who are not eligible for them, and then taking into account the policies on public sector pay, how many people with incomes less than £18,500 a year will be experiencing a fall in their standard of living and real disposable income in the next tax year?
Mr Williams: We have distributional analysis, which I am just searching for, which I think shows that overall, to the extent that there is a change in—

Q235 Jim Cousins: Mr Williams, do you accept that at this rather important moment in the British economy we have contrived a situation in which, on the basis of the Government’s policies, millions of people on incomes less than £18,500 a year are going to experience a fall in their standard of living? Do you accept that?
Mr Williams: If we look at the analysis for the distributional impact, that analysis shows that most people will gain from these changes, such as, for example, tax credits, where—

Q236 Jim Cousins: But we have just established that the great majority of people who would be entitled to the working tax credit do not actually claim it, and then there are all the people with growing numbers of jobs where the hours worked are less than 30 a week so they cannot claim the tax credits, and then there are all the people under the age of 25 who are not eligible, unless they have children, for the working tax credit. Then there are all the low-paid workers who will suffer because of the loss of the 10% tax band. I am asking you how many millions of low-paid, low income workers will there be who this forthcoming year will experience a fall in their real incomes?
Mr Williams: That goes back to whether or not they claim tax credits to which they are entitled.

Q237 Jim Cousins: But, Mr Williams, if they do not claim them, for whatever reason, and part of the reason they do not claim is because of the difficulties that people on tax credits who are in insecure jobs at low incomes face and who do not necessarily want to face these high tax benefit withdrawal rates. The reality of the situation is that most people entitled to the working tax credit do not claim it. That is the fact. Therefore, Mr Williams, how many people will there be this year who earn less than £18,500 a year who will face a fall in their standard of living?
Mr Williams: The other reality as regards the working tax credit—

Q238 Jim Cousins: How many people will there be on less than £18,500 a year who will face a fall in their standard of living because of a combination of the tax changes and the policies on public sector pay? There will be millions of them, will there not?
Mr Williams: The reality, Mr Cousins, is that take-up of the working tax credit, which I agree has not been as good as we would have liked, is increasing. That is also an important reality to bear in mind, and steps are being taken to draw the attention of people who can claim that tax credit to the fact that it is available, and that is having some success. More people are claiming the working tax credit.
Q239 Jim Cousins: A combination of these policies is going to lead to a fall in the standard of living of almost everyone earning less than £18,500 a year. That is the fact, is it not?  
Mr Williams: In most cases most households in the bottom fifth of the income distribution will gain from personal tax and benefit measures coming into effect by April 2010 compared to this year, 2007–08. I think that is the most significant fact.

Q240 Jim Cousins: Let us not talk about 2010; let us talk about people right now who are facing rises in their food costs, rises in their energy costs, and now a combination of tax changes which will lead to a cut in their standard of living, and this is an economic growth which needs more spending power in the hands of low income people, surely, not less?  
Mr Williams: Again, if we look forward—

Q241 Chairman: I think we have gone over this point quite a bit, so try and give us a final answer on it.  
Mr Williams: I think the key answer is that, as a result of changes made in the personal tax and benefit measures introduced since 1997, by April 2010 (but many of the changes have already been introduced) a single earner family on male average earnings with two children will be at least £265 a year better off as compared to 1997. A single earner family on half male average earnings, again with two children, will be at least £4,200 a year better off as compared to 1997.

Q242 Mr Breed: We seem to be moving to more of a principles-based taxation regime in some aspects rather than just rules-based. Is it part of those principles to increase more retrospectivity and give less time for people to make changes to their own personal arrangements in order to fit in with your tax rules because you are giving them so little time to undertake that but at the same time you are increasing retrospectivity?  
Mr Ramsden: I think that in the interests of trying to give the Committee as much information as we can, if the Chairman is okay with it, I will pass over to Mr Troup to answer that question.  
Mr Troup: I think there are two separate points there. There is principle-based legislation and retrospection. There is consultation currently going on about some principle-based anti-avoidance legislation, which has been generally welcomed, although we have put off the introduction of that until next year to make sure—

Q243 Mr Breed: And will that increase retrospectivity?  
Mr Troup: No; that will just be a new set of rules replacing some existing rules and dealing with some loopholes. The retrospection point is slightly more complex because there is both difficulty in defining what you mean by retrospection and also different circumstances in which it can be applied. We did in 2004 announce that in relation to particular kinds of avoidance of tax and national insurance on City bonuses if necessary the Government would legislate retrospectively back to the date of the announcement in December 2004 to stop any further avoidance schemes in that area. That was generally welcomed by the professions and was used on one occasion. Elsewhere there has been retrospection and there is a retrospective measure in this year’s Budget to correct what was a defect of drafting in the tax law rewrite. That sort of retrospection again I think has been generally welcomed, and on occasions, and I think you raised it with the experts yesterday, with regard to the anti-avoidance measure on double tax treaties we do go retrospectively where it has been perfectly clear what the intention of the law was and there have been attempts to abuse it. That was a fully retrospective measure and has stopped some extremely egregious avoidance. The other point to be made in relation to retrospection is the extent to which announcing a measure might be perceived as retrospection because it can apply to activities which are already in the course of taking place.

Q244 Mr Breed: There is indication here from Mr Whiting’s notes to us that a measure, BN66, has been introduced which will have a retrospective effect back to 1987. This is in his view unacceptable and I think will be unacceptable to most of us.  
Mr Troup: That was the anti-avoidance measure which I referred to. It related to the Isle of Man double tax treaty. In 1987, under the previous administration, the meaning of that treaty was clarified retrospectively at that time to make it clear that individuals in the UK who operated through partnerships in the Isle of Man but generated income in the UK could not avoid tax.

Q245 Mr Breed: But the thrust of what he is saying is correct, is it?  
Mr Troup: It is correct because what happened was that, following the introduction of the disclosure rules in 2004, it was disclosed that a number of individuals, particularly in the property industry, had been taking a different interpretation from that which had been announced in 1987 and were continuing, without any active presence in the Isle of Man and only having income in the UK, to be claiming that 99% of their income was effectively covered by the Isle of Man double tax treaty. The action that has been announced here is retrospective. It confirms what was set out quite clearly in 1987 and what was intended by the Isle of Man treaty when it was entered into. I do not think that members of the Committee would have any difficulty in agreeing that the particular circumstances it applied to were out-and-out tax avoidance.

Q246 Mr Breed: Just finally on the other aspect about people’s ability to have some time to order their affairs, particularly in respect of capital gains tax, is this going to be another feature of principles, giving people virtually no time to make the proper, normal adjustments?
Mr Troup: This is an entirely separate point from the
question of principle-based legislation. Mr Williams
will talk if necessary on any further details of the
capital gains tax changes but those changes were
announced in October with further changes
announced in January.

Q247 Mr Breed: For some people they are going to
have to order their affairs within weeks, not months.
Mr Troup: For implementation with effect from the
tax year beginning on 6 April this year.
Mr Breed: Yes, weeks. Thank you.

Q248 Mr Dunne: Mr Williams, for how many years
are taxpayers’ affairs able to be opened by the Revenue and Customs retrospectively?
Mr Williams: I am not sure what you mean by
“retrospectively”, Mr Dunne. In the normal
circumstances you can go back six years.

Q249 Mr Dunne: How do you envisage policing the
new entrepreneur lifetime relief under the capital
gains tax regime?
Mr Williams: The million pounds?

Q250 Mr Dunne: Yes. Mr Williams: The million pounds will be policed by
having people who have used any part of the million
pounds keep a running tally of how much of the
million pounds they have used. If you have had, say,
a £200,000 slice then you need to keep a record that
shows you had a million and you have now deducted
£200,000 for a particular year.

Q251 Mr Dunne: And you will have power to go
back beyond six years to check whether that has
been done properly?
Mr Williams: There will not be the need, I think, to
go back because the £200,000 will be the figure
agreed when the tax return for the particular year is
agreed between the taxpayer and HMRC. Let us
assume that figure is £200,000. That then takes
£200,000 out of the million. If we then assume that
there is another—

Q252 Mr Dunne: Who has responsibility for
maintaining the records? You or the taxpayer?
Mr Williams: The reality in that situation is that
both will keep records, the taxpayer and HMRC, for
the relatively small number of taxpayers who
actually will claim the entrepreneur relief.

Q253 Mr Dunne: So in effect you are extending the
requirement to keep records beyond six years?
Mr Williams: What I am saying to people who take
advantage of the entrepreneur’s relief is that if they
do so and they do not use up the full million pounds
the first time they use it then they will have to keep a
tab of how much of the million pounds they have used.

Q254 Mr Dunne: What assumptions have been made
about the behavioural changes in consumption
levels in relation to the changes to alcoholic duties?

Mr Troup: HMRC publish the elasticities which
they use with our forecasts. The forecasts that are
published in the Budget assume a decline of 1.5% in
consumption next year, 2.5% the year after and 3.5%
the following year in aggregate.

Q255 Mr Dunne: What proportion of motorists will
be affected by the changes to vehicle excise duty?
Mr Troup: How do you mean?

Q256 Mr Dunne: How many motorists will be
affected, or how many vehicles will be affected if that
is easier?
Mr Martin: All motorists will be affected because all
the VED rates have changed. Do you mean how
many gain?

Q257 Mr Dunne: Indeed. What proportion are net
gainers because there are some reductions? Sorry—
what proportion would be paying more is what I am
trying to say.
Mr Martin: Half of new car buyers from 2009 will be
better off and nearly 70% of new car buyers will be
no worse off.

Q258 Mr Dunne: So you are saying that only 30% of
new car buyers will be worse off?
Mr Martin: Yes.

Q259 Mr Dunne: On page 187, table C6 suggests that
council tax increases for next year will be 5% above
this year. On what basis has that assessment been
made? It seems to be higher than the published
average of around 4.5%.
Ms Mullen: Did you say that you thought that it
implied that tax rate rises were—
Mr Ramsden: The growth rate.

Q260 Mr Dunne: Yes, the increase in receipts from
council tax appears to be just over 5% compared to
assumptions.
Ms Mullen: Our expectation of council tax in—
Mr Ramsden: It is set out in paragraph C66 of the
document, and I think the assumptions we are
making there are unchanged.

Q261 Chairman: Look at that and we will come back
to you and maybe write to you on that before
tomorrow if need be.
Mr Ramsden: Okay. Can I say that the assumption
is 4%?
Ms Mullen: Our expectation in 2008–09 is that
council tax rises will come in at about 4%.

Q262 Mr Dunne: So why does the table say 5%?
Ms Mullen: I think we will have to provide a note
on that.4

Q263 Peter Viggers: I have some questions about the
assumptions underlying the treatment of non-
domiciled taxpayers. How many people are you
assuming will leave the United Kingdom?

4 Ev 60
Mr Williams: In the consultative document that we issued in December the assumption is that it will be around 3,000 people but, as we said in that document, estimating in this area is particularly difficult because there is a limit to the amount of data.

Q264 Peter Viggers: What effect are you assuming on the economy of them departing? Mr Williams: I think 3,000 people, not necessarily all of whom are particularly wealthy people, would not of itself have a very significant effect on the economy.

Peter Viggers: Of the remaining people in the United Kingdom who are affected by the change of rules how many will be in employment and are you anticipating that employers will compensate them for increased taxation? That is the first question. Secondly, how many people will be casuals? I am talking now about Polish plumbers. How many of them will be affected?

Jim Cousins: There is nothing casual about Polish plumbers.

Peter Viggers: The final question is, can the HMRC cope? What assumptions have you made about the numbers of those remaining?

Q265 Chairman: Do you want to write to us on that as well before tomorrow? Mr Ramsden: I think we can answer the question. We can be comfortable that HMRC can cope.

Q266 Chairman: Fill in the details for us tomorrow, will you? Mr Ramsden: Yes.

Q267 Mr Brady: The consultation on aviation duty is coming towards its end. Will freight be included? Mr Martin: That consultation will not finish until, I think, 24 April. Our presumption is that it will be but the consultation is open and obviously ministers will consider the results of the responses from the consultation and then announce final decisions in the PBR later this year.

Q268 Mr Brady: Is the Budget announcement of a 10% increase in the revenues to be brought in by the new tax based on a change in assumption about the number of taxable flights or a change in the rates to be levied? Mr Martin: We have not set the rate yet. What we are undergoing the consultation is that we essentially model the counter-factual using air passenger duty, so we would assume an increase in rates of that to generate that particular rate of revenue. When we come to set the rate under the new system after a decision has been made about the exact design of it then we will set a rate appropriate to generate the amount of revenue that we forecast.

Q269 Mr Brady: You have already said that it will be 10% higher in the next year.

Mr Martin: Yes.

Q270 Mr Brady: That is based purely on a 10% increase in rates? Mr Martin: No. It depends what your counter-factual is. For the purposes of modelling it for the forecasts here we have actually used air passenger duty as the counter-factual because we do not have a final design of the scheme because we are consulting on that.

Q271 Mr Brady: But you have already said there is going to be a 10% increase on whatever it is you levy in the first year of operation of the new rates. Mr Martin: That is right.

Q272 Mr Brady: So that is based purely on a 10% increase in the rate, whatever that rate may be? Mr Troup: Shall I just come in? The actual number is derived as 10% higher than the yield would have been for the second full year of operation of aviation duty, and, as Chris has said, that will be delivered through an appropriate rate setting in the new duty.

Q273 Mr Brady: I have one final question on this regarding the impact on regional services, particularly those connecting to long haul. What assumptions are you making about the number of passengers travelling from regional airports currently going to Heathrow or other London airports to connect to long haul flights who it is said will use a continental hub?

Mr Martin: I do not think we have made an assumption about that because, as I say, that is not the way we have modelled the spending. When we have a final design for the scheme, and that will depend on the results of the consultation, we will then need to apply a model to that to assess what the yield would be under various different rates and you might well consider those sorts of factors there if we felt at that point that the design of the scheme was likely to have that kind of behavioural effect.

Q274 John Thurso: Who would be responsible for taxation matters in regard to small businesses? Mr Troup: That would be me.

Q275 John Thurso: Do you have somebody on your team who is responsible for small businesses? Mr Troup: We have a team which deals with taxation of small and medium sized enterprises, yes.

Q276 John Thurso: How many people are in the team? Mr Troup: I cannot give you an exact number. It is about ten or 12 and they work closely with other colleagues in the Treasury who also work on other business tax matters, and also with colleagues dealing with other business matters, so it is quite hard to say because small business tax can, for instance, overlap with capital gains tax where Mr Williams has a team, and with other non-specific—
Q277 John Thurso: So a reasonable sized team. What estimates have they made of the amount of revenue being lost through income shifting?

Mr Troup: The estimates of revenue are done by Her Majesty’s Revenue and Customs in the usual way and, as you will have seen from the Pre-Budget Report, we expect the introduction of income shifting rules, once they are agreed, to produce about £260 million.

Q278 John Thurso: We have had estimates that it will cost as much as that to administer it. What estimates have you made about that?

Mr Troup: Our estimates are much lower because I think there has been a considerable misunderstanding as to the number of businesses that will actually be affected. The costing is based on the assumption that 85,000 businesses will be affected. One of the things that has come out of the excellent consultation that we have had on this, and we had over 260 responses, was that there are a lot more businesses out there which are concerned that the legislation might apply to them and from whom I think some of the wilder figures that we have seen about the potential costs have been derived.

Q279 John Thurso: What estimate have you made of the potential cost? Presumably, if you have a husband and wife business, the income available has to be over 40% tax to start with. If you paid the maximum amount to the wife you would have the benefit of the personal allowance, the benefit of the difference between 20p and 40p, and you would net off the extra national insurance that would have to be paid that would not be being paid if it was 40p, so you are probably going to end up with a maximum take per person of round about £6,000 or thereabouts. You then have to assume that everybody is capable of being at the maximum. Do those figures sound about right?

Mr Troup: Sorry—I am not sure whether your question is about the costs of administering or the actual tax burden.

Q280 John Thurso: No, the actual tax.

Mr Troup: Those figures for somebody who does what you have described sound broadly right. What is important to get right in the implementation of these rules is to ensure that they act as a deterrent for those who are setting out to mitigate tax in a way which the Government does not intend and not as an administrative burden for ordinary small businesses.

Q281 John Thurso: It sounds to me like the best relief you could possibly give a husband and wife team as small entrepreneurs and a lot better than 10% for people on millions in private equity. Why is it unfair?

Mr Troup: I think it is unfair because it is effectively giving a tax relief to some husbands and wives—

Q282 John Thurso: To somebody who is an integral part of the business.

Mr Troup:— and partners who are working together where one may not be contributing to the business.

Q283 John Thurso: Could it be that the small business team have not thought this through and they need to go back and look at it a lot harder?

Mr Troup: The team have thought it through extremely well. We do want to make sure that small businesses, where both the husband and wife or both partners are contributing, are not adversely affected by this if all they are doing is entering into ordinary commercial arrangements.

Q284 John Thurso: If you have two directors of a company are you now going to say as “We, the Treasury”, or, “We, HMRC”, “You, director, we have decided you are not really doing as much as you think you are doing. Therefore, we are going to take that away”? Is it the Treasury which is now setting the directors’ fees for small companies in the United Kingdom?

Mr Troup: The points you raise are exactly the points we have had out of consultation, and the main reason that this is being put off for a year is to look at the rules and make sure that we can deliver something—

Q285 John Thurso: Is it because there was nobody with qualified competence on small businesses when this was first put forward?

Mr Troup: No, I do not think that is true at all.

Q286 John Thurso: That is what we think.

Mr Troup: I think what has come out is that because of the diversity of small businesses and the significant number of small businesses we have to consult widely and that consultation has been very useful.

Q287 John Thurso: It was described as a “sticking plaster solution” by John Whiting.

Mr Troup: Yes, I saw that comment and I did not agree.

Q288 John Thurso: I thought he was being generous.

Mr Troup: And if the Committee has got time I will tell you why.

Q289 Chairman: Just a couple of questions from me to finish up on. The Treasury announced in the 2007 Budget that IFRS would be implemented in central government from 2008–09. Give us a short explanation of why that timetable is no longer possible.

Mr Ramsden: Sarah Mullen will give you that short explanation

Ms Mullen: We announced in the 2007 Budget, as you said, that we are moving in 2008–09. We have been consulting with departments and with the FRAB over the last year and looking at how we implement IFRS. As a result of those consultations it has been concluded that the timetable was too short for some departments, so we have—

Q290 Chairman: Are the MoD and the Department of Health the only two departments?
Ms Mullen: I think a number of departments thought the timetable was quite challenging. Those two departments in particular, not surprisingly because they have very complex budgets and a large number of assets, found the timetable quite stretching. However, I would also say that DCLG raised some issues with us about local authorities who were not moving to IFRS until 2009–10, so that was another factor.

Q291 Chairman: Members of the Financial Reporting Advisory Board told us on 4 March that they had recommended that all departments that could do so should produce 2008–09 shadow resource accounts on an IFRS basis alongside their 2007–08 accounts on a modified UK GAAP basis. Has the Treasury accepted this recommendation and what steps are being taken to ensure that the momentum towards IFRS is not lost?
Ms Mullen: Those departments that are able to produce them we will get to produce them and we want to maintain the momentum.

Q292 Chairman: But not every department will have a shadow budget?
Ms Mullen: That is right. We will still expect departments to be working towards implementing this in 2009–10. We do not want to lose the momentum.

Q293 Chairman: Over £20 billion of the savings reported for the period ending on 31 March 2008 are classified as “final” and the Treasury has stated that “no efficiency gain will be scored as ‘final’ until maintenance of service quality is evidenced”. Is the evidence about service quality relating to these gains in the public domain and, if not, will it be in the public domain after 31 March?
Ms Mullen: We will certainly make available all the evidence when we finally say that we have or have not met the targets. We have just reported in the Budget what departments are telling us. I think about 87% of those gains are final but when we get to a point where we are able to quantify finally how we have met the target we will make the evidence available in the normal way.

Q294 Chairman: Okay. It will be interesting to see how many cases there have been where claimed efficiency savings have been rejected by the Treasury because service quality has not been maintained. Will you provide us with a list of such cases?
Ms Mullen: We can certainly look at that. What usually happens is that where we have questions for the department about service quality we go back and get them to address the issue, and that is the important thing.

Chairman: It is very important for us, in trying to assess if these efficiency gains are indeed efficiency gains and if the quality of the output is maintained, and certainly the customer focus, that you get that information to us. Mr Ramsden, thank you and your team for your evidence this morning. No doubt we will see you tomorrow afternoon.
Wednesday 19 March 2008

Members present

John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Jim Cousins
Mr Philip Dunne
Mr Michael Fallon
Ms Sally Keeble

Mr Andrew Love
Mr George Mudie
John Thurso
Mr Mark Todd
Peter Viggers

Witnesses: Rt Hon Alistair Darling, MP, Chancellor of the Exchequer, Mr Dave Ramsden, Managing Director, Macroeconomic and Fiscal Policy, Mr Mike Williams, Director, Personal Tax and Welfare Reform, Mr Edward Troup, Director, Business and Indirect Tax and Mr Simon Gallagher, Team Leader, Financial Services, gave evidence.

Q295 Chairman: Chancellor, good afternoon to you and your colleagues in this examination of the Budget. Can you introduce yourself and your colleagues for the shorthand writer, please?
Mr Darling: Yes. Thank you very much, Mr McFall. I think three of my colleagues will be familiar to you, since you saw them yesterday evening. Dave Ramsden is the Managing Director of Macroeconomic and Fiscal Policy, sitting to my left. Mike Williams, to my right, is Director of Personal Tax and Welfare Reform; and Edward Troup, who is Director of Business and Indirect Taxes. And, new to you, at least on this occasion is Simon Gallagher, who is the Team Leader, Financial Services.

Q296 Chairman: No, he was with us yesterday! Mr Darling: Perhaps I should have been here last night and we could have got the whole thing wrapped up then! Anyway, here we are.

Q297 Chairman: Do you still stand by your Budget forecasts, Chancellor, since they have been made, what with Bear Stearns and the subsequent fall in market confidence?
Mr Darling: Yes. The forecasts that we made last week in the Budget are for the long term, and from the pre-Budget report last October to the Budget last week we were very conscious of the fact that we are going through a period of considerable uncertainty, especially in the money markets and the financial markets. As you know, I downgraded our growth expectations last October by half a per cent and I downgraded them again for the budget because we were acutely aware that the present uncertainty and turbulence, which is unprecedented in recent times, will have an effect over the coming year and it will affect the growth not just of our country but of countries right across the world. I did say last week that right across the world all developed countries, and even many developing countries like China, India and Brazil, were also taking the same view that there will be an effect on growth. What I would say, if I may, Mr McFall, in relation to the last few days, is that I think what you are seeing now is a manifestation of exactly what I was talking about last week; there is a great deal of uncertainty and turbulence in the financial markets at the moment, and Bear Stearns in America is the latest example of that. Fortunately the Fed and the US authorities were able to intervene, though quite clearly Bear Stearns paid the price in that it was being taken over by JP Morgan at two dollars a share, which is a fraction of what it was worth at the beginning of this year. But right across the world I think you will see—not just in America but just as we did last October—the authorities in the shape of governments, central banks and regulators doing everything they can to ensure that we maintain stability in what is a very uncertain time. So we are prepared to take action, whatever is appropriate, and what is appropriate will vary from country to country because it is important that we should do that. I will add two other things, if I may? One is the need now for us to take international action at the G7 level and with the meetings coming in Washington I believe it is absolutely essential to get greater transparency, to get far more effective reporting, far better coordination between the regulators and supervisors, to deal with the question of credit rating agencies, to improve the information available to investors, that all of that is absolutely essential and we make progress as quickly as we possibly can so that we can improve market conditions not just now but in the future as well. The last point I would make has a direct bearing on what you were saying right at the start in relation to our forecasts. Yes, of course, we are very focused on what is happening now in the immediate term but we also need to remain focused in the long term, and if you look at two of the indicators that are very important—the employment and unemployment figures which were published this morning, which yet again show strong growth, particularly an increase in jobs over the last quarter, which is during this period of financial instability—I think 166,000 extra jobs—in addition to that you will see that unemployment is the lowest it has been since 1975. The other thing is the CBI’s Industrial Survey published today again shows, especially in relation to output, some very healthy figures. I have always made the point that you cannot read too much into any one set of figures but I think if you look at the data that is published today it bears out our forecast and that is that there will be a slowdown but our economy remains fundamentally strong. It
remains resilient and we are well placed to deal with a period of great uncertainty. Having said that, in terms of the immediate problems we face, as I have just said, that is something on which I am very focused now and over the next few weeks as we move towards the meetings in Washington in the middle of April.

Q298 Chairman: But your growth forecasts are out of kilter with most outside economists and we have received evidence, both in writing and orally, on that point.

Mr Darling: I know you discussed this yesterday when you spoke to Treasury officials and I do not believe they are. If you look at the range that we set out, the growth for this coming year and thereafter, I believe that what we have done is realistic. If you look at the Treasury’s forecasts over the last few years in relation to growth they have been pretty good and they have been recognised as such, and there are some people who are forecasting more positive, higher levels of growth than we are and of course, inevitably, if you have 30-odd economists commenting on something it is unlikely that they are all going to agree and come to exactly the same conclusion. But I do believe that given the resilience of the economy, given what we know of what has happened in the past, that what we are setting out is realistic. As I say to you, if you look at the figures today, the employment figures, if you had been asking this question 15 years ago, would Britain be in a position where unemployment was the lowest it has been since 1975, and especially at this time, despite the turbulence that we are going through at the moment, would we see more people going into work even in the last three months, to the end of January, people would have said that that would be surprising. It has actually happened. I think it is important that we look at what is actually happening and look at the resilience of the British economy and look at our strengths as well as, of course, we must take account of what is happening presently because it will have an effect, as is patently obvious.

Q299 Chairman: Again, to many economists and outside observers it seems that more could have been done by the government to, in their words, “consolidate the public finances when the economy was above trend”. If we have a biblical analogy when we have a series of fiscal rules. If you look at our debt levels now they are lower than most of our competitors, they compare well internationally and they have enabled us to build the resilience and have the flexibility we need to deal with the problems. The other thing I would say—and I know that many people, not so much the commentators but inside this House are now saying—“You should have cut back at times when the economy was growing above trend.” Firstly, I do not actually remember them saying that at the time, and indeed many of them were actually calling for more spending. Also, if we had actually not borrowed when the economy was growing above trend then we would have had to cut back quite substantially into some of the investment that we have been making in our long term infrastructure, and I think that would have been to repeat all the mistakes of successive governments—and I am not just talking about the last one but other governments of different political colours over the last 30 or 40 years.

Q300 Peter Viggers: Chancellor, you led your Budget with a proud statement about resilience and said, “This resilience puts the UK in a strong position to deal with the current global economic uncertainties.” but commentators do not agree with you and they think that the UK economy is less resilient than most other OECD countries. The market, of course, has blown you a comprehensive raspberry since the Budget; how can it be that you are right and they are all wrong?

Mr Darling: I believe that our economy is resilient and perhaps I would draw a comparison between where we are now and where we were, say, in the 1990s. Now we have comparatively low levels of debt; we have low interest rates; we have inflation that is historically low; and we have unemployment the lowest it has been in 30 years. In the early 1990s we had much higher levels of debt; we had more than three million people out of work; we had interest rates that were in double digit figures and, as a result of that, our economy took a huge knock—in fact there were the two biggest recessions in the 1980s and 1990s of the last century. Now our economy is much more resilient than it was in that case and it has enabled us, if you just look to more recent times, to get through the dot.com bubble burst in the United States at the beginning of this century and the Asian market problems that we had in the late 1990s and our economy has come back strongly after both of these. And after 9/11, for example, when the stock markets really took a dramatic drop we were able to come back quickly because we have a resilient economy, we have much more flexible labour markets, we have flexible capital employment markets, which we simply did not have then. So I think our economy is in very good shape to deal with
these uncertain times and, at the same time, as I said to Mr McFall, we have also been able, which is one of the things we set out to do right from the start, to maintain investment in key things like health, education and transport and so on, which are actually vital for the future of our economy.

Q301 Peter Viggers: Every one of the points you have made looks backwards, but commentators are looking forward to the fact that we have very strong links with the United States; we have a housing market which has been overpriced in a similar manner to that of the United States; and of course we rely much more on the financial markets than most of our European colleagues, making us similar to the United States in that way. You have looked backwards; the Treasury paper on resilience looked backwards. If you look forward can you be similarly confident?

Mr Darling: Inevitably, if you want to examine how resilient the UK economy is you do need to look backwards to see what happened when there have been shocks in the past. But looking forward, let me deal with some of the points that you made. Firstly, it is true that in a number of respects in relation to our financial markets we have a lot in common with the United States, and a lot of their banks are over here and a lot of our banks are over there, and both would share a common feature that our biggest banks are truly international. Also, if you look at our relationship with Europe most of our trade is actually with the European Union and, as I think Dave Ramsden was saying to you yesterday, of the uncertainties we face, but what we have tried to do is to look at the evidence that we have not just in the United States but also in Europe. The other thing is—and maybe we will come back to this—that even in the present times we reckon that the global economy, if you like, will grow at about 4%, which is less than people thought, but it is still quite a useful upward pressure on the overall prospects.

Q302 Peter Viggers: Could I turn to one other question? I want to ask about non-domicile tax papers. There are three categories, of course. The very rich, we are told that something like 3000 people might leave. So my first question is how concerned are you that some of these might be very prosperous and important employers and entrepreneurs? The second question, how do you expect companies to deal with executives who are caught by the £30,000 impost; and my third part of this question is how many categorise them as Polish plumbers—people are there who may not be registered for tax, who have some kind of external financial connections will be caught by this, and how will the Revenue cope with this larger burden of taxpayers?

Mr Darling: The 3,000 is the estimate that we made and with anything the Treasury does it has to make an estimate as to how many people might be affected. I think in relation to Polish plumbers, that unless they were left over 80,000 a year offshore rather than remitting it to this country, which—maybe they have very successful plumbing practices in Poland—I think is unlikely, it would not be worth their while to pay the £30,000. In relation to the general point that you were asking about companies and executives, perhaps I could just make a general point and then come to the particular? One is that I do not want people to leave this country, far from it. Our country’s wealth over the last few years, and especially over the last ten years or so, has been...
substantially enhanced by people coming from all over the world, choosing to live and work there. Some will come for a short period, and of course until you have been here for seven years this measure does not affect you at all and I think it would have been quite wrong to impose a charge from day one as some have proposed. These people contribute substantially. I also want to see people to continue to live here after that seven-year time if they choose to do so. I just remind you that the position is that we are one of, I think, two countries in the world that operate on the basis that if you are non-domiciled you pay tax on what you earn here but above that only on what you choose to remit here either by income or way of capital. What we are saying is that if you want to maintain that tax treatment, which is more favourable than anybody who is domiciled here, then you need to pay a fee of £30,000. As I said to you at the start, unless you are actually remitting more than about £80,000 a year it is not worth your while doing it. But I do think it is fair that if you live here for a long time you should make a contribution. I believe that if you actually look at what we are proposing, as opposed to some of the speculation about what we are not proposing to do, I think it is fair, I think it is reasonable and I hope that not only will people remain here but that more people will choose to come and live and work in the UK because, frankly, the UK has an awful lot going for it that many countries do not.

Q303 Mr Love: In your budget statement you talked about fiscal policy supporting monetary policy, and this was a theme that your officials took up yesterday. Did the fiscal position allow you to provide enough support considering the very difficult economic circumstances that we face?

Mr Darling: Yes. As I think you were discussing yesterday, if you look at the position over the next three years there is a fiscal loosening this coming year, the position is more or less neutral next year and there is a slight tightening the year after, and that is consistent with our forecasts for growth. As I said when we were discussing borrowing, for example, in the Budget last week, borrowing will go up next year but it is actually an awful lot less than it was 15 years ago; but that is the right thing to do to support the economy, especially at this time. The important thing is to have the scope to do these things and by getting borrowing debt down to a level that is much lower than we had in the past we do have that room for manoeuvre that we would not have had in the past; and, of course, as you know, the Bank of England has been able to reduce rates in December and then again in February. The Bank of England clearly has an inflation target that it has to reach but if you look at the combination of last year’s budget and this year’s budget there is a loosening this year, which I think will help the economy. As I say, we remain vigilant but my objective, just as my predecessor’s obviously was, is to make sure that we maintain a stable economy, which means looking to the long term—taking account of what is happening in the short term, but we remain very much focused on what is happening in the long term.

Q304 Mr Love: Let me just press you a little on that. The markets have been suggesting that there will be a further cut of a quarter point in interest rates later on this year. How much was that a factor in the desire to have an interest rate cut in your decision about the Budget judgment you made?

Mr Darling: As you know, the Bank of England’s job, the Monetary Policy Committee’s job is to have regard to our inflation target, which I reset again at the Budget at 2% on a CPI basis. That is its policy. We do not comment on what it does and the Bank of England has to reach a judgment—that is the whole point of having an independent Bank and that is one of the great reforms we made ten years ago, which has been very successful. When we set forecasts of course we look at the inflationary outlook and, as I said last week, we said that inflation would rise in the short term and yesterday’s figures bear that out, but we expect it to return back down to the target towards the end of this year and into next. So we do take those things into account. The inflationary pressure at the moment is energy prices but many of the other historically troublesome pressures on inflation we have been able to deal with. But it is all part of maintaining that stable economy.

Q305 Mr Love: Yesterday we met the Managing Director of the IMF and he said to us that the IMF’s view of the international difficulties that we are all facing would be longer and deeper than most people were estimating. In those circumstances, if it is going to be slightly bleaker is there not some pressure on you to put more money into the economy, if I can put it in its crudest terms?

Mr Darling: I think what Dominique Strauss-Kahn was saying—as I think I met him just after you and I just wanted to check to see what he told you!—is exactly what I said, that if you had asked people what do you expect world growth to be a year ago they would have probably said that it was “5% plus and we think it is going to come down to about 4%”. We have taken that into account just as we have taken into account the lower growth that we would expect in America and in other parts of the world. In relation to what should we be doing—and people do raise this when they say, “Look at what is happening in America, why are you doing something different?” and the obvious thing is that the American economy’s demands are different from our own—we will do what is right for this economy, and my judgment was what I announced in the Budget last year, that a slight loosening this year, and a slight tightening in two years’ time was the right thing to do having regard to where we are. As you rightly said, I have also said that our fiscal policy will support monetary policy, but I believe—going back to both John McFall’s question and Peter Viggers’ question—that we have a resilience and
therefore a flexibility to respond to these that perhaps we would not have had in the past, and I think we will have in the future.

Q306 Mr Love: One of the interesting things about the American experience, very dramatic in recent weeks, has been the working together of the Treasury Secretary and the Chairman of the Federal Reserve. How is the relationship between you and the Governor of the Bank of England? Are you consulting each other to make sure that we get the right path ahead for the economy?

Mr Darling: Yes, of course. We speak very regularly and we meet very regularly, as you might expect, just as I speak and meet with the Chairman of the Financial Services Authority. Especially at this time we keep very, very closely in touch, and I may say that both in the lead-up to the Bank of England’s decision last December to put more money into the system, which resulted of course in the inter-bank lending rate being reduced towards the policy rate, and again the Bank’s decision to continue that facility earlier this week, that was an example where the three of us are working very closely together. As you would expect at this time we work very closely together, it is absolutely essential.

Q307 Mr Fallon: Chancellor, you say things are stable but your borrowing for the next three years is 29 billion higher than at the time of the last Budget and 18 billion higher than you yourself had planned at the time of the pre-Budget report just six months ago. Why have the public finances got so much worse so quickly?

Mr Darling: In relation to borrowing and what I am forecasting for next year, it is in relation to the fact that having regard to what is happening in the financial markets that it is bound to have an effect on the revenues that we can expect, both in relation to corporate tax receipts and in relation to stamp duty on shares, on commercial property and so on. That is quite simply why it has risen. Yes, I could have done something about it but at this stage, and especially at a time when I think we need to be supporting the economy rather than trying to take money out of it, it is the right thing to do.

Q308 Mr Fallon: But you have done something about it—you have increased the borrowing.

Mr Darling: I said that the reason borrowing will go up next year is because of the pressures that we face because of what is happening in the financial markets at the present time, and the effects that we think it will have overall. I am simply taking account of what I expect to be the case and what I forecast would be the case actually starting from the pre-Budget report last year.

Q309 Mr Fallon: But the credit crunch began last summer.

Mr Darling: It did but it started to manifest itself in August and then through September, and by the beginning of October, when I presented the pre-Budget report, that is the time, you may recall, that I down rated my growth forecasts.

Q310 Mr Fallon: But you have changed them again now; you are 18 billion wrong.

Mr Darling: But it is inevitable given that things have changed between October and March that I would take account of that. Indeed, the figures for this year came in as I said, and I think it is prudent to assume that in the coming year borrowing will rise for precisely the reasons I stated.

Q311 Mr Fallon: But the fear is that as well as dithering over Northern Rock and messing around with non-doms and botching the capital gains tax reform that you have actually lost control of the public finances at the very point that the British economy is at its most vulnerable.

Mr Darling: If you want to exchange political banter I am tempted to do so but I will not, but what I would just say about Northern Rock is the decision that we took at the time was right and it was widely supported—I cannot remember whether you supported us or not—and it was the right thing to do. I think it was also right over last autumn to see whether or not we could find a private sector solution. My guess is that if we had not done so and had moved straight to nationalisation then many of the people who now say, “You should have done it,” would have been the first to say that we are acting peremptorily, and that is just nonsense, frankly. In relation to the non-doms, I think it is fair and reasonable, and fairer and more reasonable than some of the other suggestions that were put about in the House of Commons. In relation to the public finances, just as I said to Mr McFall and Mr Viggers earlier on, I think the action we have taken over the last ten years has been right, it has enabled us to get debt down, it has enabled us to have a far stronger and more stable economy than we have ever had, frankly, in recent times, and I think that is very, very important. If you actually look at the amount of borrowing that we have at the moment, if you look at the average borrowing we have had it is a lot lower now than it has been in the past. So I just do not accept your analysis.

Q312 Mr Fallon: Bear Stearns was rescued over a weekend but you messed around with Northern Rock for six or seven months. Other industrialised countries are running a surplus and not a deficit. What the City is wondering, Chancellor, is whether you are really up to this job. Are you?

Mr Darling: You raise two separate issues there. In relation to Northern Rock, at the risk of repeating myself we took the action that we did last September to maintain stability in the financial system, to protect savers and depositors and we succeeded in both those regards. If you go back to last September you will recall that at that time when, I think, in the wider world people did not realise just how serious
these problems were becoming, if we had attempted to do what you suggest with Northern Rock when its shares were very much more than the equivalent of Bear Stearns, then I think that might have had consequences which might be quite damaging, which is something that you yourselves recognised in your very good Treasury Select Committee report, to which I think you were a signatory, Mr Fallon. So I agree with your analysis on that point—your position today is slightly different, it would appear.

In relation to the rescue by the Fed and JP Morgan over the weekend, by Friday Bear Stearns’ shares were virtually worthless—they were two dollars a share and at the beginning they were worth substantially more than that. Of course the Fed has played a major role in providing guarantees to make that takeover possible. My guess is that if you had attempted to do that to Bear Stearns last August the reaction might have been quite different. So I do not think you are comparing things in quite the same way. In relation to the public finances, again I have made this point to you before and I will repeat it again, that I believe our public finances today are in much, much better shape than they were 15 or 20 years ago, and I think that will stand us in good stead during this time just as it will in the future.

Q313 John Thurso: Chancellor, can I ask you about the Golden Rule? Clearly the concept of rules is a good one but the value of financial rules must be that they are clearly understood and able to be used as an honest benchmark. Given the problems that we appear to have with defining when the economic cycle ends or begins, is the Golden Rule really that useful?

Mr Darling: Yes, it is. If I cast my mind back to the period in the 1980s and 1990s you may recall that that government appeared to have several different objectives and they changed over the period. I think nowadays people demand markets, demand a deal of certainty, and I think the principles of governments not borrowing to fund current consumption and also being able to maintain the public investment are actually quite important; and that borrowing should be kept at a sustainable level is important too. So, yes, I do think these Rules are important because they do provide a discipline.

Q314 John Thurso: Do you think that the problem with defining the Golden Rule, not knowing when the cycle starts and ends devalues the value that you have just described, and could we not express this in a way that people had more faith in?

Mr Darling: I certainly do not see any difficulty, far from it, of having rules that span a cycle because the whole point of doing that is to allow for the fact that in any cycle there will be some years that the economy will be growing above its trend road to growth and other times it will be growing below it. It is a perfectly stateable case to say that you balance the books every single year but I think that would lead to some very disjointed planning. As I said earlier, I think in reply to Mr McFall, if you had had another fiscal rule which said you cannot borrow when the economy is growing above trend that would have resulted in quite a substantial cutback in public investment. So I think looking across the cycle is fine but there are always going to be arguments—and I know that this is an argument that many of the groups that come and see you have—as to the difficulty in defining when the cycle came to an end, and I can appreciate that you could have an interesting debate on the matter, but I think the principle is a sound one.

Q315 John Thurso: Can I ask you to clear up one matter of fact for me? When Mr Ramsden was replying to my colleague yesterday he said, “We say that we are over the forecast period meeting the Golden Rule. We do not say over the next cycle.” But in paragraph C13 it says, “The government is therefore on course to meet the Golden Rule in the next economic cycle.” Is the Budget therefore saying that we are on course to meet the rule in the next cycle, or not?

Mr Darling: Not being here yesterday I think it is a bit unfair of me to comment on what Mr Ramsden said.

Mr Ramsden: I do not think there is any contradiction with what I said and what the Budget said.

Q316 John Thurso: “We do not say over the next cycle,” and this one says, “in the next economic cycle”.

Mr Ramsden: No, the key words in what you just read out were “on course”.

Q317 John Thurso: I am sure that is a great clarification.

Mr Ramsden: We are on course.

Mr Fallon: Working towards!

Q318 Mr Dunne: The sustainable investment rule.

The headroom three years out is less than £3 billion. Given that the average forecasting error for the budget deficit where only one year ahead is between £13 billion and £14 billion are you effectively acknowledging that the sustainable investment rule is no longer fit for purpose?

Mr Darling: No, I am not. As I was saying to John Thurso, I think the sustainable investment rule has a lot of merit because what it says is that it allows you to maintain public investment but it says that it should be kept at a prudent level, which we say is 40%; but it does allow you, even when there are times when the economy is not as growing as strongly as it has been, that you can maintain your public investment, which I think is very important. Take transport. That has been the casualty par excellence of successive difficulties with which successive governments have been faced, and I think that is something that the rule is there to clarify.

Q319 Mr Dunne: The ONS have determined that the public financial initiative off balance sheet debt will come on balance sheet, and you have decided to defer that by a year. Why did you not discuss how
you would treat that in relation to the sustainable investment rule in the Budget when you know it is going to happen?

Mr Darling: I think it is something that clearly we need to consider. What I would say to you is that—

Q320 Mr Dunne: With respect, you have considered it, you decided to defer it for a year and you have not told us how you are going to treat it.

Mr Darling: We are still considering how we deal with that. We have decided, as you say, that it is not going to be implemented this year. What I would say to you is that the PFI has enabled us to do a lot of building of schools and hospitals and so on that we would not otherwise have been able to do. What I want to do is to consider how we deal with it because we do not want to get ourselves into a situation where we reach decisions that no rational person would actually reach because of a change that might be made. But that is something which I am still reflecting upon.

Mr Ramsden: Could I just add—and I hope this is helpful—that actually the ONS when they came and discussed this issue with you said that it was rather more complicated than that they had decided. They said that they would have to look at what was decided by the accountancy guidance coming out of FRAB on the standards that were going to be applied and then they would have to see how those would be translated into the national accounts framework, which is the one that ONS use to produce their statistics. What we announced in the Budget and as we discussed with you yesterday was that as a result of discussions with departments it has become clear that the IFRS standards are going to have to be applied a year later because some departments are having particular problems, and also local authorities are having problems with the new standards on PFI. So there is a lot of detailed technical work that has to be run through first before we are in a position to consider the implications, if any, for the fiscal framework.

Q321 Mr Dunne: Just picking up on your response to Mr Fallon on the issue of Northern Rock, which, again, you have chosen not to include within the sustainable investment rule.

Mr Darling: Because it would be ridiculous to do so.

Q322 Mr Dunne: The US authorities and JP Morgan took five days to sort out Bear Stearns; you took over five months to sort out Northern Rock. Have you had the opportunity to calculate what the impact on public debt would have been had you taken the Lloyds TSB offer and provided a facility which has many parallels to what happened in the US last weekend?

Mr Darling: Let me go to this. There was no Lloyds TSB offer. When I have given evidence on two or three occasions now I have made the position absolutely clear—there was an inquiry made on a “what if?” basis but it was never pursued. Indeed, you also covered in your excellent Treasury Select Committee report the question of this and you said that you came to the view that I think you would have doubts, even if such an offer had been made, as to whether or not it would have been wise and prudent to have done it. So I really have to deal with that yet again. There was no offer made, as a number of witnesses who have appeared before this Select Committee have said. In relation to Northern Rock point generally, since you and Mr Fallon keep repeating the point, the reason that we spent the autumn looking to see whether or not we could find a private sector buyer is because I believed then and I believe now that Northern Rock’s future ultimately must lie in the private sector. That is why we worked to see whether or not we could find a solution and because of current conditions it was not possible to do so. That is why we took the decision and then eventually we took the view that because of all the considerations it was best to take Northern Rock into a period of temporary public ownership. I think we were right to do all these things and we were right to do it because of the particular time when these things took place. So I do not accept the underlying premise of your proposition but it follows, therefore, that, no, I have not made the calculation that you are asking about. The other thing is that I think it would be absolutely bonkers to take account of Northern Rock in relation to the sustainable investment rule because, frankly, it would mean you would have to slash large amounts of public expenditure to accommodate what is a temporary arrangement, and I cannot see the sense of that and I do not know if any sensible commentator is arguing that we should.

Q323 Mr Dunne: Chancellor, the parallels with Bear Stearns are now very, very close and I think your analysis that you just gave to Mr Fallon is incorrect. You said that you rested your argument very much on the share price of Bear Stearns and my recollection—

Mr Darling: No, I did not.

Q324 Mr Dunne: I think the transcript will show you did.

Mr Darling: I mentioned it as one of the points; I did not rest my argument on it.

Q325 Mr Dunne: The share price of Bear Stearns on the Friday, I believe, was of the order of $27 and $2 was the price which JP Morgan agreed to pay on the Sunday, so that was determined in negotiation with the authorities and the board of Bear Stearns and was not determined by the market, which was the argument you were trying to make.

Mr Darling: That was not the argument I was trying to make. I understand perfectly what you are trying to do and I just do not accept it. As I said to you, since you have raised the matter, in relation to Northern Rock Lloyds TSB did not make an offer; they made an inquiry over a weekend as to whether or not the government or the Bank be willing to make something like £355 million available, and as you yourselves said—and again I think you are a signatory to this report—what they were asking for
is apparently to give £30 billion to a healthy, profitable bank to purchase what, at that time, was also a bank that was a going concern. There were state aid considerations, there were the considerations of whether or not you would do it, whether it was the right thing to do; there were considerations about whether or not you would have to ask around to see whether other people were willing to do it at a lesser price—all these considerations would have to be taken into account.

As it happened Lloyds TSB did not pursue their inquiry and by the beginning of the week they had lost interest in it. Whether you like it or not those are the facts of the matter and actually if you look at the expensive part of your package. Could you confirm increase in the child tax credit element, the most expensive part of you drew in your own report that rather bears out what I am saying. The position in relation to America was different, and I mentioned that the difference in the share price was simply this: that at the time we are talking about, the conversation with Lloyds TSB, to the outside world most people were blissfully unaware of what was happening, and what you had was Northern Rock at that time having reported pretty good profits—it was trading quite happily. But the position with Bear Stearns by the end of that last week was rather different.

Q326 Ms Keeble: I want to ask about child poverty. First of all, can you give us some assurances about the government’s prospects of meeting the 2010 target for halving child poverty?

Mr Darling: That is what we are working towards. I think I said—if not at this Select Committee I have certainly said in the House—that I feel very strongly about our obligation to meet our 2020 target, which is to eradicate child poverty, and our objective is to halve child poverty by 2010. What I tried to do last week was to make a substantial contribution towards that. This is a difficult target but it is a target that is well worth pursuing.

Q327 Ms Keeble: I understand that and I think all of us would agree with that. I want to ask particularly about changes on housing benefit and council tax in relation with child benefit, which is, along with the increase in the child tax credit element, the most expensive part of your package. Could you confirm first of all that that only comes in in October 2009?

Mr Darling: Yes, I did and I have read them and that is what I am asking you about.

Q328 Ms Keeble: Secondly, the Budget papers say that the working couple with one child would get up to £17 a week. The Library did what they call a rough and ready calculation based on the information that was provided and they found that a couple with one child would get £7.46 a week—there are certain assumptions under that. The Treasury figures, working on slightly different income figures, estimated it was £19.63 a week. That is quite a wide range.

Mr Darling: I would need to see the House of Commons Library’s calculation.

Q329 Ms Keeble: The Treasury figures of £19.63 are obviously well above the “up to £17” so I wondered how robust the figures are, when all the information is going to be provided so that people can work out what it is, and also an assurance that you are actually going to be able to afford it and that it will be properly, fully funded and carried through in October 2009?

Mr Darling: On the last point, yes, it is affordable; and, yes, we will do it. I thought you were going to ask a slightly different point, but I am not sure that the Committee got the papers it asked for yesterday?

Q330 Ms Keeble: Yes, I did and I have read them and that is what I am asking you about.

Mr Darling: One of them was in relation to housing benefit and when we endeavoured to explain—which I readily accept is a complex calculation, which is to show a comparison between this year and next year in relation to the same family, and it shows how that family will gain as a result of the changes we have made. But the answer to your question is yes, we can afford it; yes, we will see it through. What I cannot comment on is the House of Commons Library calculation—rough and ready or not, I have not seen it and I think we would need to see the basis on which they were making that calculation. But there is such a wide difference and the calculations have been made of the best possible estimates we could make.

Q331 Ms Keeble: The other thing is that since this is only coming in in October 2009 the full year effect will only be in 2010–11, so how can you count these figures towards the achievement of the 2010 target?

Mr Darling: The 2010 target makes an allowance for that. From the moment they come, in October 2009 they will have an effect.

Q332 Ms Keeble: Yes, but that is two months before the end of the year—

Mr Darling: October.

Q333 Ms Keeble: That is two months before the target, is it not?

Mr Darling: The figures that we gave in the Budget are our best estimate of how many people will gain as a result of the changes that we are making to housing benefit and also in relation to the child credit. But in relation to the actual breakdown of figures, unless Mike Williams, who may have seen these things, can add to it I do not think I can say anything. But the housing benefit which comes in in 2010—the measure is implemented before 2010.


Mr Darling: Yes, that is right.

Q335 Ms Keeble: And there will be a muddle with the councils for the first two months whilst they sort it out, I have no doubt.
Mr Darling: We will try and resolve that but I would think that other people too would agree that it is quite a sizeable step in the right direction.

Q336 Ms Keeble: Yes, indeed; I agree with that. What I was going to say was that given there is still going to be a gap that has to be filled, are you then considering more measures towards the back end of next year, around about October 2009 or into 2010? Would you be looking perhaps at something like seasonal grants, or are you looking at other measures particularly to support people who are entirely on benefit, given that these advantages go to the working families?

Mr Darling: Obviously as and when we have further proposals to make we will announce them, but probably not today because it is only a week after the Budget. You will see that on the day of the Budget we published a short paper which outlines various measures that we wanted to take to tackle child poverty. You raised a perfectly pertinent point in relation to the administration of housing benefit, which particularly in London is a big problem because you want people to go into work, you want to be able to make the change calculations for in-work help as quickly as you possibly can, but there are a number of measures that we want to take in relation to that to help get more children out of poverty. Some of what we can do does come down to cash—other things come down to administration. The other key thing, of course, is getting more and more people into work. But if you look at the cumulative effect of what we have been doing over the last few years, and measures last October, which will affect about 100,000 people and about 250,000 people as a result of measures I announced last week, as well as last year’s Budget, of course, it does make, I hope, quite a substantial contribution to the objective we both share.

Q337 Ms Keeble: I agree with that. I have one further question, which is have you revised your target of three million new homes to be built by 2020 in the light of the reported closure of credit markets for speculative developments; and what impact will have that on affordable and social housing, given that increasingly that is being provided as part of percentages of private sector building?

Mr Darling: No, we have not. This is a long term target and it really goes back to what I was saying right at the start. Yes, there is short term uncertainty but we are, I believe, well placed to get through that. But it is important that in the Budget last week and in the future we remain very focused on what we need to do over the longer term, which is to get more houses. Of course, in the Budget too I also announced the review into housing finance generally and there are other measures that we are looking at to improve the financing of housing. These were important even before the recent events and they are extremely important now.

Q338 Mr Mudie: Chancellor, I thought you were a bit unfair with my colleague, Mr Dunne.

Mr Darling: I do not think I could ever do that!

Q339 Mr Mudie: I thought you were a bit unfair because our view did contain reservations about how the Bank of England had behaved with the TSB, and you can set our minds at rest if you can put on record that a representative, maybe even as high as the Governor, actually met the TSB to discuss a possible offer because we can find no evidence other than the Governor saying he “remembers a vague telephone call” put through his officers, emanating from the FSA about “some sort of bid”. When I compare it with what the Fed got stuck into last week and compare that with our Central Bank, I am certainly of the opinion that it left a lot to be desired.

Mr Darling: I have no knowledge that the Governor met anybody from Lloyds TSB. The best of my knowledge is, as Callum McCarthy said to you, that that was that a phone call was received, I think one weekend, asking speculatively “what if?” and the speculative reply was given and that was that.

Q340 Mr Mudie: No, he did not, Chancellor, with the greatest of respect, because I questioned him about it. He was very loyal—

Mr Darling: Who was?

Q341 Mr Mudie: Callum McCarthy. He was very loyal to the Bank because I questioned him as to did he think the offer that was being put forward was one that was worth consideration. They had clearly had discussions with the TSB and if the Bank of England Governor can find time to meet investors but not the TSB, it surprises me.

Mr Darling: Mr Mudie, I had no knowledge either that Callum McCarthy met anyone from the TSB. What I do know is what he said to you on 9 October last year, and he said: “I think it would be incorrect to regard the private sector solution as being a firm cut and dried offer; it was still at an exploratory stage and there are a number of issues which have to be dealt with.”

Q342 Mr Mudie: Nobody is suggesting that it was a cut and dried offer but he did not even pick up a telephone; he did not invite them in, he did not treat them to lunch, he did not find out how serious it was—

Mr Darling: He did none of these things.

Q343 Mr Mudie: . . . and he landed us picking up £100 million.

Mr Darling: He did none of these things because, as I have said on a number of occasions, there was not an offer being made. Lloyds TSB were clearly interested but they went no further than that. I will quote from your report to read into the record that you collectively said: “It is not evident that the State could, or should, underwrite a safe haven option, where a single, presumably profitable bank, received State support (in the form of a lending facility) to
undertake, or at least announce the takeover of Northern Rock.” That is what you found and I am bound to say that I agree with you.

Q344 Mr Mudie: Yes, you will find that we expressed reservations about the Bank of England’s part in it. But let us get on to child poverty. We did get figures from your very fine Mr Williams yesterday that the quarterly target, the 2004–05 target, which was to meet a quarter, which was 850,000 children out of poverty, only failed to be met by 2%. Mr Williams, yes? Which means about 830,000 children—you are shaking your head.

Mr Darling: Again, not being here yesterday, what did you say as to what Mr Mudie is asking you about?

Mr Williams: There are two numbers, Mr Mudie, which we touched on yesterday. One, there is this figure of before housing costs where child poverty fell to 2.4 million, which is a 23% fall; and also after housing costs where the number is 3.4 million.

Q345 Mr Mudie: It is the first one, if we just keep continuity. The point I am making is that 830 was the publicly stated figure—approximately 830,000 before housing costs. The 2008, paragraph 4.16 quotes the figure of children lifted out of poverty under the same measure as 600,000.

Mr Darling: Yes.

Q346 Mr Mudie: What happened? There seems a discrepancy in the figures.

Mr Darling: The SR02 target used a particular scale to measure poverty which was then modified. The 60,000 are confirmed figures on the new scale.

Q347 Mr Mudie: The 600,000?

Mr Darling: Yes, as I understand. Dave Ramsden can tell you about how these things are actually done. We can vouch for the 600,000.

Q348 Mr Mudie: Chancellor, before you do—because this is what we were trying to get and could not get—if it is now a confirmed figure, 600,000, what is the confirmed 2004–05 figure? We had a target of 850,000; what figure did we actually come in at?

Mr Darling: Where was our starting point? The baseline, when in 1998 there were 3.4 million children—

Q349 Mr Mudie: Yes, and a half of that is 1.7 and a half of that is 850,000, which was the 2004—

Mr Darling: The figure of 600,000 is the actual figure that we can confirm; and inevitably, because these things are not fixed and things change, the figure in 2004 was our forecast, our best belief. But what we can say now is 600,000 just as what I am estimating. If you look at the combined effect of last year and this year it is about half a million children being lifted out of poverty and obviously that will be confirmed at some stage.

Q350 Mr Mudie: No, no, Chancellor, this is the sort of thing that gets us into bad repute. Let us take it step by step.

Mr Darling: I am not sure it does.

Q351 Mr Mudie: In 2004–05 we had a target of 850.

Mr Darling: Yes.

Q352 Mr Mudie: What was the actual figure of children taken out of poverty by that year?

Mr Darling: By 2004? I would need to come back to you with the exact figure on that. The figure of 600,000 is the figure—I think it is 2005–06, that figure—that we can confirm, we can stand up. But inevitably on these things when you are looking ahead there is an estimate because these things change.

Q353 Mr Mudie: But Mr Williams told me a fact I got wrong. I thought we had failed by 23% but he took time to point out to me that we had reached 23% of our target in 2004–05. If we have a target at 850 at the quarter way mark and we come in at 600,000 that is not 23%, that is a large shortfall.

Mr Darling: What did you say yesterday that might help us?

Mr Williams: What we talked about yesterday was the figure before housing costs where there was a 23% fall and the figure for after housing costs where there was a 17% fall.

Q354 Mr Mudie: Yes, I know, but we are dealing with the first one so let us just stay with that. We can take both but we are dealing with the first one. Yesterday you told us that it failed to be met by 2%, which would have meant 830,000 children taken out of poverty. Why is the Chancellor telling us two years later that it is only 600,000? It is a straightforward question that you would expect from the Treasury Committee.

Mr Williams: It is because, as Annex A to the note that we provided to the Committee, Mr Mudie, explains, the SR02 target was, as you rightly say, to reduce the number of children in relatively low income poverty by a quarter by 2004–05 and that was set using a particular scale to measure poverty, and there was a modification to the OECD scale in the present target. I accept that that makes for difficulties in making the exact comparison with the run of numbers but the numbers, both sets, are accurate and on that baseline the figure is 3.1 million in poverty and that is what the figures in the Budget documentation are by reference to.

Q355 Mr Mudie: We have now agreed a figure of 600,000 and the measures taken in the 2007 Budget and pre-Budget and 2008 put 500 into that. That would leave, you would think, approximately 600,000 to meet the halfway target. You have only
two Budget years to do that in, Chancellor. I know the efforts were exceptional for this Budget. Do you think you will meet those targets with those figures?

**Mr Darling:** As I said to Sally Keeble earlier on, I think the future 2020 energy target is extremely important. We aim to halve the number in poverty by 2010. I want to do everything I can to meet that. I cannot tell you what is going to be in the next pre-Budget report or the next Budget or the Budget after that but I think you will see my direction of travel.

**Q356 Mr Mudie:** It would be helpful if you could ask your officials to give us specific targets, starting points, etc., because we seem to get a different tale. I want to go on to the saving gateway.

**Mr Darling:** I was going to agree with that proposition.

**Q357 Mr Mudie:** I have one question on the saving gateway. We asked Mr Williams to give us a note of how many low paid people were not going to be included. It adds up to four million people. Although the saving gateway covers eight million, you target it mostly at people on benefit but leave out another four million. On what basis are you leaving out these four million? The basis is in the paper: that you computer systems could not cope.

**Mr Darling:** I am not saying we will not extend it in the future. The idea of the saving gateway is a very important one where we help people who historically have not saved get into the savings habit. It includes people on the working tax credit, which is quite a sizeable group, people getting child tax credit, workers getting income support, incapacity benefit and JSA as well. It was particularly aimed at people on low incomes and that is why we chose this particular group. If it is a success, we will certainly look and see what else we can do but obviously I cannot give you a commitment about that at this stage.

**Q358 Mr Love:** You have just mentioned how important it is to sponsor savings amongst low income groups; yet this scheme started in 2001. You have had two pilots and you are proposing to introduce it in 2010. Why is there such a long delay in bringing this in?

**Mr Darling:** It is partly because it takes time to get these things set up. We would like to do it quicker but sometimes we have found in the past that you do things quickly and you get into all sorts of difficulties. In anything I do, I have to make sure I have the money to pay for it but I think it is a worthwhile thing to do. It is important that we get it set up. I know it can be irritating at times. I am constantly irritated about it but there is a long history of us getting into stuff where the IT systems do not work. We rush into it and then have plenty of time to repent. I do not wish to have the need to repent in this instance.

**Q359 Mr Love:** Thank you for that honest answer, if I may say so. Yesterday when we challenged your officials there seemed to be some ambiguity. I would not put it any stronger than that and I am sure they are passing you a piece of paper now and they are prepared for the question. The issue arose about those that may pay tax and whether the interest paid would be exempt as it is for ISAs and others. There seemed to be some ambiguity about the answer we received. Has that been resolved?

**Mr Darling:** I think there would be. If someone was due to pay tax, they would pay tax on the interest, if that is the question you are asking. Are you comparing with ISAs, for example?

**Q360 Mr Love:** The inference of the Committee was first of all whether they did pay tax. I think you have resolved that issue for us. The question then becomes people much further up the income scale are receiving very significant, interest and tax free savings vehicles. Why does it not happen for the low paid?

**Mr Darling:** Except that in the scheme there is an element of match funding so that people saving this way will get money from the state in a different way to getting it through tax relief. We will keep all these things under review. The most important thing is to get the scheme properly established on a national basis. It has been one of our objectives as a government for over ten years now to encourage people to save who historically have not done so. Inevitably, we are going to have to do this in stages but I think it is a pretty good thing to be encouraging.

**Q361 Nick Ainger:** I have some questions about fuel poverty. We were told yesterday that the one off payment which will be for the winter of 2008–09—

**Mr Darling:** The winter fuel payment?

**Q362 Nick Ainger:** Yes. The extra £50 for the over sixties and the extra £100 for the over eighties, we were told yesterday, was going to cost £575 million. We were also told that the negotiations with the energy suppliers with a view to bringing in a new social tariff regime for 2009–10 would produce hopefully £150 million which is 100 million more than is currently available. Is it your intention for the Treasury to make up that shortfall because there is a shortfall in what people will be expecting, having received their additional winter fuel allowance in this coming winter. The following winter, if they even receive a social tariff, it will be substantially less than they will have been receiving with the additional winter fuel allowance.

**Mr Darling:** I see the two measures as being complementary rather than one being in substitution for the other. Any decisions in relation to future payments on winter fuel are taken on a Budget or pre-Budget basis. I know there have been times when we have balanced things in the longer term but basically these decisions are rather like pension increases and so on and are taken on an annual basis. There is a broader issue in relation to what we are asking the energy companies to do. As you rightly say, they have been paying about £50 million a year into social tariffs. We think they could...
be doing more than, especially at this time, so we are working with them to raise that to £150 million or thereabouts. The second element is also worth mentioning because I think it is important. People accept that if you have a prepayment meter there is an additional cost. I have seen evidence to suggest that some people using a prepayment meter are paying up to £400 more a year than people on direct debit. That cannot be right because the people on the prepayment meters are usually on low income. One of the things that we are working on is to reduce that discrepancy. I am told that the cost of a prepayment meter is about £80 a year more, not 400, but I think it is important that when people get into difficulties or if they are on low incomes they should not be put in a position where they are paying an awful lot more than somebody who may be very well off.

Mr Darling: Quite simply, we want to make progress on this and we think it is appropriate that we should deal with the suppliers. The further back you go in the supply chain, I suppose the wider the group of people you have to talk to. My general observation is that they make their contribution through the taxes that they pay.

Q368 Nick Ainger: The social tariff will only cover mains electricity and mains gas. What about rural consumers who are dependent upon central heating oil supplied directly by the oil companies and LPG? Those two sources of energy have seen the biggest percentage rises and have significantly increased fuel poverty particularly in rural areas but there is no social tariff to cover those two products. Should we not again be looking to the oil companies to come up with some sort of social tariff for those products?

Mr Darling: I appreciate the point you make in relation to that. I cannot say that we have resolved the problem but it is certainly something we can look at.

Q369 Nick Ainger: Finally, the concern that I know one energy supply company has is how to identify consumers that should be in receipt of the social tariff. Obviously there is reluctance for the DWP to provide information on those in receipt of income support or pension credit, for example, if you are going to use that criterion. Have you given any thought to how and how many people are going to qualify for the social tariff and how that information should be passed to the energy supply companies?

Mr Darling: This is something that we are discussing in government. On the face of it, you might think: why do we not just give the electricity companies or the gas companies the names of people receiving benefits. There is a real difficulty in that there are some people who just do not want that information passed on. They have every right to have their privacy respected just as you or I have. What we are doing is to see whether or not there is some way around this. We are discussing it within government. There ought to be a way round it because we know who people are who are likely to be fuel poor. I can quite see the difficulty that, if somebody is getting benefit and they do not want their name passed on to a supplier, they are entitled to say, “Sorry, I do not”. I would have thought it was possible to resolve this by at some stage asking somebody, rather like you tick boxes on your postal vote for example, “Do you wish to appear on the general register or do you not?” It ought to be possible to get round that.
point where the marginal rate deduction increases. This is always a problem. When you decide you want to increase people’s incomes through the tax credit system, the down side is that when they come off it there might be a disincentive there. You try and avoid that by a taper but of course the taper will then take you further up the income scale. There are ways in which you can mitigate that but I would not want to get myself into a situation where frankly I did not increase the incomes of people if I thought that was the right thing to do.

Q371 Mr Fallon: Your former Cabinet colleague, Stephen Byers, said in the House on Thursday that this was “an unacceptable situation for a progressive government.” He said that was because it mainly affects people earning less than 20,000 a year with children, who are school dinner ladies, hospital cleaners and so on. You have been running your tax credit system for five years now. What I want to know is why is it getting worse?

Mr Darling: It is not getting worse. It is benefiting an awful lot of people in this country.

Q372 Mr Fallon: This figure is getting worse. It has gone up 200,000.

Mr Darling: If you take the view—I do not know whether you do or not—that tax credits are a bad thing and you want to get rid of them, then say so. If you give people in work benefits or even out of work benefits, you always run a risk that there comes a point when they come off the tax credit system or the benefit system, as the case maybe, when there could be a disincentive in the system unless you taper it out on a longer basis.

Q373 Mr Fallon: Why is it getting worse? Why are there another 200,000 people caught in this trap?

Mr Darling: Because what is happening is that we are giving various groups of people more money in order to boost their incomes. You may think that is a bad thing. I think that is quite a good thing, though I accept that the penalty one pays is that, if one does that, there can be a higher marginal rate of deduction.

Q374 Mr Fallon: Will it get better ever?

Mr Darling: What do you mean by “better”?

Q375 Mr Fallon: Will the number of people caught in this trap reduce over time?

Mr Darling: You mean are we going to reduce the amount of tax credits we pay?

Q376 Mr Fallon: No. When you came into office there were three quarters of a million people caught in this trap. Now there are 1.9 million. What I want to know is whether you structure that number ever going down.

Mr Darling: There are two great advantages of the tax credit system. One is that we can get money to people who need it most. The second thing is it has meant that unlike in the past it makes work pay. I think that is a good thing. One of the reasons that we have nearly three million people in work is because work has paid for a lot of people. You are right though that if, as a matter of policy, you decide that you are going to give more money to people on tax credits, then you do have this marginal deduction rate problem but I think that is a better problem than a situation where frankly it does not pay to work or, put another way, you are not giving people on low incomes sufficient money so that they reach the conclusion that it does not pay to work.

Q377 Mr Fallon: You are not going to do anything about it?

Mr Darling: I did not say that.

Q378 Jim Cousins: Do you not accept that there are millions of workers who cannot go on tax credits or who choose not to, whose incomes are likely to fall in these next few months because of a combination of withdrawal of the 10p tax rate, the 2% pay policy and the absence of any firm proposals in the Budget to deal with every day shopping costs which are rising steeply and every day heating and lighting costs which are also rising steeply?

Mr Darling: In relation to heating and energy costs, I was discussing a moment ago through Nick Ainger’s questions some of the things we are doing there. Also in relation to the tax credits, I accept the point that I think you raised yesterday that there are some groups—

Q379 Jim Cousins: Very large numbers.

Mr Darling: That is right. There are particular groups who would be eligible for the working tax credit who are not taking it up and that is something that we need to do something about. Sometimes people do not know about it. There may be other reasons as well but if it is available for people in work then I would like to see them take advantage of that. Of course in addition to that, the fact is that there are more people in work who have increased their incomes. The pay policy I will come back to. It is a slightly different issue. On top of that, through normal pay progression, people will be earning more. I accept that we still have more to do to make sure that progressively through the system, as people go into work, it actually pays to work. On the public sector pay position, you know our position in relation to the inflationary pressures that we were facing a year ago. However, it has to be said that if you look at the amount of increase in public sector pay, the percentage increases over the last ten years, there are many people working in the public sector who have seen very considerable rises compared with ten years ago.

Q380 Jim Cousins: This is a moment in the economic life of the country when it is not fair or sensible to act as though you think we are rolling out good policies on into the distance in the longer term when in fact we have an immediate situation in which there are a large number of low income, low paid workers who are facing a fall in their real standards of living. That is not right.
Mr Darling: We have introduced the tax credit system which is helping millions of families in this country. Where takeup is insufficient, particularly with people without children, I would like to see us do more. In addition to that, the minimum wage has been operating for a number of years now. In addition to that, if you look at public sector pay, it has increased quite substantially. If you look at the amount of money that nurses have had, it is something like a 48% increase in the last few years. I think we have been showing ourselves as ready and able to increase the wages of many of the people that you are quite rightly concerned about. That has been our objective as a government. We have increased the amount of money that people in the public sector are receiving by way of pay. In addition to that we have been supporting families who have gone into work. We have three million more people at work in the economy than we did have ten years ago. As I said to you too, there will also be cases where we need to do more and we need to be helping people and I hope we will be able to do that.

Q381 Jim Cousins: In these proposals in the Budget, there is absolutely nothing to address the situation of people who cannot get mortgages under the present situation or have real difficulty in sustaining the mortgages they have because they are facing an increase in mortgage costs; and very large numbers of low income, older home owners who do not have mortgages but who are really stuck to know how they are going to raise the money to keep their homes in decent nick. There are no proposals in this Budget to deal with any of those issues.

Mr Darling: I would make the general observation that the tax changes we have made over the years are helping millions of people in this country, not least the reduction in the basic rate of income tax. In relation to mortgages, you raise a very important matter there. In the Budget there were proposals to help people in shared ownership schemes. In relation to the mortgage market generally, as we were saying right at the start of this hearing, quite obviously what is happening in the financial markets just now will have an effect on mortgages. Mortgages are still available and people can get them but the banks and building societies are likely to impose stricter conditions. The days when you could get a 125% mortgage are probably gone. I think lending on a sensible basis is probably the right thing to do. One of the other things we are looking at following the Budget is how we can help reopen some of the mortgage markets so we can get more money coming into the system, which will make it easier to get mortgages. The last thing I would say is in relation to interest rates which of course have a direct read across into mortgage rates. Interest rates have come down twice in the last three months, in December and February, which does help mortgage payers. As I said before, I hope that banks and building societies will pass on those reductions to their borrowers.

Q382 Jim Cousins: Do you not accept that we are going into a period when monetary policy may not be able to help us, where interest rates will be coming down but the actual interest rates which home owners will be paying will be going up?

Mr Darling: If interest rates come down, generally speaking, mortgage rates will come down with them and that will help mortgage payers.

Q383 Jim Cousins: The end of the fixed term rates?

Mr Darling: Of course it is the case that people who take out fixed term rates, at the end of those—that is always the case, no matter what the economic conditions are—and if you take a two or three year fixed term rate, when you come out of it, you then have to look and see what further rate you can get. I am afraid that is the nature of taking out a mortgage over a long period. The interest rates will go up or down as the case may be. If you look at our interest rates now they are historically at a much lower level than they were. Both of us remember when interest rates would be regularly up at 11, 12 or even 15% at some stages. The position is quite different now. Looking to the medium term, as I said in the Budget, we are looking to see what we can do in relation to the mortgage market to try and get that operating as efficiently as possible because that too would apply downward pressure on the costs of getting mortgages and therefore the amount of money that people actually pay.

Mr Ramsden: The average rate on new mortgages was 5.9% in January. There was an increase in the number of remortgages in January, so it was up to 40%. That suggests that the mortgage market is still working. The rate of 5.9% is still very low by historical standards. While we recognise the issues that you raise, which is why we have set up this working group to look at how to reopen the RMBS market, the position in terms of the evidence is as the Chancellor is setting out.

Q384 Jim Cousins: With great respect, there are large numbers of home owners on low incomes who are fearful of where they stand now and how things are going to work out for them over these next few months. It is no earthly use talking to them about what Mrs Thatcher did in the 1980s or what some working group might produce in 2010.

Mr Ramsden: On the facts, we said that the working group would be reporting back to the Chancellor in the summer and then there will be a final report by the PBR.

Mr Darling: I agree with what you are saying. The point I was making was that interest rates and therefore mortgage rates in this country are a lot lower than they were in the past. Surely one of the central objectives of government is to make sure that we keep them as low as possible, which is why I attach so much importance to stability, because that is the best way of making sure that inflation is kept down and therefore it has a downward pressure on interest rates and therefore mortgage rates. You may disagree with this but I think that is one of the best ways you can help mortgage payers, to develop
conditions to keep interest rates as low as possible. That seems to me to be a very sensible way of protecting the interests of people who pay. In addition to that, a stable economy means that we maintain high levels of employment and we have one of the lowest levels of unemployment we have seen for 30 years. You said you did not want to go back to the past but the problem we have had in the past is, when people were fearful they would lose their jobs, they could not keep up their mortgages and then you got the repossessions. That is something that we need to try to avoid. That is why stability is so important. That is one of the best things you can do to help home owners.

Mr Darling: It is obviously for my colleagues, the Secretaries of State to these departments, to decide what is best.

Q388 Mr Todd: There is an overall goal?

Mr Darling: Take MoD procurement. I think all of us would agree that we could be more efficient in the way we procure equipment. In relation to drugs for example, the drugs bill has been quite substantially reduced as a result of reforms that were being made. We have saved something like £300 million a year. Let me give you another example of personal experience when I was Secretary of State for Social Security and then Work and Pensions. It is an example I think of both efficiency and culture. Basically, ten years ago, the system was not terribly efficient. The buildings in which benefits were administered were frankly a disgrace and it was basically a system to pay out money. It was not there to help people get into work. The DWP today through Jobcentre Plus is much more efficient. There are fewer people administering the system. It has a far better outcome so I think those are examples of where you can make a contribution.

Q389 Mr Todd: What I am highlighting is a definitional problem which is that what might in some cases be described as efficiency savings and might be seen as service cuts in terms of quality of service provided and, in one or two of these cases, one is talking about a straightforward transfer of cost to another party, a third party.

Mr Darling: If they can do it more efficiently, there might be an argument for it. I am talking in the abstract because—

Q390 Mr Todd: I appreciate you are not an expert on the individual items but the rebranding of this as a value for money programme suggests perhaps a lesser focus on the idea of driving down unit costs of exactly the same transaction and more on simply discretionary cuts in spending, which may well be as you say perfectly justified and may well be the right thing to do.

Mr Darling: I think you have to look at each one of these things on its merits. I was told when I was Secretary of State for Social Security that what I wanted to do in Jobcentre Plus was just cuts. I was told that it was quite wrong that we should move people out from behind screens in what were old labour exchanges and put them into far more pleasant premises.

Q391 Mr Todd: You were right to stick to it.

Mr Darling: I was right to stick to it. In relation to a piece of military equipment a decision does have to be taken from time to time. Do we actually need it or if we have a given amount of money do we buy that or do we buy something else?

Q392 Mr Todd: You are leaving as the guardians of this process the individual departments who are scarcely the most objective sources of advice on what is an appropriate provision of a service, one might
think. Is there going to be an objective test at a corporate level in government to decide whether these are reasonable savings or reductions in cost that can be accepted as part of the overall corporate target? What I am trying to get across to you is that there is an overall corporate goal here. To simply say that the Department will make their minds up and that the NAO will look at this at some point—

**Mr Darling:** The process is iterative to some extent. You cannot leave everything entirely to a department any more than you can leave everything to the Treasury because unless the department owns the decision, in my experience, not a lot will happen. Whilst the Treasury knows many things, it may not be able to form a view as to whether one particular helicopter is better than another. It may have a view on it. It may point out that other countries can do things apparently cheaper and have a discussion about it but in the spending settlement of last year every single department was required to be more efficient because departments themselves have to make very often a better decision to say, "Okay, we do not need to do this or we can do that in a more efficient way."

**Q393 Mr Todd:** Is there a challenge in this process?

**Mr Darling:** There is, because all the settlements assume quite a substantial saving. The challenge is, if you do not do it, at some stage you will run out of money.

**Q394 Mr Todd:** The challenge to the detail of those savings, as to whether they are reasonable?

**Mr Darling:** Yes, but not at every single level because departments can make their own decisions in terms of how they organise their staff and so on. In some of the bigger decisions especially, departments will say, "Hold on, if you are asking us to do this, this will cause all sorts of difficulties." A collective view has to be formed as to what the right thing is to do.

**Q395 Chairman:** We come to this deeply sceptical having looked at some of these efficiency gains. If you get Gazelle helicopters withdrawn with flying hours and they are clapped out, how is that an efficiency gain? We have quite a number of examples of that but we will return to that issue.

**Mr Darling:** That is absolutely fine. The point I was making to Mark Todd was that inevitably, if you take military equipment for example, the MoD will have a very strong view on it just as the service chiefs will and that is something we need to listen to; but equally, it is right that the Treasury, with one of its prime duties to make sure that money is well spent, improves things like procurement where frankly, as a country, our record could be a lot better.

**Q396 Chairman:** We have seen ways of counting efficiency gains which stretch us to the limit.

**Mr Darling:** I would be happy to return to the subject.

**Q397 Mr Dunne:** I have a couple of questions about the capital gains tax reform proposals. Given that they were introduced without prior consultation, you then went away to rethink them. You delayed the announcement of the rethink. Would it not have been more appropriate either to put back the effective date or to have had some form of transitional period before the new arrangements came in, given the impact they have had on business decision-making?

**Mr Darling:** No, I do not think so. The same argument applies to the non-domiciled people. Some people said, "Look, put the thing off" but a lot more were saying, "Whatever you do, we would like to know what the position is." When you think about it, if you have somebody in business who wants to make plans, if we had said we would not make our mind up until March 2009 I do not think that would have been desirable. I am not saying this is a universally held view but most people believe, if you cannot decide what to do, you should just get on and implement it. You had a second point on capital gains tax?

**Q398 Mr Dunne:** I have other questions. By contrast, you have decided to defer the income shifting arrangements for a whole year to undertake further consultation. The point I was making is that businessmen have to make decisions and it may take more than the few weeks that were available to them to implement those.

**Mr Darling:** Yes, but on income shifting you may recall it started off with the decision of the Arctic case in October. Having looked at it, I think it is important that we get it right. That is the view that has been broadly welcomed by most people.

**Q399 Mr Dunne:** You listened to representations from businessmen and introduced the entrepreneurs’ relief in response to those and yet you chose to ignore the representations made by the life insurance industry who had a particular problem with products that they had arranged which they have estimated may result in some £35 billion worth of business being lost. Why did you decide not to make ——?

**Mr Darling:** I did not ignore it. As I said in the House in January—the point has been made in many discussions since that time—whatever solution they came up with, whilst it might have sorted one particular category of life policies, it would have in some cases an adverse effect on others. We also found that whilst there was some group of companies saying, "You must do something in relation to this particular problem", there were other groups saying, "If you do that, that will adversely affect the products we are selling elsewhere." When I looked at the amount of sales that were affected and at what was happening in the market generally, I do not think the position was quite as clear-cut. The real clincher is that what we were being asked to do could have run the risk of perhaps—and I only
say perhaps—sorting one problem only to discover we opened up another problem. I think it is best to try and avoid doing that.

**Q400 Mr Dunne:** Can you confirm that employees investing in employee share schemes will not be able to benefit from the new entrepreneur relief?

**Mr Williams:** In general, most of them will benefit from the—

**Q401 Mr Dunne:** Any gain in excess of the annual amount will not have the benefit of entrepreneur relief?

**Mr Darling:** The entrepreneurs’ relief is restricted to officers and people with shareholdings greater than 5%, exactly as I set out in January.

**Q402 Mr Dunne:** The answer is no?

**Mr Darling:** The position is exactly as I set out in January. I say that for those who follow these proceedings so that no one is misled.

**Q403 Mr Dunne:** What estimate have you made of the number of employee shareholders who will therefore lose out from the capital gains tax charge being increased effectively for them?

**Mr Darling:** I cannot give you that figure offhand. We can perhaps write to you about that.

**Q404 Mr Dunne:** An estimate will have been made, I presume?

**Mr Darling:** Perhaps it would be better to write to you.¹

**Q405 Mr Dunne:** On vehicle excise duty, what percentage of vehicles will pay a higher rate following the Budget proposals?

**Mr Troup:** In 2009 the majority of new vehicles will pay the same amount or will pay less, around 70%.

**Mr Darling:** Some will pay more. As I said last week, what we are trying to do is to give incentives to manufacturers to produce cars that are more environmentally friendly and also to give incentives to people to choose the least environmentally damaging car. It follows that if you reduce it at one end there will be an increase at the other. Some of the claims that appeared last week were grossly misleading in terms of the percentage of new cars bought. An awful lot of people will gain from this which I think is a good thing.

**Q406 Mr Dunne:** It also applies to all cars manufactured since 2001, so it is not just the new cars: it is a continuing charge for existing ones.

**Mr Troup:** The old regime applies pre-2001.

**Mr Darling:** The position is exactly as I set out in January. I say that for those who follow these proceedings so that no one is misled.

**Q407 Mr Dunne:** That means 47% will be worse off.

**Mr Troup:** 45. There must be some rounding.

**Q408 Mr Brady:** There are a couple of aspects of specific Act changes. First of all, can I ask you why you decided to defer the 2p increase in road fuel duty for six months?

**Mr Darling:** Quite simply because in the current circumstances when people are facing increased costs and given the fact that the price of oil is so high at the moment, I thought it was the right thing to do to defer it until October.

**Q409 Mr Brady:** Specifically in your Budget statement, you said that you did it because you wanted to support the economy now and help business and families by postponing that increase until October. If the oil price remains as high or higher in October and if the inflationary pressures on ordinary families are as great in October and the general economic uncertainty is as great, would the option remain open to defer it again?

**Mr Darling:** What I said was I was going to defer it until October which means that the increase will come into effect in October. I gave my reasons for deferring it until that time. I meant what I said. It has been deferred, not cancelled.

**Q410 Mr Brady:** Can I press you on the rationale for it? What I want to get to is, if the purpose of it is for environmental reasons, then surely any change in behaviour will be affected by the cost of fuel, not by the proportion of it that is tax? Looking forward, if we see continuing increases in fuel costs as a result of the oil price, would you be looking as a matter of policy to revisit the levels of taxation?

**Mr Darling:** You are right that the policy reason for increasing taxation on fuel, rather in the same way as the policy reason underlies the changes I made in relation to road tax, is because we want to encourage people to be more conscious of the environmental costs of driving. That is why the road fuel will be going up next year and the year after. I set out my proposals in the Budget but in relation to both those changes and indeed the changes to vehicle excise duty and the VED ones start coming in 2009 with further changes in 2010, which is consistent with what I was saying earlier. Because we think it is the right thing to do, it is tightening the stance we take at that time but in all these things every Chancellor will look at the impact of what is happening on the economy as a whole and reach a judgment as to what is right. Those are just that; they are judgments. My judgment was that for this coming period of six months we should postpone the increase because I think that will help businesses and families.

**Q411 Mr Brady:** Clearly this is a tax that impacts directly not only on families but also has a very important impact on the road haulage sector which is dealing in a very competitive market often with European competitors that have much lower rates of
duty payable on fuel in their own economies. To what extent do you take account of that difference in duty rates between the UK and competitor countries?

**Mr Darling:** I took into account the impact on business, including hauliers, and as you probably know I met the FTA and the RHA a short while before the Budget. I listened to what they had to say. The second point is a more general point and that is the differential in fuel duties here as opposed to France and Germany and so on and there of course you have to take into account other factors such as the costs of hiring people in France and Germany. There are all sorts of other taxes that hauliers have to pay and, as you know, there have been several studies done on this over the last seven or eight years. They show a mixed picture across Europe frankly, but the reason I took my decision was to support business in general rather than in response to the particular points that both those organisations made to you.

**Q412 Mr Brady:** Can I turn then to aviation duty? You were very clear in the Budget, saying that in order to strengthen the environmental signals through taxation the new per plane duty will be increased by 10% in the second full year of operation. That 10% will be an increase in the duty level based on the previous year. It is not based on an estimate of increased movements. Given that this is all about the environmental signal that it sends, what is your policy regarding the future of this duty once the aviation sector is covered by the EU environmental trading scheme? Will it be your policy to reduce it again or increase it further?

**Mr Darling:** I said of course I would look at what we charge in duty as well as the impact of the ETS and I made the point that I think it is important that we support the aviation industry but it is also important that it meets its environmental costs.

**Q413 Mr Brady:** Just to be even clearer, if and when aviation is covered by the European emissions trading scheme, I think you have just accepted the case that these duties should be reduced.

**Mr Darling:** If we are being absolutely clear, I did not actually say that.

**Q414 Mr Brady:** That was why I was pressing you further.

**Mr Darling:** I think we know quite a lot of them.

**Q415 John Thurso:** At paragraph 4.69, the Red Book states, "The government firmly believes it is unfair that some individuals can arrange their affairs to gain a tax advantage by shifting part of their income to another person.” Why is it unfair?

**Mr Darling:** If you have two people who are employed, they pay through the PAYE system and they have no choice about it. It just comes off at whatever rate is applicable. What is unfair is if you get a husband and wife, the husband is doing all the work and the wife does not make a contribution to the business and she can utilise her tax advantage in a way that just would not be open to anybody else.

**Q416 John Thurso:** Let us define that.

**Mr Darling:** We had always understood that that was what the law was until the Arctic case last summer. I do not have any problem with husbands and wives who are partners in a business and they are both working. It seems to me that it is absolutely right that we should recognise that through the tax system. Where you have the problem is where one of them is not doing any work at all.

**Q417 John Thurso:** Let me get to the core of my question. I appoint my wife as a non-executive of my company. How do you value that contribution?

**Mr Darling:** The answer to that is you have to see what somebody is actually doing.

**Q418 John Thurso:** She comes to the board meeting four times a year and I pay her £5,000. As a non-executive, is that value?

**Mr Darling:** This is one of the things that we need to get right in the consultation that we are carrying on at the moment. What I think is unfair and the whole point of having a consultation to look at this is, if you get one couple who happen to be in the PAYE system—one may be working and one may not—the working man or woman cannot transfer money to the spouse.

**Q419 John Thurso:** The business is paying them both the rate.

**Mr Darling:** If they are working—

**Q420 John Thurso:** Define “work”.

**Mr Darling:** That could keep us here for a long time.

**Q421 John Thurso:** That is the point. People can be useless directors but they do not get punished for it. I think we know quite a lot of them.

**Mr Darling:** What I am anxious to avoid is us getting into a situation where more and more people can avoid what they should fairly be paying into the system.
Q422 John Thurso: Let me challenge that if I may. 
**Mr Darling:** That is exploiting a situation that is not open to the majority of people. Up until last summer when we had this court case, I think it was generally understood that if somebody was working, making a contribution, they could be fairly rewarded for that. What I readily accept, which is why we have delayed this, is that it is quite difficult to legislate for it. What I am very sure about is that if we do not address this problem we are going to lose more and more tax. More and more people will take advantage of that and the burden will fall on people who have no choice but to pay their tax. I pass no comment on your non-executive spouse. Whether it is hypothetical or not I do not know.

Q423 John Thurso: I would not. She is quite cross already. The maximum we had in evidence yesterday would be in the order of 6K that the Treasury might lose. It is the differential between 20p and 40p. It is the NIC on the 40p that is not being paid. Take my word for it. There is another way of calculating it. HMRC say it is 260 million and it is 88,000 businesses. If you do the maths, it averages out at just over £3,000. What we have in the main is large numbers of small businesses, spouses being employed or helping the business, maybe not employed but just doing a lot of work or whatever, who you are chasing for an average of 3,000 and a maximum of 6,000 when the masters of the universe have been creaming you for millions for five or six years. Where are fairness and unfairness in that? 
**Mr Darling:** The 6,000 figure you were quoting is per couple.

Q424 John Thurso: No, it is the shift. 
**Mr Darling:** Yes, but the loss to the Exchequer will be rather more than that.

Q425 John Thurso: It cannot be. 
**Mr Darling:** It would seem that the invitation you proffered to me once to visit your constituency has probably been withdrawn now.

Q426 John Thurso: You are always welcome. If I can demonstrate to you the value of my relations in my business, it would be a delight. 
**Mr Darling:** As I have not got there yet, I cannot promise you when I will get there.

Q427 John Thurso: I hope I have not put you off. 
**Mr Darling:** I have no difficulty with the idea that you get many husbands and wives who are partners in business, who both make a contribution. Some of it is very obvious in terms of somebody doing work and some of it is less obvious. What I think any Exchequer would have a problem with is if you have a system that allows people to reduce the amount of money they pay on tax where it is not at all obvious that somebody is making a contribution. Trying to draft that legislation is difficult. I grant you, which is why we are consulting to try and get the thing right. What you cannot do—and this is a problem right across the tax system—is allow a situation to develop where more and more people can take advantage of something that is not open to the majority of people in this country, because I think that becomes unfair.

Q428 John Thurso: It is even worse because if I choose to have a mistress and I manage to keep it quiet and I make her a director and she does absolutely nothing, there is nothing you can do about it. I can pay my mistress but I cannot pay my wife. This is a turkeys of Orwellian proportions. You should wring its neck and stuff it back in the freezer. 
**Mr Darling:** I am looking forward to my visit to Thurso to see the ménage when I get there.

Q429 Chairman: I have not had an invite from John to his constituency. 
**Mr Darling:** Maybe we should all go.

Q430 Chairman: Maybe I could come along to protect you from his wife. Can I go on to spirits and Scotch whisky? The Scotch Whisky Association contacted me and said that the HMT model which was published three years ago of elasticity for spirits looked at a 40% duty rise producing just 6% more revenue but it would cause the UK spirits market to shrink by one third. That being the case, your figures of raising £400 million in revenue, 2008–09, £505 million in 2009–10 and £625 million in 2010–11 seem in jeopardy. 
**Mr Darling:** I find that difficult to accept as far as the Scotch whisky industry is concerned because 90% of its sales are export. It is a hugely successful export industry and the duty-paid depends upon the markets into which it is sold. If you speak to anybody in the Scotch whisky industry, they are doing very well. Certainly compared with ten years ago, they are doing exceptionally well. It is a huge industry for Scotland that is very important.

Q431 Chairman: You have not answered the question. 
**Mr Darling:** The estimates we give are the best estimates of what we believe will be the effect of increasing the duty. In relation to the Scotch whisky industry, given that 90% of what it produces is exported, I find that argument difficult to understand.

Q432 Chairman: I will provide you with that information. Given the cautious view of CPI 2% inflation plus 2% for duty accelerator each year to 2013, that puts further doubt on the revenue benefit and on the damage to the industry. We are talking about a 16% increase in spirits over five years. 
**Mr Darling:** My officials will correct me if I am wrong but the estimates we make are based on our forecasts for inflation, which are the ones you would expect us to use. We can make an estimate of what we think will happen to overall sales but if you look at whisky you are talking about 59p a bottle. In relation to some of the other drinks we are talking
about, if you went into a supermarket the average price of a bottle of wine was about £4.40 10 years ago and it is now about £4. I make no bones about it. The reason I did this was to pay for what I wanted to do for the winter fuel payments and child poverty. Given that we had frozen spirits taxation for ten years—and there are very few sectors where we have done that, which is a benefit to the Scotch whisky industry as well as the other spirits industries, a lot of which is exported as well—I do not think it is unreasonable.

Q433 Chairman: When we go down for our darts and pool night to the pub, we can say child poverty and winter fuel allowance have gained so that is your sacrifice.

Mr Darling: I will leave it to you to decide what you say down at the pub but you asked me for the rationale and that is what I said last week and what I say again today.

Chairman: You have been very open with us, Chancellor. Thank you to you and your officials for coming along.
Written evidence

Supplementary memorandum from HM Treasury

1. Child Poverty Numbers

The baseline year for the Government’s child poverty target is 1998–99, when relative child poverty was 3.4 million.

Halving child poverty by 2010 implies getting child poverty levels down to 1.7 million children in 2010–11. The latest available data is for 2005–06 showing 2.8 million children in relative poverty, so there needs to be a fall in relative poverty of 1.1 million between 2005–06 and 2010–11 to meet the target.

Child poverty is influenced by a number of factors:

— parental employment rates;
— demographic factors, such as the number of children and the type of households in which they live;
— growth in incomes across the distribution, in particular how incomes grow among the poorest families compared to the median; and
— the effects of changes to the tax and benefit system.

The last three fiscal events are expected to make further progress and lift over 500,000 children out of poverty as a result of changes to the tax and benefit system, of which:

— Budget 2007 is expected to lift 200,000 children out of poverty;
— 2007 Pre-Budget Report and Comprehensive Spending review is expected to lift 100,000 children out of poverty; and
— Budget 2008 is expected to lift up to 250,000 children out of poverty.

The 500,000 figures represents the number of fewer children in poverty compared to what would have happened without policy intervention. The actual change in poverty in the future depends not only on that, but also the underlying trends in poverty, which could either be rising, falling or remaining flat. As such, the above estimate of 500,000 children taken out of poverty are not necessarily a projection for the future.

The Institute for Fiscal Studies has estimated that after taking account of policy changes, and the underlying trends in child poverty, a further 450,000 children need to be lifted out of poverty to meet the 2010 target.

Annex A

THE SRO2 TARGET

SR02 set a target to reduce the number of children in relative low-income by a quarter by 2004–05. This was set using the McClements Equivalisation scale which is different to the modified OECD scale which is currently used.

Under this scale the baseline was 3.1 million children in 1998–99 (BHC) and 4.1 million children (AHC). In 2004–05 child poverty fell to 2.4 million (BHC) and 3.4 million (AHC) representing a 23% and 17% fall respectively. This fall was less than the Government SRO2 target of a fall of 25%.

2. Child Benefit Disregard in Housing Benefit and Council Tax Benefit

Housing Benefit (HB) in 2007–08 is calculated according to the formula below. The calculation of Council Tax Benefit (CTB) is similar.

\[
\text{Housing Benefit} = \text{Eligible rent} - (0.65 \times (I - A))
\]

That is, HB is withdrawn at 65p (20p for CTB) for each £1 of net income for housing benefit purposes (I) that exceeds a family’s applicable amount (A) in HB.

Income is net of income tax and employee National Insurance Contributions, and also includes Child Benefit and tax credits received; there are earnings disregards ranging from £5 to £25 per week, and an additional disregard for those eligible for Working Tax Credit. Applicable amounts for HB vary by family circumstances, eg there are different rates for singles and couples, and additions for dependent children.\(^1\)

Under the 2007–08 system, Child Benefit is included in the calculation of net income for HB purposes, ie is not formally disregarded. However, exactly equivalent amounts are also included in a family’s applicable amount for HB. This means that two families identical in all respects except that one receives Child Benefit and the other does not, both receive exactly the same amount in HB and CTB.

\(^1\) Additions for dependent children in 2007–08 are as follows: a per family premium of £16.43pw, equal to the sum of the family element of the Child Tax Credit and the difference between the eldest and subsequent rates of Child Benefit; and a per child premium of £47.45pw, equal to the sum of the per child element of the Child Tax Credit and the rate of Child Benefit for subsequent children.
Budget 2008 announced that from October 2009 Child Benefit income will be disregarded in calculating income for HB and CTB purposes. Compared to the current system, this reform amounts to an additional disregard in net incomes for HB/CTB purposes up to the value of Child Benefit for any family receiving Child Benefit. This new disregard will be additional to the existing Child Benefit premiums in HB/CTB applicable amounts which already ensure that families receiving Child Benefit do not have any of this income taken away from them through withdrawal of HB/CTB under the current system.

Compared with the current system then, this reform will lead to a genuine increase in income for any family receiving Child Benefit whose net earnings for HB/CTB purposes currently exceeds their applicable amount (and who currently face withdrawal of HB/CTB). A worked example for HB is provided in the table below.

In addition, some families receiving Child Benefit whose entitlement to HB/CTB is fully withdrawn on the basis of family income under the current system will also see gains. Working families with children will be the main beneficiaries of this measure; non-working families currently receiving maximum HB/CTB are unaffected. For example, a family with one child on the lowest incomes will gain up to £17 a week from this change; gains are greater for larger families. The measure has an estimated exchequer cost of £350 million in 2010–11 (Budget 2008, Table 1.2).

Transferring additional resources via HB and CTB ensures that gains are focussed on low income families with children, with greater gains for larger families where the risk of child poverty is greater. Together with other Budget 2008 announcements, the measure is expected to lift up to a further 250,000 children out of poverty. By boosting in work incomes, the reform also improves incentives to work for low income families.

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**Worked example for Housing Benefit in 2007–08: Single earner couple with two children, with net earnings of £140 per week, paying rent of £60 per week**

<table>
<thead>
<tr>
<th>£ per week</th>
<th>Including disregard of Child Benefit$^1$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2007–08 system</strong></td>
<td><strong>Applicable amount:</strong></td>
</tr>
<tr>
<td></td>
<td>Couples Allowance: 92.80</td>
</tr>
<tr>
<td></td>
<td>Family premium: 16.42</td>
</tr>
<tr>
<td></td>
<td>Child premium: 16.42</td>
</tr>
<tr>
<td></td>
<td>Total: 204.00</td>
</tr>
<tr>
<td><strong>Net income for HB purposes:</strong></td>
<td><strong>Applicable amount:</strong></td>
</tr>
<tr>
<td>Net earnings: 140.00</td>
<td>Couples Allowance: 92.80</td>
</tr>
<tr>
<td>Child Benefit: 30.20</td>
<td>Family premium: 16.42</td>
</tr>
<tr>
<td>Tax credits: 127.69</td>
<td>Child premium: 16.42</td>
</tr>
<tr>
<td><strong>less</strong></td>
<td><strong>Total:</strong></td>
</tr>
<tr>
<td>Earnings disregard: 10.00</td>
<td>Total: 204.00</td>
</tr>
<tr>
<td>WTC disregard: 15.45</td>
<td>Less</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td>Housing benefit: 35.14</td>
</tr>
<tr>
<td>272.44</td>
<td>Earnings disregard: 10.00</td>
</tr>
<tr>
<td></td>
<td>WTC disregard: 15.45</td>
</tr>
<tr>
<td></td>
<td>Child Benefit disregard: 30.20</td>
</tr>
<tr>
<td></td>
<td>Total: 242.24</td>
</tr>
<tr>
<td><strong>Housing benefit: 15.51</strong></td>
<td>Housing benefit: 35.14</td>
</tr>
<tr>
<td></td>
<td>= 60.00 — 0.65 x (242.24 — 204.00)</td>
</tr>
<tr>
<td></td>
<td>Family gains 19.63</td>
</tr>
<tr>
<td></td>
<td>= 0.65 x child benefit (30.20)</td>
</tr>
<tr>
<td></td>
<td>(35.14 — 15.51)</td>
</tr>
</tbody>
</table>

$^1$ For illustrative purposes, HB calculations with and without a formal disregard of Child Benefit income are shown in 2007–08. Budget 2008 announced that Child Benefit will be disregarded in income for HB and CTB purposes from October 2009.

$^2$ Equal to the family element of Child Tax Credit plus the difference between the eldest and subsequent rates of Child Benefit.

$^3$ Equal to the child element of Child Tax Credit plus the rate of Child Benefit for subsequent children.

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3. **COUNCIL TAX: TABLE C6**

The figures in Table C6 are produced on a National Accounts basis and are not solely gross Council Tax—they include accruals adjustments, Northern Ireland domestic rates and are less Council Tax Benefit.
Within the overall projection, gross Council Tax figures for 2006–07 are based on outturn and 2007–08 figures on CIPFA data, including historic growth in the Council Tax base. The 2008–09 figure reflects the average bill increase in England and Wales in the previous three years plus base growth (eg. more households). The Scottish Parliament announced no cash increase in bills over the CSR07 period and that forecast assumes only base growth. The underlying bill increase and base growth numbers assumed in Table C6 are below:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>England</td>
<td>% Change</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4.5</td>
<td>4.2</td>
<td>4.3*</td>
</tr>
<tr>
<td></td>
<td>Base growth</td>
<td>0.8%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Scotland</td>
<td>% Change</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3.2</td>
<td>1.8</td>
<td>0**</td>
</tr>
<tr>
<td></td>
<td>Base growth</td>
<td>0.5%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Wales</td>
<td>% Change</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4.4</td>
<td>4.7</td>
<td>4.3*</td>
</tr>
<tr>
<td></td>
<td>Base growth</td>
<td>0.5%</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

* Three-year average 2005–06 to 2007–08
** Announced by Scottish Parliament

Local authorities, not the Government, determine Council Tax increases annually. The Council Tax projections in Table C6 are based on stylised assumptions and are not Government forecasts. In seeking to forecast growth in Council Tax bills in 2008–09, it is more appropriate to refer to the Local Government Association who, in January 2008, reported that average Council Tax increases in England would be around 4%.

4. Residence and Domicile Numbers

Of the people who don’t leave the UK how many will be in employment?

There is a limited amount of data in this area as the recent consultation document indicated. Currently our data shows that around 80,000 remittance basis users have UK employment income. We expect this to stay broadly the same following the changes announced at Budget.

Are you expecting them to be compensated by their employers?

Our understanding is that currently employers do offer workers posted from overseas tax equalisation packages for limited period. How employers wish to structure their pay packages is however a matter for them. It should be noted that we believe the £30,000 charge will now be creditable against US tax, compensation would not therefore be necessary.

How many will be casual workers?/Can HMRC cope?

HMRC will provide support and guidance for migrant workers and other low income groups who find that they are impacted by the changes. It is however important to note that not all casual workers coming to the UK from abroad will use the remittance basis. Some may not be here long enough to qualify as UK tax resident. Those who are resident for UK tax but don’t use the remittance basis will find that if they have paid tax on employment income in their home country they are unlikely to need to pay more tax in the UK. If they do qualify for the remittance basis, most non domiciled workers on a low income who will not be touched by the new proposals as personal allowances are not removed unless they have more than £2,000 unremitted income and gains, which implies savings income on capital of around £40,000. Similarly, if they are casual workers they are unlikely to be here for more than seven out of 10 years and so will not be affected by the charge.

How many will leave?

As mentioned above, there is a limited amount of data in this area as the recent consultation document indicated At the time of the consultation our working assumption was that 3,000 people would leave. This is broadly still the case.

What assessment has been done of the economic impact of people leaving?

HM Treasury does not do economic impact assessments for personal tax measures. It should however be noted that the estimated increase in tax yield in 2009–10 is £700 million.
5. SAVING GATEWAY AND ELIGIBILITY

Eligibility to the national Saving Gateway will be passported from qualifying benefits and tax credits.

People who are retired will not be eligible as other forms of support are in place for those who are retired and on low incomes, such as the Pension Credit and the Winter Fuel Allowance. Students are able to access financial support through student loans and maintenance grants.

Building on the lessons learned from the Saving Gateway pilots, individuals will be eligible to open a Saving Gateway account if they are in receipt of:

- Working Tax Credits (WTC)
- Child Tax Credit paid at the maximum rate
- Income Support
- Incapacity Benefit or Employment and Support Allowance
- Severe Disablement Allowance
- Jobseeker’s Allowance

This will give a potential eligible population of around eight million individuals. Passporting access to the scheme provides the simplest and most cost effective way of reaching the target population.

Some individuals on low incomes of working age would not have access to the Saving Gateway through passporting. Details of these are set out below:

<table>
<thead>
<tr>
<th>Group</th>
<th>Size of Group (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Those on low incomes, in work, aged 18–25 who do not qualify for WTC</td>
<td>0.5</td>
</tr>
<tr>
<td>Working 16–30 hours not eligible for WTC</td>
<td>0.7</td>
</tr>
<tr>
<td>Eligible for a qualifying benefit but do not take it up</td>
<td>2.7</td>
</tr>
</tbody>
</table>

To bring these groups into eligibility for the scheme it would be necessary to set a separate income and asset test for those who do not qualify through passporting but think they have income and assets low enough to qualify.

There are a number of issues which would arise in doing this. Primarily a separate income and asset test would detract from the simplicity of passporting and may act as a further barrier to helping individuals on low incomes to save. It would also not be possible to put the necessary computer systems in place to do this in time for the introduction of the scheme in 2010.

6. VFM—DISALLOWING GAINS DUE TO SERVICE QUALITY INDICATORS

Under the SR04 Efficiency Programme all efficiency initiatives have service quality indicators and gains are not allowed to score as final until it can be demonstrated that service quality has not been adversely affected.

HMT’s challenge process looks at a range of issues including whether service quality is being robustly measured. Our process is designed to engage constructively with departments to ensure that genuine efficiencies are being achieved. When HMT has concerns about any aspect of an SR04 efficiency initiative, we engage with the department to understand the issue and resolve it quickly. The success of this approach is demonstrated by the fact that 87% of the gains departments reported to December 2007 are now classified as final, and therefore have demonstrated that service quality has not been adversely affected. This compares with 68% of the gains reported at Budget 2007, indicating the progress that has been made in resolving measurement concerns.

As we look to bring the programme to an end we will be working to ensure that all the gains counted towards the target are real, robust and have demonstrated that quality has not been affected. If Departments have put forward gains that cannot meet this criteria they will not be counted. However we are not at this stage now, and our engagement with departments has been characterised by constructive challenge and support, not “disallowing” programmes.
7. How many people with incomes less than £18,500 a year will be experiencing a fall in living standards?

The Government gave details of those affected by the tax changes announced in Budget 2007 in answers to Parliamentary Questions by Mr Frank Field (Official Report 18th Oct 07, Col 1266W–1268W) and Mr Drew, Mr Boswell, Mr David Anderson and Mr Syms (Official Report 18th Oct 07, Col 1268W–1270W).

Specifically, estimates are that 0.8m single earners with income under £18,500 will see their income decrease by around £1.45 a week on average. The reforms overall, however, are of particular benefit to low income households. The reforms will lift around 200,000 children out of poverty, and analysis of the reforms by the Institute for Fiscal Studies showed the greatest gains are for households in the poorest two deciles.

The maximum amount any single individual could be worse off by is £232 per year (£4.46 per week)—about 3% of net income. This loss would be completely offset by increases in Working Tax Credits for those eligible to claim. For those not eligible for WTC it is possible that households around or under the level of income achieving the maximum loss could be receiving Housing and/or Council Tax Benefits and could therefore have up to 85% of this loss offset by increases in HB/CTB. For households that are worse off, the average loss is about £2 per week.

In October 2008 the National Minimum Wage increases by 3.8% outweighing the losses arising from the income tax changes for many. For a single person aged 22 or over, working full-time on the National Minimum Wage and not eligible for, or not claiming, Working Tax Credit will be £77 per year (£1.49 per week) better off in real terms by October 2008 compared with October 2007.

As a result of personal tax and benefit measures announced in Budget 2007, PBR 2007 and Budget 2008 around 22 million households will be better off or no worse off in 2008 in real terms than compared with the 2007–08 tax and benefit system. More than nine-in-ten households in the bottom fifth of the population will be better or no worse off in real terms in 2008 compared with 2007. On average, households in the bottom fifth of the population will be £160 per year better off in real terms—an increase in their net incomes of 1.2%.

It is not possible to estimate how many people with incomes less than £18,500 will experience a fall in their living standards as it depends on their individual circumstances and earnings growth.

Memorandum from John Whiting, PricewaterhouseCoopers LLP (with input from the Chartered Institute of Taxation and Low Incomes Tax Reform Group)

This paper is a commentary on some of the taxation measures contained in the Chancellor’s 12 March Budget speech, associated Press Releases and other papers. It does not attempt full analysis and cannot be exhaustive.

Whatever the economic impact of the 2008 Budget, it will have a considerable impact on the UK’s tax system as the 107 Budget Notes and multiplicity of accompanying documents are put into effect. Whilst it was good to see progress on simplification (eg BN4 on Associated Companies and BN35 on Repealing Anti-Avoidance Provisions), the overall package does point to a still more complex system.

Consultation

One general lesson to be drawn from this Budget is surely on the importance of consultation—consultation that is timely, properly managed, includes working with the right people and organisations, and having regard to what they say.

The steady progress on the reform of HMRC’s powers is a testament to good consultation; a number of other measures of considerable significance (Income Shifting, Residence and Domicile, CGT and Principles-based drafting) show welcome evidence of listening and an ability to make some changes in consequence. However, the process in all these areas would have been so much more effective for the development of the UK’s tax system had consultation taken place in the right sequence—before the announcement of how changes would be made, not afterwards and against a background of decisions already largely made.

Residence and Domicile

HMRC is to be congratulated on listening to the (strongly expressed) concerns with the original proposals on Residence and Domicile and moving to alleviate many of them. The result is a package that no longer
acts as a deterrent to investment in the UK; nor will it act retrospectively. However, three areas still need attention:

(i) **Personal allowances**—the doubling of the de minimis amount of foreign income to £2,000 does not solve the unfairness or impracticality of the denial, from day one, of personal allowances for anyone on the remittance basis. This will catch two groups in particular:

— The UK employer (often a foreign bank) of non-domicileds who are on a tour of duty to the UK. The employer will potentially have to monitor every such employee’s position, modify the payroll accordingly and in most cases compensate affected employees through a tax equalisation payment or face a demand for higher pay. It is not enough for the Treasury to say employees have a choice in this area; the fact is that many will end up paying additional UK tax and look to their employers for compensation, thus increasing employment costs.

— The low paid, who will, in great numbers, unwittingly breach the new rules and so risk a future penalty. The de minimis amount is unlikely to cover everyday situations such as the rent on the let-out flat back home, or earnings from helping with the family farm in the summer, or a student’s summer vacation job at home. HMRC is simply not in a position to cope with the practicalities of educating and coping with this community.

The only fair and practical solution to this issue is to harmonise this loss of personal allowances with the £30,000 charge, to come in after seven years rather than immediately.

(ii) **Residence test**—the modification to only count days where the individual is in the UK overnight is welcome and sensible but has to be set against the lack of a UK statutory residence test. We are still largely dependent on case law and on HMRC practice. This also orientates towards a 91 day test, out of line with other countries. The UK needs a statutory test of residence that is clear and easy to work with; there needs to be a commitment to develop such a test.

(iii) **Confidence rebuilding**—the changes to the original proposals will contribute significantly to reducing an exodus of non-doms. However, many in that community have, rightly or wrongly, gained the impression that the UK no longer welcomes them as much as it used to. There is work to be done to ensure that the UK is still perceived as an attractive location for work and investment, especially in relation to the financial sector.

**Retrospection**

It is one of the general principles of UK tax law that tax changes are not made with retrospective effect. That said, the Paymaster General’s statement that accompanied the December 2004 Pre-Budget Report gave warning of possible retrospective action against avoidance schemes—but only in a limited area and only back to 2004.

To find that a measure (BN 66) is being introduced which will have retrospective effect back to 1987 is unacceptable. It is not even on an area dealt with by the PMG’s statement. The subject of the change may be an avoidance scheme, but that is not an excuse for such far-reaching action which is well beyond “clarification”, as claimed by the note. This is a dangerous precedent for the integrity of the UK’s tax system.

**Small Business**

The decision to postpone the impractical and unworkable income shifting proposals is very welcome. It is to be hoped that the opportunity will now be taken to have a proper review of the principles of small business taxation. The result should be a taxation system that rests on practical, workable rules for the small business community, rather than resorting to a sticking plaster solution to the perceived problem.

This sector is concerned with the continuing rise in corporation tax, albeit that the Annual Investment Allowance is welcome. However, the success of that initiative needs to be kept under review and assessed against the alternative of a simple, lower tax rate in due course.

**Large Business**

The key Budget issue for large business, given that the change in rate of corporation tax and the revamping of the capital allowances system were inexorable, was how and when the Foreign Profits discussion document was to be taken forward. Whilst the proposed dividend exemption was broadly welcomed, significant concerns were raised by business around the interest cap and the tightening and extension of the controlled company regime, especially in relation to the taxation of intangibles. Concerns have centred on the potential for a significantly increased compliance burden and the fact that the proposals seem unlikely to be revenue-neutral in their current form. It is to be hoped that the delay in progressing the ideas points to careful reconsideration.

The consultation document on a “principles-based approach to financial products avoidance” (mainly covering disguised interest payments), published last December, has several overlaps with the foreign profits proposals and the possibility of double taxation arises. It also represents a fundamental change in approach which needs careful exploration rather than rushed implementation. The announcement that
implementation of the principles-based approach is being deferred to 2009 is welcome and allows more time for the issues to be debated and any changes to be aligned with the introduction of legislation on the taxation of foreign profits.

Overall, the concern is that these proposals will have an adverse effect on the competitiveness of doing business in the UK. In this regard, the commitment “...to maintain the most competitive corporation tax rate of any major economy...” is welcome but the commitment needs to be in terms of the whole business tax system, not just the rate of corporation tax.

HMRC POWERS

As noted above, the proposals on HMRC powers are the result of a good consultative process. The latest round of consultations, relating to the measures in BNs96-98, has only just closed and so it remains to be seen whether and how the various areas of concern that respondents raised have been answered. The concerns include areas such as HMRC’s access to premises; ability to assess and take away records; debt offset powers; and the operation of penalties for late notification.

The development of proper, modernised powers is, of course, very necessary to enable HMRC to police effectively the tax system. But this process also highlights the need for proper safeguards for the taxpayer. To that end, the commitment by the Government to start discussions on a Taxpayer’s Charter/Bill of Rights is especially welcome and it is to be hoped that this can be brought to fruition in parallel with the general powers review.

TAX AND THE ENVIRONMENT

The various changes under this heading are all valid, but what business (and, one suspects, individuals) would welcome is a clear framework that will be used to develop the UK’s “green” tax agenda. In simple terms, will the tax system be used to raise money or change behaviour? If the latter, will there be a solid and consistent system to allow businesses to plan, long-term, accordingly?

OTHER MATTERS: COMMUNICATION

There are a number of other matters that deserve to be noted. These include welcome measures such as:

- The transitional Gift Aid rules.
- The tax credit on overseas dividends.

As a final point, it has to be noted that many of the changes to income tax and NICs that are about to affect taxpayers were announced a year ago. Some aspects, especially relating to the 10% tax band and the savings rate, remain a source of considerable confusion. It does demonstrate the need for an effective communication strategy over tax changes, so as to ensure as far as possible that taxpayers understand what is happening and that the risk of surprises in the pay packet are minimised.

March 2008

Memorandum by Professor David Heald,2 specialist adviser to the Committee

THE IMPLICATIONS OF THE DELAYED SWITCH TO IFRS

INTRODUCTION

1. The Budget Report (Treasury 2008, para C.103) made the following announcement under the heading “Public Sector Financial Reporting”:

As announced in Budget 2007, in order to bring benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice, the annual financial statements of government departments and other public sector bodies will in future be prepared using International Financial Reporting Standards (IFRS) adapted as necessary for the public sector. Following consultation with departments and the Financial Reporting Advisory Board on the technical work needed to implement this change, the Government now intends to move to IFRS from 2009–10 to minimise burdens and to ensure a smooth transition. Whole of

2 Declaration of interest: the author is a member of the Financial Reporting Advisory Board, nominated as an independent economist by the Head of the Government Economic Service.
Government Accounts (WGA) will now be published for the first time for 2009–10 to allow time to complete the alignment of local government and central government accounting policies and to enable WGA to be published on an IFRS basis.

2. The oral evidence given to the Committee on 4 March 2008 on behalf of the Financial Reporting Advisory Board (FRAB) demonstrated that this rescheduling from 2008–09 to 2009–10 was the only practical decision that could be made (Treasury Committee 2008). Two key departments (Defence and Health) had indicated that they could not meet this timetable, albeit for somewhat different reasons.3

3. Although this rescheduling is widely recognised as having been inevitable, it raises a number of important issues:
   - Unsatisfactory accounting for Private Finance Initiative (PFI) assets.
   - Delays to the publication of Whole of Government Accounts (WGA).
   - The International Financial Reporting Standards (IFRS) implementation timetable.
   - The relationship between IFRS accounts and the national accounts on which the fiscal rules are calibrated.

These issues are briefly considered in this memorandum.

**UNSATISFACTORY ACCOUNTING FOR PFI ASSETS**

4. The FRAB witnesses explained on 4 March that the Board’s recommendation to the Treasury on PFI accounting is that the public sector client should account for concession assets according to IFRIC 12, an Interpretation issued by the International Accounting Standards Board (IASB). However, IFRIC 12 is directed to the private sector operator, not to the public sector client. Applying what has become known as the “mirror-image treatment” led FRAB to the view that IFRIC 12 can be applied in government and that the likely effect is that most PFI concession assets would be recorded on the balance sheet of the public sector entity. The International Public Sector Standards Board (IPSASB) is developing its own standard for concession accounting by public sector entities, and it seems likely that a forthcoming statement will reach a broadly similar conclusion to that of the Treasury and FRAB. There are unresolved issues about the authority attached to IPSASB standards, and this may become an issue in future.

5. The late decision-making with regard to how PFI assets would be accounted for under IFRS as modified for UK public sector entities contributed to the Ministry of Defence and the Department of Health indicating that they could not implement in 2008–09. However, it would be wrong to conclude that the underlying issue is moving from UK GAAP (as modified in the Financial Reporting Manual (FReM)) to IFRS (as modified in the IFRS-based FReM known as I-FReM). The underlying issue is the pre-existing unsatisfactory accounting for PFI assets, an issue that FRAB has raised with the Treasury in successive annual reports since its establishment in 1996. If PFI accounting had been done properly under FRS 5A (ASB 1998; Heald 2003), it is unlikely that the switch to IFRS would have seen large changes to public sector balance sheets. Under such circumstances, the numerical effects of the switch from FRS 5A (where the criterion is “risks and rewards”) to IFRIC 12 (where the criterion is “control”) are likely to have been manageable.4

6. Table 1 has been calculated from the October 2007 PFI data published on the Treasury website. Overall, this shows 43% on the public sector balance sheet and 57% off.5 What is most striking is the variation in the On/Off proportions between departments. These differences are heavily driven by the identity of the auditor (the National Audit Office has been stricter about FRS 5A balance sheet treatment than the appointed auditors of the Audit Commission5) and the control framework (local authorities and NHS bodies have known that on-balance sheet PFI would not normally be approved). This situation persisted because it suited the Government’s policy of promoting the PFI as a procurement route. This inconsistency was facilitated by the scope for arbitrage6 between FRS 5A (published by the Accounting Standards Board) and Treasury Technical Note 1 (Revised) (published by the Treasury as an interpretation but which effectively became treated as a competitor standard) (Treasury Taskforce 1999).

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3 The difficulties facing both departments relate primarily to accounting for Private Finance Initiative assets. In the case of Defence, the main issue is the sheer number of PFI contracts and assets that would have to be reviewed. In the case of Health, the main issue is that funding allocations for 2008–09 have already been issued; changes to PFI accounting in 2008–09 would therefore lead to many NHS bodies breaching their statutory financial obligations.

4 Although one would expect that bearing the majority of risks and rewards would normally align with control, it is possible to think of specialised cases where this might not be the case. For example, a PFI-financed toll road might be controlled by the public sector client (IFRIC 12 criterion) whereas the majority of risks and rewards might have been passed to the private sector (FRS 5A criterion).

5 An earlier version of this table was supplied by the Treasury to the Treasury Committee (2007, page 25).

6 Paradoxically, the Treasury Technical Note 1 (Revised) related to central government (but where the National Audit Office has insisted on FRS 5A) but not to local government and the NHS (but where it was used to validate off-balance sheet treatment).
Table 1

BALANCE SHEET TREATMENT OF SIGNED PFI DEALS (OCTOBER 2007)

<table>
<thead>
<tr>
<th>Is capital value scored on or off the Departmental Balance Sheet (on/off)?</th>
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<tr>
<td>No. of schemes</td>
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<td>On</td>
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<tr>
<td>Cabinet Office</td>
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<tr>
<td>Crown Prosecution Service</td>
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<td>Department for Business, Enterprise and Regulatory Reform</td>
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<td>Department for Children, Schools and Families</td>
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<td>Department for Communities and Local Government</td>
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<tr>
<td>Northern Ireland Executive</td>
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<td>Scottish Government</td>
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<tr>
<td>Welsh Assembly Government</td>
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<td>TOTALS</td>
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</tbody>
</table>

Source: http://www.hm-treasury.gov.uk/media/B/E/pfi_signeddeals_231007.xls (last accessed 22 February 2008); calculation by author.

Note: no balance sheet information was available for two Scottish Government schemes, so they have been excluded from these figures.
7. In early 2007 FRAB appeared to have brokered an agreement on PFI accounting under the existing modified UK GAAP basis. This would have involved the withdrawal by the Treasury of Technical Note 1 (Revised) and sole reliance on FRS 5A, with effect from 2008–09 because it was judged to be too late to implement for 2007–08. Before a formal recommendation was made to the Treasury by FRAB, the 2007 Budget Report (Treasury 2007a, bold emphasis in original) announced the switch to IFRS from 2008–09: 6.59. . . . In order to bring benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice, this Budget announces that from the first year of the CSR period these accounts will be prepared using International Financial Reporting Standards (IFRS) adapted as necessary for the public sector.

6.60. This Budget also announces the Government’s intention that Whole of Government Accounts will now be published for the first time for the 2008–09 financial year. This revised timetable is to allow time to complete the alignment of local and central government accounting policies and to enable WGA to be prepared on the new IFRS basis.

8. The subsequent FRAB meeting on 19 March 2007 welcomed the announcement of the switch to IFRS, in anticipation of which much work had been done on the draft I-FReM. However, the Minutes (FRAB, 2007, paras 10–12) record discussion of the implications for PFI accounting. One practical consequence was that neither FRS 5A nor the Treasury Technical Note 1 (Revised) would apply beyond 2007–08 because these both relate to UK GAAP; therefore the latter was not withdrawn. One year later the chosen basis for PFI accounting under IFRS appears to have been settled as IFRIC 12, but implementation will now not be until 2009–10.

THE IFRS IMPLEMENTATION TIMETABLE

9. Given the five-year timetable available to the private sector for IFRS conversion, together with the linkage in the public sector between accounting and the budgetary funding of organisations such as NHS bodies, the one-year timetable announced in Budget 2007 was over-ambitious. Even though departments and other bodies have known for a long time that conversion to IFRS was coming, the revised official timetable only gives two years from the official announcement.

10. It is therefore imperative that all departments and other bodies produce shadow 2008–09 IFRS resource accounts, with the exception of those granted an explicit exemption by the Treasury. These shadow accounts should be thoroughly reviewed by the National Audit Office, if not formally audited. In the run-up to the conversion from cash to resource in 2001–02, the Treasury operated a trigger-point strategy, with clear milestones, and regularly report progress to Parliament. The same approach is now required for the IFRS conversion in 2009–10, otherwise there is a severe risk of further delays.

11. If there had been a trigger-point strategy put in place immediately after the March 2007 announcement of IFRS conversion for 2008–09, it would have quickly become apparent that the timetable was at risk. Because of the need for comparative figures for the prior year, entities reporting for the first time under IFRS for 2008–09 must be able to restate their 1 April 2007 balance sheets on an IFRS basis. Moreover, the links between accounting and budgeting, particularly in the case of the NHS, meant that the accounting regime had to be finalised—at the latest—before funding allocations for 2008–09 were issued by the Department of Health in late Autumn 2007.

DELAYS TO THE PUBLICATION OF WHOLE OF GOVERNMENT ACCOUNTS

12. The Treasury committed itself to the production of Whole of Government Accounts (WGA) in the 1998 Scoping Study (Treasury 1998b; Chow et al 2007). An already delayed timetable slipped again at Budget 2007 (the switch to IFRS for 2008–09) and another year at Budget 2008 (the rescheduling of IFRS to 2009–10). The original timetable was that a fully audited 2005–06 WGA would be published in 2006, having been preceded by published dry run Whole of Central Government Accounts (WCGA), possibly as early as 2002. The Government has subsequently decided against publication of WCGA, apparently on the basis that these would not be “useful”.

13. It is difficult to be sure about the reasons for these delays, which contrast markedly with the Treasury’s success in holding to the original schedule for Resource Accounts to replace cash-based Appropriation Accounts in 2001–02. Contributory factors may include:

(a) There might have been a loss of belief at high levels in the Treasury as to the potential benefits.

(b) The numbers emerging from the WGA project may not have been welcome, in particular those relating to the WCGA, publication of which is no longer planned.

8 The present author does not accept this view, but this matter does not receive consideration here.
(c) There may have been a lack of staffing resources and skills in the Treasury and in departments and other entities within the area of the WGA consolidation.

(d) The WGA may have lacked political and bureaucratic clout within the Treasury, with the result that Treasury enforcement powers over departments have not been used.

(e) The credibility of the WGA project with departments may have been sapped by delays, with the result that insufficient priority has been given to the consolidation returns.

Complex consolidations are a central feature of the accounting process in listed companies. The WGA consolidation is certainly a formidable exercise, but genuinely technical problems seem unlikely to explain the actual delays.

14. These circumstances mean that it is imperative that Parliament does not allow the commitment to slip out of sight. Such matters may seem boringly technical, but the production of audited WGA is of major political importance:

(a) The sustainability of UK public finances is an important matter of public debate and the Government’s decision not to publish the dry-run WCGA and WGA deprives that debate of relevant information held by Government but not by Parliament and the public, for example, in debates about the possible reformulation of the fiscal rules and about the affordability of current policies.

(b) One of the five principles of fiscal management in The Code for Fiscal Stability (Treasury 1998a) is “fiscal transparency”. The Treasury’s WGA website claims transparency benefits: “producing Whole of Government Accounts (WGA) . . . will assist in ensuring that best practice accounting methods are used to construct accounts covering the public sector as a whole, and that fiscal reporting is as transparent as possible” (http://www.wga.gov.uk/pages/introduction.html, last accessed 19 March 2008, italics added)

(c) The Governance of Britain White Paper (Secretary of State for Justice and Lord Chancellor 2007) contains a section on “Transparency of government expenditure”, though the content is narrowly focused on the objective of “a clearer line of sight”. In terms of making the Executive more accountable to Parliament—a central theme of this White Paper—published WGA can make an important contribution towards reviving Parliamentary fiscal scrutiny.

15. The final sentence of the Budget 2008 announcement (see the quotation in para 1 above) connects the 2009–10 timetable for the IFRS-based WGA to the alignment of local government and central government accounting policies. However, the local government timetable for conversion to IFRS is for implementation in 2010–11 (http://www.cipfa.org.uk/pt/consultations.cfm#future, last accessed 19 March 2008), not in 2009–10. This means that considerable adjustments will have to be made to the local government figures in the 2009–10 WGA consolidation process.

16. At the rhetorical level there is Government commitment to WGA as an additional tool of fiscal analysis. However, implementation is a different matter. The WGA programme is now four years behind the schedule of publishing an audited WGA for 2005–06, with the timetable now being for 2009–10. Consistent pressure upon the Treasury, particularly at each Pre-Budget and Budget, is an essential role for the Treasury Committee to play. The WGA might well bring unwelcome news about UK public finances, and so there may be an incentive for ministers and officials to delay publication. However, there might be circumstances in which the Treasury wished to emphasise past failings: one is reminded of Fiscal Policy: Lessons from the Last Economic Cycle published as part of the 1997 Pre-Budget documentation (Treasury 1997).

17. The turmoil about PFI accounting has focused attention on two issues regarding the authority and legitimacy of accounting regulation:

(a) The regulation of financial reporting is moving to a global level, as evidenced by the spread of IFRS in the private sector. However it should be noted that what UK listed companies follow is not “pure” IFRS as promulgated by the IASB but EU-adopted IFRS.

(b) The approach of the Treasury has been to align government accounting directly with EU-adopted IFRS, albeit with some modifications to suit the circumstances of the public sector, in the same way as it did with UK GAAP from 2001–02. Over the intervening period the influence of IPSASB, a body under the umbrella of the International Federation of Accountants (IFAC), has greatly increased. It is possible to envisage circumstances where there may be disagreement between direct adaptation from IFRS and adaptation mediated by IPSASB.

* In January 2008, the CIPFA/LASAAC Local Authority SORP Board published a consultation on whether to recommend to ministers that governance of the Local Authority Accounting Standard of Recommended Practice (SORP) should move from the aegis of the Accounting Standards Board to that of FRAB (CIPFA 2008).
18. Whereas the above are medium-term issues, there is an immediate issue regarding the relationship between financial reporting regulation and the national accounts, currently prepared under the European System of Accounts 1995 (ESA 95). This issue is of profound significance because the Government’s fiscal policy objectives and fiscal rules are formulated on a national accounts basis. Moreover, the United Kingdom’s conformity with its international obligations (eg Maastricht Treaty) is assessed on a national accounts basis. This means that the tensions between regulatory systems have to be managed because their sources cannot be eliminated.

19. Two difficulties arise. First, different conceptual frameworks govern the work of the accountants who produce the accounting standards that regulate the preparation of IFRS-based financial reports and of the statisticians who produce the ESA methodology that regulates the preparation of national accounts. Second, the periodicity of revision is completely different: IFRS evolves rapidly, often in a piecemeal fashion in response to new issues, whereas ESA is subject to revision at long intervals, lagging the revision of the System of National Accounts (SNA). This means that alignment issues are inevitable, and will have to be dealt with by accounting adjustments. Readers of the annual Public Expenditure: Statistical Analyses are familiar with such adjustments but their existence and, in some cases, changing character, complicate exposition to non-specialists.

20. Given these circumstances and the fact that, for practical and resource reasons, the Office for National Statistics (ONS) is heavily reliant on the judgements made by accountants, there are important issues to address. First, complexity creates opportunities for avoiding substantive fiscal transparency. However, the ONS has worked to establish the economy-wide position about PFI, as neither On-On treatment nor Off-Off treatment is acceptable in the national accounts. The ONS work on PFI liabilities (Chesson and Maitland-Smith 2006) contributed to the pressures for the regularisation of the financial reporting treatment. Second, there is the danger of arbitrage between financial reporting treatments and national accounts treatments. In the context of PFI accounting, the question has been raised as to whether the “risks and rewards” approach embedded in ESA and in the ESA 95 Manual on Government Deficit and Debt (Eurostat 2002) would require public sector reporting entities to make an assessment of their PFI schemes for national accounts purposes in addition to that made for IFRS. The ONS does not have the resources to review all PFI schemes so that, if “risks and rewards” were thought likely to lead to different On/Off decisions to “control”, then the approach might have to be one of dual reporting by entities and/or sampling by ONS.

21. Just as in the case of developments with IPSASB in terms of financial reporting, developments in national accounts regulation are likely to be of major significance. Many other countries have PFI schemes and may wish to keep them off-balance sheet and out of deficit and debt figures. There will be a new System of National Accounts 2008, to be followed after a lag by a new ESA. An important issue will be how the IFRS-based WGA relates to national accounts measures of government size, deficit and debt.

REFERENCES


http://www.hm-treasury.gov.uk/media/B/B/frab85_minutes190307.pdf


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10 Treasury (2007b, pages 191–201) provides an exposition of the accounting adjustments between budgeting aggregates (Departmental Expenditure Limits and Annually Managed Expenditure) measured on a resource basis (ie modified UK GAAP) and the national accounts aggregate Total Managed Expenditure.

11 In financial reporting, it is possible that the accountants and auditors of the two sides of a PFI will make independent judgements that lead to On-On or Off-Off. However, this should only happen in genuinely marginal cases whereas analysis of the UK experience has shown that Off-Off treatment is currently extensive.

12 Although UK GAAP and ESA 95 both use the risks and rewards criterion, the national accounts measures have been distorted by the way in which financial reporting treatment of PFI has been distorted. This point should be remembered when considering the possible divergence between the IFRIC 12 control criterion and ESA 95’s risk and rewards criterion.
Memorandum from Professor Colin Talbot

BUDGET 08—EFFICIENCY AND PERFORMANCE ISSUES

This memo covers four areas:

— Efficiency in Government—Impact of Gershon
— Efficiency in Government—CSR07 and Budget 08
— Performance in Government—CSR07 and Budget 08
— Public Value Programme—Budget 08

EFFICIENCY IN GOVERNMENT—IMPACT OF GERSHON

The government continues to make claims about achievement of the Gershon efficiency targets set out in SR2004 and the Gershon Report which are not substantiated by independent verification. Given the doubts the NAO has expressed previously and the fact that some of the issues they have identified are probably irresolvable (due to absence of historical data and baselines) there will continue to be substantial doubt as to whether “Gershon” really met the targets.

I continue to have further doubts. Firstly, it is difficult to reconcile the outcomes of the ONS’s work on productivity of the health service with the reported efficiency gains from the “more productive working” stream of the Gershon programme. ONS reports a fall in NHS productivity whether measured purely quantitatively or even if quality improvements are included.

One possible, generous, explanation for this is that whilst ONS is trying to measure the productivity of the whole system, the Gershon reported savings are based on a “project” basis. It is quite possible for “local” efficiency to improve within a particular “project” or area whilst overall efficiency or productivity of the system is declining. The worst-case is that local savings actually produce systemic reductions in productivity/efficiency. A private sector example might be where purchase of an inferior part produces local savings but causes consequential production or quality failures which cost more than the local saving.

The irony of this situation is that, as I have pointed out several times, the Gershon programme probably has produced substantial savings and these are probably bigger than any similar programme in the past 20–30 years but the combination of questionable reporting and over-ambition has undermined the public credibility of the effort.

There is now evidence to support this assertion. A recent IPSOS-Mori survey (March 2008) asked the following question:

“Do you think a Labour or Conservative Government would be most effective in getting good value for the public money it spends?”

In 2005 (shortly after Gershon started) the responses to the same question were:

Labour 41% Conservative 30% Other 4% None 13% Don’t Know 12%

By 2008 these figures had changed to:

Labour 27% Conservative 29% Other 3% None 22% Don’t Know 19%
These figures are bad news for governments in general as well as the Government: the decline of the confidence in the current Government is notable, but perhaps more worrying is that the combined “none” and “don’t know” categories have increased from a quarter to getting on for half (41%) of voters.

In other words, voters have not switched their confidence to the Opposition (who’s figures are static) but to doubting anyone’s ability to achieve VfM. This is worrying for continuing confidence in public administration and services generally.

**Efficiency in Government—CSR07 and Budget 08**

The challenge set in CSR07 is much stiffer than Gershon for several reasons:

— The Gershon savings (whatever they have actually been) have already been made; they are now net of investment;
— They are now all cashable (making this £30 billion in effect twice the cashable savings under Gershon);
— Despite there not being formal targets for non-cashable savings other Government initiatives on improving services, and especially quality improvement and “personalisation”, means there is still pressure for these types of improvements.

Given that any reasonable observer would conclude that the Gershon targets were not fully met it is difficult to see how the new targets can be fully achieved.

Doubts about the new programme are compounded by the manner of its implementation:

— The shift of responsibility for overseeing the programme into HMT in the name of “mainstreaming” removes what was clearly a useful “check and balance” in the semi-independent role which OGC played. (Incidentally, the physical move of OGC into Treasury was reported at a recent public event to have mainly been to reduce HMT’s occupancy cost to space ratio, which was previously and embarrassingly the worst of any Whitehall department.)
— The introduction of the new “Value for Money Delivery Agreements” on a department by department basis has been patchy at best.
— An initial scan of the new documents suggests that some departments are struggling to implement the new guidelines and that measurement problems in particular seem acute.
— Given these “agreements” are heavily dependent on those outside of the civil service, there is little evidence they have been involved in their development and are therefore likely to be much less committed to their implementation. This suggests that top-down command and control will yet again be used to force implementation.

**Performance in Government—CSR07 and Budget 08**

CSR07 set out the new “performance management framework” which included “whole of government” Public Service Agreements (PSAs) alongside Departmental Strategic Objectives (DSOs). The government made great claims for a reduction in performance reporting which are not born-out by the facts. The combined number of PSAs and DSOs are similar to the number of PSAs in SR2004.

Serious doubts remain about the new system:

— The relationship between PSAs and DSOs remains to be clarified—whilst HMT clearly sees PSAs as the most important, high-level priorities and DSOs as the “business as usual” objectives of departments, this view is not universal across Whitehall.
— Even if it were, public explanation of how trade-offs between these two systems are to be handled is conspicuous by its absence.
— There is a clear view—how widespread I cannot say—in spending departments that DSOs are at least as important, if not more so, than PSAs—especially those for which a department is only a “partner” and not the lead agency.
— There is little evidence that the ambition of some in government to link resources clearly to objectives (in both PSAs and DSOs) has been anywhere near achieved. Work is apparently now underway to look at this within some departments (supported by NAO and HMT) but there is a very long way to go. Without such a link, performance management as opposed to just performance reporting will remain elusive.
— Performance management of long-term outcome based PSAs (which most are) is in any case always problematic. Complexity of causation, long-time horizons, external factors and measurement problems all conspire to make management of such outcomes very difficult. Whilst a focus on outcomes may be laudable, a focus on management of resources and outputs is at least equally necessary. The new system does not yet provide this.
PUBLIC VALUE PROGRAMME—BUDGET 08

Finally, Budget 08 announced the new “Public Value Programme” which is apparently to look at “all major areas of public spending to identify where there is scope to improve value for money and value for money incentives.”

Given that CSR was supposed to have just made “zero-based” reassessments of all spending and has put in place a new £30 billion “value for money” programme—what is this new initiative for? There is no further information available about the nature of this programme, who will run it, how it fits with the other systems put in place, etc, etc.

There has been a persistent tendency for Governments in the past 30 years to launch multiple, overlapping and often insufficiently coordinated and integrated initiatives of this type. There is a very real danger here that departments struggling to deal with the new VfM Programme and new Performance Management Framework, alongside in many case challenging budget restrictions, will find this additional “Public Value Programme” at best a distraction and at worst a positive hindrance. The Government needs to urgently clarify this new initiative and not—as Budget 08 indicates—wait until Budget 09 (page 79).

19 March 2008

Memorandum from the Institute of Chartered Accountants in England and Wales

1. INTRODUCTION

We welcome the opportunity to submit evidence in response to the invitation published on 6 February 2008 on the Committee’s website.

Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

2. FORMULATION OF TAX POLICY

We welcome the measures in the Budget designed to improve on the original proposals in the 2007 Pre-Budget Report.

A key lesson that must be taken from the reaction to the tax reform announcements made in the October 2007 Pre-Budget Report is that the government must improve its tax policy formation process. It is critical that tax policy formation—particularly where simplification is the objective—must follow effective consultation, whether open or informal. The ICAEW Tax Faculty remains committed to assisting the government in creating good tax policy. As a body we represent the largest group of qualified tax advisers in the UK and can offer a unique assessment of the likely behavioural impacts and unintended consequences that a particular policy approach is likely to create.

In our submission to the Chancellor ahead of the Budget (see TAXREP 16/08 http://www.icaew.com/index.cfm?route=154645), we expressed concern that the major reforms proposed to the existing tax system in the 2007 Pre-Budget Report (PBR), namely:

— Income shifting;
— Capital gains tax reform; and
— Residence and domicile

had been announced without prior consultation, with inadequate transitional provisions and with a lack of appreciation of the likely behavioural impacts and compliance costs that they would impose. Further, we were concerned that insufficient consideration had been given to the potential damage that the measures would inflict on the international reputation of the UK as a place to live, work and invest.

Since the PBR proposals we have worked closely with HM Treasury and HM Revenue & Customs to clarify the policy objectives of the Government and to suggest improvements to the original proposals. We are pleased to see that in the light of the representations of the ICAEW Tax Faculty, and other representative bodies, organisations and taxpayers, the following major changes have been made to the original PBR proposals:

— Income Shifting—the proposals have now been deferred until 2009;
— CGT Reform—entrepreneur’s relief was announced in January 2008; and
— Residence and Domicile—a number of relaxations have been announced in the Budget, which we reflect on below.

Notwithstanding these welcome changes, we remain very seriously concerned about the approach to policy formulation as shown by these recent developments and we repeat below what we wrote in our Budget Submission this year:

“...we believe that these highly controversial changes have been announced without proper prior consultation, inadequate transitional provisions and a lack of appreciation of the likely behavioural impacts and compliance costs they will impose. Further, the announcements showed a lack of appreciation of the potential damage they could inflict on the international reputation of the UK as a place to live, work and invest.

This whole process has seriously undermined confidence in the UK as a place in which business can plan for the future with certainty. Whilst we have been working with HM Treasury and HM Revenue & Customs (HMRC) officials since the PBR to help improve these proposals, this is far too late in the process and there is a pressing need to build in adequate consultation at a much earlier stage. It is essential that the views of taxpayers and other stakeholders with relevant experience, for example the ICAEW, are sought when policy ideas are being formulated rather after the policy has been decided. If this had been done, we believe that policies in these areas could have been formulated that met the Government’s needs but which also enjoyed the wide support of stakeholders.”

3. INCOME SHIFTING AND SMALL BUSINESS TAXATION ISSUES

We welcome the Budget announcement to defer the implementation of the income shifting proposals. This should provide time for proper consultation and we think that this provides an opportunity to reconsider the underlying policy objective.

We believe that these proposals were fundamentally flawed and deferring the proposals for one year without a reconsideration of the underlying policy will merely defer the considerable implementation problems that will otherwise arise. We do not think the income shifting policy has ever been properly articulated and that the rules as drafted went further than the publicly stated position. The proposed legislation would have caused considerable administrative burdens upon businesses and a high level of uncertainty as to whether people were caught or not.

We welcome the opportunity for further consultation on this issue. We believe that this is an opportune time for a considered review of small business taxation. The proposed income shifting rules bore all the hallmarks of other recent measures in this area, namely IR35 and managed service companies, which are in the nature of “sticking plaster” changes, in other words piecemeal changes being made in a reactive way that are merely papering over the underlying problems rather than providing a comprehensive solution and which are damaging confidence in a key growth sector of the economy.

We still believe the solution to the problem found in these areas is a reinvigoration of the small business tax review, launched in 2004. The only tangible outcome from this review that has been seen to date is to raise the small companies’ rate of taxation. It could, however, be used as a constructive consultation process to identify some longer term answers to:

— how owner/managed businesses should be taxed;
— how this should interact with the taxation of—and social security (including tax credit) provision for—the family;
— how this might be achieved in a way which is workable in practice by, in many cases, unsophisticated taxpayers; and
— is framed in such a way that it is in accordance with our Ten Tenets for a Better Tax System (summarised in Annex B).

The ICAEW welcomes the publication of the Enterprise White paper, which sets out an impressive ambition. The central themes of the paper, in particular the recognition of the often acute burden of regulation on small businesses are an important step forward. However, we believe that a high level, pan-government commitment to delivery on the stated aims is vital.

4. CAPITAL GAINS TAX REFORM

We have welcomed in principle the Chancellor’s move to make a significant simplification of the existing capital gains tax (CGT) regime but we still remain concerned that the initial announcement was made with no prior consultation and, even now, we believe that some of the detailed impacts of the proposed legislation are not well understood.
We welcome the introduction of entrepreneurs’ relief but are concerned that taxpayers should have been given more time to understand the implications of this new relief before it is implemented. The announcement of the new relief was not made until 24 January, despite promises that this would be done before Christmas, and the delay meant that the detailed draft legislation was not finally available until 28 February 2008, when the new rules will come into force on 6 April 2008.

We remain concerned that the proposed changes have not respected taxpayers’ legitimate expectations. To take just one example, there are a number of situations where under current rules disposals of business assets now will qualify for business asset taper relief but if they are disposed of after 6 April 2008 they will not qualify for entrepreneurs’ relief. We believe that a fundamental principle of taxation is the preservation of legitimate expectations. We believe that the move to a flat-rate CGT would have been assisted by improved transitional rules, either by grandfathering existing reliefs and/or providing taxpayers with a longer period to reorganise their affairs.

5. Residence and Domicile

We welcome the changes announced in the Budget to the proposed new regime for non-domiciled individuals and changes to the residence rules.

Similar comments in relation to legitimate expectations apply to the residence and domicile changes as they apply to CGT mentioned above.

We are also concerned that the new regime is highly complex, for instance the rebasing election available to trustees of non resident trusts.

We remain concerned that the new rules will impose considerable compliance burdens and costs on relatively low earning non-domiciled individuals. Such individuals are now much more likely to find themselves within the self assessment regime.

The residence and domicile changes have highlighted the need for the UK to introduce a statutory definition of residence. The UK is now out of line with international practice in maintaining a rule that is largely based on (often conflicting) case law and practice that does not deal satisfactorily with increased international mobility. A statutory definition of residence is needed to provide certainty to taxpayers, their advisers and to HMRC.

6. Tax Simplification

We welcome the Government’s explicit commitment to a radical programme of simplification of the tax system.

We are concerned that the Government has “dived into the detail” without first articulating an agreed tax simplification strategy. The present approach looks like a “change agenda” with many different initiatives, but we remain concerned about the overarching strategy and principles that we believe should underpin such a major work of simplification.

We believe that if simplification is to be successful, there also needs to be recognition that not only does it take time and thought if real progress is to be made but there should also be some formal structure to guide the process and make sure that simplification remains an ongoing commitment for Government.

We have previously recommended that the Government set up a Tax Simplification body, similar to the Steering Committee of the Tax Law Rewrite Project, to bring together representatives of Government, business including employers, taxpayers and the tax profession. This idea has not been taken up but we remain of the view that the tax simplification agenda would be improved by strategic guidance and input from committees that considered specific areas of tax.

7. HMRC Service Standards

We remain concerned that HMRC appears to be under resourced for the wide range of tasks that the department undertakes.

Given that compulsory electronic filing is being extended to all taxpayers in some sectors, we continue to be concerned about HMRC’s ability to deliver efilng services that have sufficient capacity and robustness. Efiling around the deadline should be as easy and reliable as using a credit card on Christmas Eve. We believe that HMRC should reaffirm its commitment to the Carter principle that no new service should be launched until it has been fully tested and that the date of introduction should be deferred if the systems prove to be insufficiently robust and reliable.
8. REVIEW OF HMRC’S POWERS

Three major consultations by HMRC on their powers ended on 6 March 2008.

We are disappointed that measures relating to these consultations have been announced in the Budget, a mere six days after the closure of the consultation period. We question whether this was sufficient time in which properly to consider all the responses received and make a series of suitable recommendations. The hasty issue of these decisions shortly after the expiry of the consultation period does little to encourage the perception of the tax profession and taxpayers generally that there has been proper consultation; rather, it suggests that Government has already made its mind up and is merely going through the motions of consulting.

Two particularly controversial issues which we consider need more careful consideration and continuing discussion are visits by HMRC to business premises and record-keeping requirements.

17 March 2008

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter TAXline to more than 10,000 members of the ICAEW who pay an additional subscription.

THE TAX FACULTY’S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see http://www.icaew.co.uk/index.cfm?route=128518.

Memorandum from the CBI

The 2008 Budget included some welcome measures amounting to a credible first step on the road to winning back the government’s enterprise credentials, after the damaging changes to capital gains tax. But overall, this was a tax-raising Budget, with a major focus on transport-related and other taxes likely to impinge on the net profitability of UK-based business activity. Nor can we lose sight of the whole raft of tax rises announced in the previous Budget and the Pre-Budget Report, scheduled to kick in from April and putting a further squeeze on firms at this already turbulent economic time. We are also concerned that, despite all of this revenue-raising, the government will borrow a cumulative £140 billion over the next four years, up from the projected £120 billion in October’s Pre-Budget Report. And even that is on the basis of what we regard as a fairly optimistic forecast.

The Overall Impact for Business of the New Budget Measures

Overall, the Budget will be broadly neutral in its impact on the economy this year, which is sensible in the circumstances. But there is a net tightening next year of around £0.8 billion, and for the year after approaching £2 billion. Given the state of the public finances, the tightening itself cannot be criticised—indeed the CBI had argued for a bolder tightening in the £5–7 billion per annum range. But in contrast to the CBI proposals, the whole of the tightening is accounted for by increases in tax. The Spending Review totals have not been revisited and indeed the Budget package adds to them slightly further by boosting benefits.

The new revenue-raising measures fall into three groups:

— Environmental taxes (building to a net exchequer gain of £1.8 billion in 2010–11). These will affect business in general by adding to various costs, and particular sectors—notably vehicle manufacturers—to the extent that the full cost of the increases aimed at the final household consumer cannot simply be passed on in full in the near term.

— Alcohol duties (£0.6 billion). These will constrain the profitability of the drinks industry, with Single Market competition adding to the squeeze.

— Technical tax rule changes (£0.6 billion), many under a “revenue protection” banner. These will require further scrutiny. But amongst other things we note that the revenue to be raised from the North Sea sector far outweighs the cost of the modest fiscal reform to which the Chancellor drew attention in his speech.

In total, these revenue-raising measures build to £3 billion in 2010–11. We cannot be precise about how the cost will be split between the “business” and “household” sectors. But we would expect business to bear a significant proportion in the near term, through the routes identified above. International competition, including from other Single Market countries where excise duties are typically lower, will also make it harder for the government to achieve its environmental, health and social objectives through these tax-raising routes.

Just over £1 billion is to be added back to private sector disposable income, mainly through increased benefits and tax credits for families and pensioners. There are a few welcome tax reforms benefiting business and its investors, with several measures helping enterprise (see later section for detail). But at a total value of just £80 million in the final year, these reforms pale into insignificance (at least in revenue flow terms) when compared with the potential impact on business of the new Budget tax increases—not to mention the policy changes announced last year and set to come in shortly.

Table 1

<table>
<thead>
<tr>
<th>IMPACT OF THE NEW BUDGET 2008 MEASURES IN FINANCIAL FLOW TERMS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ebn exchequer gain (+) or loss (−)</strong></td>
</tr>
<tr>
<td>Vehicle excise duty reforms</td>
</tr>
<tr>
<td>Real increase in road fuel and oil duties</td>
</tr>
<tr>
<td>Additional duty increase for biofuels</td>
</tr>
</tbody>
</table>

13 In the longer term we would expect most if not all of the cost to be passed to UK residents in their capacity as employees and consumers, as with all tax increases in today’s world of cross-border capital mobility. Along the way, the UK’s capital stock would fall below what it would have otherwise have been, constraining achievable productivity—and thus pre-tax wage levels too.
Ev 78  Treasury Committee: Evidence

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<table>
<thead>
<tr>
<th>£bn exchequer gain (+) or loss (−)</th>
<th>2008–09</th>
<th>2009–10</th>
<th>2010–11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company cars: tax and fuel benefit charge</td>
<td>−</td>
<td>+0.10</td>
<td></td>
</tr>
<tr>
<td>Capital allowances: business cars</td>
<td>−0.01</td>
<td>+0.04</td>
<td>+0.07</td>
</tr>
<tr>
<td>Aviation duty increase¹</td>
<td>−</td>
<td>−</td>
<td>+0.04</td>
</tr>
<tr>
<td>Landfill tax and land remediation</td>
<td>−</td>
<td>−0.01</td>
<td>−</td>
</tr>
<tr>
<td><strong>Total environmental taxation</strong></td>
<td>−0.57</td>
<td>+0.49</td>
<td>+1.77</td>
</tr>
<tr>
<td>Real increase in alcohol duty</td>
<td>+0.40</td>
<td>+0.50</td>
<td>+0.62</td>
</tr>
<tr>
<td>“Revenue protection” package²</td>
<td>+0.75</td>
<td>+0.75</td>
<td>+0.65</td>
</tr>
<tr>
<td><strong>Total revenue-raising measures</strong></td>
<td>+0.58</td>
<td>+1.75</td>
<td>+3.04</td>
</tr>
<tr>
<td>Reform of North Sea fiscal regime</td>
<td>−0.02</td>
<td>−0.02</td>
<td>−0.02</td>
</tr>
<tr>
<td>Reforms benefitting business investors³</td>
<td>−0.01</td>
<td>−0.01</td>
<td>−0.03</td>
</tr>
<tr>
<td>Other reforms benefitting business⁴</td>
<td>−0.02</td>
<td>−0.03</td>
<td>−0.02</td>
</tr>
<tr>
<td><strong>Total reforms benefiting business</strong></td>
<td>−0.06</td>
<td>−0.07</td>
<td>−0.08</td>
</tr>
<tr>
<td>Family and pensioner benefits and tax credits</td>
<td>−0.58</td>
<td>−0.76</td>
<td>−0.96</td>
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<tr>
<td>Other tax reductions⁵</td>
<td>−0.07</td>
<td>−0.12</td>
<td>−0.14</td>
</tr>
<tr>
<td><strong>Total net impact</strong></td>
<td>−0.14</td>
<td>+0.79</td>
<td>+1.86</td>
</tr>
</tbody>
</table>

¹ The eventual full year impact will be nearer £0.25 billion, based on the targeted 10% increase.
² The “revenue protection” package in the Budget Report includes measures affecting North Sea management expenses, “disguising interest” and the controlled foreign companies regime amongst other things. The line in this table also includes other technical tax changes which raise revenue, most notably VAT on staff hiring and corporation tax treatment of unclaimed assets.
³ Enterprise Investment Scheme, Enterprise Management Incentives and dividend tax credits.
⁴ VAT on commercial property, capital allowances write-off and rules for associated companies.
⁵ Mainly the helpful tax changes for charities.

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Once again, therefore, the net result of the Budget will be to constrain businesses’ net profitability in the near term, reducing both the incentive to invest and expand here in the UK, and the funds readily available to finance that activity.

**Measures already in the pipeline**

The changes to corporation tax, business rates and capital gains tax are to go ahead from next month on the basis already announced, as are the various “green tax” increases with the exception of the six-month delay in the fuel duty rise. The “income shifting” reform has however been postponed to allow for further consultation, which is welcome, although the Treasury is still counting on some significant sums from this proposal in 2010–11. The £30,000 charge for non-domiciles will also go ahead, though some welcome concessions and clarifications have been made (see later section).

**Table 2**

<table>
<thead>
<tr>
<th>£bn exchequer gain (+) or loss (−)</th>
<th>2008–09</th>
<th>2009–10</th>
<th>2010–11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation tax reform¹</td>
<td>+0.29</td>
<td>+0.03</td>
<td>+0.41</td>
</tr>
<tr>
<td>Business rates restrictions</td>
<td>+0.95</td>
<td>+0.90</td>
<td>+0.90</td>
</tr>
<tr>
<td>Environmental tax changes</td>
<td>−0.30</td>
<td>+1.07</td>
<td>+2.88</td>
</tr>
<tr>
<td>New local authority revenue-raising powers²</td>
<td>−</td>
<td>+ ?</td>
<td>+ ?</td>
</tr>
<tr>
<td>Capital gains tax reforms³</td>
<td>+0.25</td>
<td>+0.30</td>
<td>+0.50</td>
</tr>
<tr>
<td>“Income shifting” rules</td>
<td>−</td>
<td>+0.02</td>
<td>+0.26</td>
</tr>
<tr>
<td>Residence and domicile rules</td>
<td>−</td>
<td>+0.70</td>
<td>+0.50</td>
</tr>
<tr>
<td>Alcohol duties</td>
<td>+0.40</td>
<td>+0.50</td>
<td>+0.62</td>
</tr>
<tr>
<td>Other revenue-raising measures⁴</td>
<td>+1.01</td>
<td>+1.34</td>
<td>+1.37</td>
</tr>
<tr>
<td><strong>Total of revenue-raising packages⁵</strong></td>
<td>+2.60</td>
<td>+4.86</td>
<td>+7.44</td>
</tr>
</tbody>
</table>
Our concerns in any of these areas. The Budget has done comparatively little to allay critical of the way in which transport and “green” tax revenues paid by business are being used to fund the pipeline will bring in almost £7 billion for the exchequer by 2010–11. We expect a substantial proportion of this to be effectively borne by the business sector in the near term. By contrast, the business share of the reforms with an exchequer cost—just £0.1 billion out of some £5 billion—is barely noticeable.

On the specific measures due to come in as a result of last year’s announcements, we have already made our concerns known on business rates, supplementary levies, capital gains tax, non-doms, income shifting, and elements of the corporation tax shake-up—most notably the rise in the lower rate and the phasing out without counting measures under the “revenue protection” banner.

In addition, the residence and domicile rule changes threaten the more general climate for doing business in the UK, while the profitability of specific business sectors is likely to be squeezed by the environmental and alcohol duty rises aimed at household consumers. In total, the revenue-raising packages now in the UK, while the profitability of specific business sectors is likely to be squeezed by the environmental and alcohol duty rises aimed at household consumers. In total, the revenue-raising packages now in the future public spending (1.9% per annum in real terms) after 2010–11. Firm decisions on this will of course only be made in the next Spending Review, and it remains to be seen whether this line really can be held.

The main difference with the Pre-Budget Report projections can be found on the revenue side, where there is cumulative shortfall of £21 billion over the four year period 2008–09 to 2011–12, and a £20 billion borrowing overshoot associated with this. Borrowing is now projected by the Treasury be £140 billion over those four years—adding perhaps £7 billion per annum to the subsequent annual public sector interest bill—compared with £120 billion in the PBR and £108 billion in Budget 2007. The projections repeat the familiar pattern of successive borrowing overshoots from one Budget to the next.

The downgrading in revenues is associated with a downward revision in the Treasury’s assumptions about economic growth. We nevertheless believe the projections to still be a little over-optimistic, for two reasons:

— The financial projections are based on a “cautious” GDP growth assumption of 2¾% in 2009–10. But the consensus GDP growth forecast for 2009 is just 2%. Given the constraints on real household disposable income and the shifting attitude to borrowing and debt here in the UK, plus unhelpful developments in the global economy, we would not be at all surprised to see at least two years of clearly below-par growth.

— In 2010–11, government receipts are projected to increase by 6.4%, which seems unusually strong given the money GDP growth rate of 5.3%, which is no more than the long-run average. Over the past 15 years, when money GDP growth averaged 5.6% per year, revenue growth averaged 6.1%. It is possible that a robust recovery in property and share prices, and/or in financial service sector incomes, will help to boost revenues in this way. But that is by no means guaranteed.
Concerning the fiscal policy framework, we accept that it is quite reasonable to exclude Northern Rock for the purposes of the sustainable debt rule. It would also be reasonable to say that the economic cycle ended in 2006–07, although the Treasury has not confirmed that this is its definitive view.

But more generally, it is clear that the fiscal framework has not delivered the benefits that the CBI hoped for. We believe that the spirit of the “golden rule” is consistent with allowing—indeed encouraging—fiscal policy to be counter-cyclical. But in practice the rule has not proved sufficiently binding. It has not prevented the government from running a fairly significant current budget deficit over a six-year period of robust growth, as a result of which the Treasury has been forced to initiate a fiscal tightening just as the economy is entering a potentially prolonged and risk-laden downswing. Unless the fiscal framework is strengthened, there may be nothing to stop the policy dilemma facing the Chancellor this year from being repeated in future.

**The Treasury’s public finance projections**

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<tbody>
<tr>
<td><strong>Spending</strong></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Budget 2008</td>
<td>586</td>
<td>618</td>
<td>646</td>
<td>679</td>
<td>710</td>
<td>744</td>
</tr>
<tr>
<td>Pre-Budget 2007</td>
<td>589</td>
<td>617</td>
<td>647</td>
<td>678</td>
<td>711</td>
<td>747</td>
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<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Budget 2008</td>
<td>550</td>
<td>575</td>
<td>608</td>
<td>647</td>
<td>683</td>
<td>721</td>
</tr>
<tr>
<td>Pre-Budget 2007</td>
<td>551</td>
<td>581</td>
<td>616</td>
<td>651</td>
<td>686</td>
<td>724</td>
</tr>
<tr>
<td><strong>Borrowing</strong></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Budget 2008</td>
<td>36</td>
<td>43</td>
<td>38</td>
<td>32</td>
<td>27</td>
<td>23</td>
</tr>
<tr>
<td>Pre-Budget 2007</td>
<td>38</td>
<td>36</td>
<td>31</td>
<td>28</td>
<td>25</td>
<td>23</td>
</tr>
<tr>
<td><strong>Current surplus</strong></td>
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<td></td>
<td></td>
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<td></td>
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<tr>
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<td>−4</td>
<td>+4</td>
<td>+11</td>
<td>+18</td>
</tr>
<tr>
<td>Pre-Budget 2007</td>
<td>−8</td>
<td>−4</td>
<td>+3</td>
<td>+9</td>
<td>+14</td>
<td>+20</td>
</tr>
</tbody>
</table>


**ENTREPRENEUR MEASURES**

Although the anger over capital gains tax is still simmering, entrepreneurs and smaller businesses will recognise that the government has made an attempt to listen. The government’s new enterprise strategy published alongside the Budget includes a number of CBI recommendations, including on associated companies, improved access to finance and further deregulatory commitments. Together with the decision to delay income-shifting legislation this package is a first step towards rebuilding the government’s enterprise credentials.

The CBI can specifically welcome:

— The decision to delay the “income-shifting” legislation to 2009. As drafted it would have been a tax raid on family-run businesses and would have placed an intolerable burden on the wider SME community.

— The promised radical measures to cap Whitehall departments’ ability to impose new regulations, in particular those affecting SMEs, by changing the culture, considering exemptions or simplifications for SMEs and giving a stronger role to accompanying guidance. However to date this government’s delivery has fallen short of its regulatory promises so this pledge needs to be followed through in practice.

— Improved access to finance, with the removal of the five year trading restriction in the Small Firms Loan Guarantee, the injection of new capital for the current year, and stimulation of mezzanine finance.

— Measures to improve access to public procurement contracts, including the removal of clauses which can prevent SMEs using factoring and invoice discounting from gaining access.

— The uplift in thresholds for the Enterprise Investment Scheme which should encourage more investment in growth companies. The consultation announced on the EIS covers areas that have been raised by the CBI in its Budget submissions.

— The modification of the current rules relating to the small companies’ rate of corporation tax, where a director or a shareholder is separately in a partnership, is welcomed as a first step in simplifying the associated companies’ rules. This has long been sought by the CBI.

— Consideration of a nation-wide roll-out of the innovation vouchers scheme, which encourages SMEs to interact with universities and to undertake more innovative activity.

— Action to simplify and improve England’s business support system.

The CBI was however disappointed to see no further modifications to the impending CGT changes, and the go-ahead for the further rise in the small firms’ rate of corporation tax.
Environmental Measures

The new environmental measures announced in the Budget will raise a net £1.8 billion in 2010–11, taking the total net impact in that year—of all transport and “green” measures now in the pipeline—to £2.9 billion (tables 1 and 2). Within the latest package, the main focus is on fuel and vehicle-related taxes, with vehicle excise duty reform bringing in a net £0.7 billion in 2010–11 and removal of the lower excise duty rate for biofuels, £0.6 billion. The road fuel duty increase due in April has been postponed for six months, but a new above-inflation increase was announced for 2010–11. That year will also see a further rise in aviation tax, on top of the £0.5 billion net increase unveiled in the Pre-Budget Report.

While the CBI believes that tax reform can have a legitimate role to play in achieving society’s environmental objectives, we believe that the government is approaching the matter in completely the wrong way. Our view is that the primary aim of environmental taxes should be to change behaviour, and not to raise revenue. Where revenues are in the event raised as a side-effect of well-designed and objectively-justified tax reforms, they should be either be used specifically for environmental purposes, or balanced by offsetting tax reductions so that the overall burden is left unaffected. In the latter case, green tax revenues raised from business should be offset by other tax reductions for the business sector.

The CBI is therefore particularly disappointed that these reforms have not been carried out on a revenue-neutral basis. The revenues raised from business will not be used to fund “green” initiatives, nor balanced by offsetting reductions in other business taxes. Indeed revenue-raising appears to be a major motivating factor. We note that, for example, the government has already made an assumption about the revenues to be raised from the new aviation duty, well before the structure of the tax has been determined.

On the specific issues, we have a range of views:

— The decision to delay the 2p increase in fuel duties will be a welcome relief to hard-pressed hauliers, businesses and other motorists, particularly since oil has leapt from $60 a barrel when the increase was announced to $104 today. The further half a pence rise from 2010 needs to be kept under review. In the longer term the government needs to level out the playing field for UK hauliers to compete with their foreign counterparts who enjoy far cheaper fuel prices.

— As it stands, air passenger duty is a very blunt instrument and ineffective as a green tax. That is the reason the government gave for its decision to consult on an alternative “per flight” tax, which in principle could indeed be more effective if well-designed. But the Budget announcement that tax revenue from the new duty will increase by 10% in the second full year of operation seems to confirm fears that the government sees this primarily as a revenue-raising exercise, rather than a genuine attempt to change behaviour. This increase is likely to be less obvious to the individual consumer than it would have been had the existing “per passenger” tax been retained, and as such can be thought of as another element of the government’s “stealth tax” agenda.

— While we welcome the broad approach on green taxation in relation to cars, the pace and scale of the proposed new car taxes will present a sting in the tail for some manufacturers. The fact that this move will raise £735 million by 2010–11 will not build confidence in the government’s green measures. Both business and the wider public could buy in far more easily to the environmental agenda if “carrots” as well as “sticks” were used in the government’s attempts to force behavioural change.

— The target that all new non-domestic buildings should be zero carbon by 2019 is the right sort of ambition—the CBI’s climate change task force highlighted buildings as a major area of potential. Defining what constitutes zero carbon, and how we get there, poses major challenges which need to be properly addressed in the consultation.

— Concerning the ambitions to help low income households with their fuel bills and to reduce the use of plastic bags, the CBI recognises that action of some kind is desirable. But we remain concerned at the threat of legislation and believe that the better approach would be for the government and private sector to work together to seek voluntary solutions.

Residence and Domicile

The CBI can welcome the fact that the government has recognised and acted on several of the concerns in this area. Worthwhile changes to core aspects of the proposals include leaving alone gains and income from assets in trusts kept offshore, and pledging to avoid double taxation issues. All of this will soften the impact. However, damage has been done to the UK’s reputation for tax stability and as a country which actively wants to attract talent and capital. And this is not the end of the story as new draft legislation will need to be carefully scrutinised when issued.

When the legislation is finalised over the coming weeks it must be crystal clear, especially in relation to double taxation, in order to rebuild confidence in the system. This is particularly important if the welcome assurance that the regime will not be changed for several years is to have its desired effect of delivering certainty. Then it will be a case of waiting and seeing what the fall-out of the whole process and final
proposals will be. The CBI is however pleased that number of concerns identified by us will be acted upon, and initial discussions with HM Treasury have identified a number of points which they will pursue with HM Revenue & Customs.

Some key points emerging from the Budget are:

— On creditability of the £30,000 charge against US and other tax, we understand that official US views are unlikely to be given until the actual UK legislation is seen. However the government has taken US private sector legal opinion and believes it can now draft the UK legislation in such a way as to gain US acceptance.

— The £30,000 charge will be per individual whereas the CBI suggested that it should be per family. However, the increase in the qualifying age to 18 is welcome.

— The increase in the de minimis threshold from £1,000 to £2,000 is also welcome.

— On residence day counting the government has also listened to CBI concerns, with days to be counted only where a person is in the UK at midnight. The government has also agreed with the reasoning about the need to exempt travellers moving around the UK in transit.

— We are also pleased at the pledge for no further changes during this Parliament or the next.

— The legislative details relating to trusts will warrant careful scrutiny and initial CBI discussion with HM Treasury has identified a number of points for the government to consider further.

— New provisions based on current VAT rules for temporary imports will prevent income tax and capital gains tax charges arising in relevant situations in relation to works of art. This is sensible.

— The CBI’s concerns about employers’ PAYE position have now been recognised. PAYE will not apply in the first year and, as suggested by us, there will now be consultations with business on practical issues before any attempt to impose it.

OTHER TAX ISSUES

Financial products avoidance: The government has deferred introduction of new “principles-based” legislation to counter tax avoidance in relation to financial products from April 2008 to April 2009 to allow time for further refinement, as called for by the CBI.

Reporting errors: The increase in the limit below which errors in indirect tax returns can be corrected on the return for the period in which they are discovered, rather than by a separate voluntary disclosure, responds to CBI requests in previous Budget submissions.

Simplification: The fact that there are 107 new technical tax proposals, with HMRC Budget Notes running to 270 pages, does not support the Chancellor’s claims to be moving towards a simpler tax system.

PUBLIC EXPENDITURE AND RELATED POLICIES

Public service reform: The Budget Report contains a welcome recognition of the importance of competition in delivering better quality public services and improving value for money. The Chancellor’s words on reform, like the Prime Minister’s earlier in Budget week, are a good sign but the government will need to be judged on its actions.

Science in schools: “Project Enthuse”, and a £6 million campaign to promote science in schools, will be welcomed by business. Too many companies have serious problems recruiting individuals with science skills. Inspirational teachers are key to encouraging more young people to study science, while high quality careers advice is vital to show them that these subjects open doors to well-paid and interesting careers.

Skills: The expansion of “Train to Gain” and the introduction of skills accounts should ensure public funding follows the needs of employers and employees more closely. The focus must be on developing the economically valuable skills that the UK needs to compete. The announcement of additional funding for intermediate skills and adult apprenticeships is welcome, as employers’ skills needs are often at these higher levels.

17 March 2008

Memorandum from Allen and Overy LLP

THE PRE-BUDGET REPORT: IMPLICATIONS FOR PRIVATE BANKS

The Treasury Committee has announced that it will take evidence from experts in the light of the Budget announced by the Chancellor of the Exchequer on 12 March. The Committee has indicated that it would welcome written evidence, prepared in response to the Budget, as part of this inquiry. It expects to publish a Report arising from its inquiry before the second reading of the Finance Bill.
The following memorandum addresses the serious technical implications that we believe arise from one particular measure in the Pre-Budget Report and the Budget.

1. EXECUTIVE SUMMARY

1.1 A particular aspect of the Chancellor’s Pre-Budget Report is of serious concern to the UK private banking and investment management industry. The problems are likely to be common to most banks and investment managers offering global banking services which provide any of their services to UK resident but non domiciled (RND) clients from the UK or deal with the UK on their behalf. It is even possible that the problem will extend to banks which offer services to clients offshore where there are UK non-client facing operations behind the scenes.

1.2 There is a real risk that the consequence will be that many UK private banking operations will be obliged to consider moving significant parts of their operations offshore. We recommend that amendments be introduced in the Finance Bill 2008 to address this.

1.3 We are drawing this danger to the attention of other private banks and various industry bodies.

2. TECHNICAL ANALYSIS

2.1 The Chancellor’s Budget on 12 March contained some welcome concessions for non-UK domiciliaries. Nothing in the Budget nor the accompanying notes, however, has addressed the technical concerns which are described below.

Definition of “remittance”: section 809H

2.2 The concern results from the proposed new definition of “remittance” in section 809H Income Tax 2007. Section 809H comprises two conditions (“Condition A” and “Condition B”) which, taken together, are extremely broad. Condition A (broadly speaking) tests whether assets (not just cash) have been brought to, are received or are used in the UK, or whether any service has been provided in the UK. Condition B “links” the assets or cash identified in Condition A with unremitted income or gains, using an extremely wide and undefined test of derivation.

Application to fees of investment advisers

2.3 It appears from the new definition of “remittance” that, under the new test, payments of fees outside the UK to banks and fund managers will now be capable of constituting a remittance of foreign income and gains to the extent that the fees relate to any part of the global services by the bank or fund manager provided from the UK. Establishing exactly how much of a global service relates to the UK will be challenging in many cases. There is no definition of what constitutes a “service in the UK” for the purpose of the new test of remittance, and no guidance on how (if at all) a composite cross-jurisdictional service should be analysed. Some products may, for example, be developed in one tax jurisdiction, marketed from another and transacted in a third. The end user gets some benefit but which are services provided to or for his benefit?

The competition issue

2.4 The remittance considerations set out above will make it very difficult for banks and fund managers based mainly in the UK to compete with offshore rivals for RND client business because the payment of their fees will entail reporting obligations and the payment of tax on top of those fees.

2.5 Likewise, where unremitted income and gains are invested in UK assets, or paid offshore to settle derivative transactions and deals with UK brokers or counterparties, it appears that there will be a remittance even if payment is made offshore. Given that the banks’ mandate will generally be to obtain the best deals for their customers, investment in UK assets, and transactions with UK brokers and counterparties, will accordingly be unattractive. This will affect both UK branches and overseas branches of banks and fund managers, which will be under pressure to avoid UK deals for RND clients.

2.6 The effect may extend far beyond the RND market. Many banks and fund managers offer a global investment service to all clients, whether RND or not, and source services and investment opportunities worldwide. It would be very difficult for such global businesses to set up special teams and opportunities outside the UK just for RND clients. As a result, they may have no option but to move all their investment services outside the UK, and to avoid transactions with UK brokers and counterparties, if they are to be able to assure RND clients that their platform will avoid remittances, which is what will be required if they are to be able to compete for the RND business which is often a very substantial part of their client base.
3. **Suggested Solutions**

*Investment Management Exemption*

3.1 Elsewhere in the tax code, the use of UK investment services is given express protection. The Investment Management Exemption (“IME”) protects offshore persons from the UK tax that would otherwise be levied on trading profits where a trade is carried on in the UK through an independent investment manager. We believe that it would be consistent with this policy to ensure that UK private banking and fund management services for RNDs; inward investment by RNDs; and deals with UK counterparties are all similarly protected in order to avoid a flight of private banking and investment business from the UK.

*Clarification of what is meant by "services"*

3.2 In other contexts, such as VAT, there are specific statutory and case law tests to determine where cross border composite services are provided. Given the particular complexities involved in the context of the provision of global services, we strongly believe that similar guidance is needed in the context of the proposed new test for remittance.

17 March 2008

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**Memorandum from Children in Crisis**

I am writing to you as Trustee & Treasurer of CHILDREN IN CRISIS, a British—but global in scope charity—helping forgotten children everywhere gain education and safer life.

Perhaps we would be the last people you would expect to hear from when evaluating the benefits of “non-dom” taxation but unfortunately we (and I am sure our colleagues) have already been affected by the proposed new legislation.

We have been receiving not insubstantial help from various individuals and organizations controlled by them who are going to be affected by the changes of their tax status.

Already it was made known to us that future giving will be both dependent on whether they remain in the UK and when they do will be “shortened” by monies extracted by the tax authorities.

Perhaps you could give it some thought.

10 March 2008

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**Further supplementary memorandum from HM Treasury**

**Q403: Share Schemes and CGT**

— There are four tax advantaged employee share schemes: Share Incentive Plan (SIP), Save As You Earn (SAYE), Company Share Option Plan (CSOP) and Enterprise Management Incentives (EMI).

— SIP gains are sheltered from CGT while shares are in the scheme. Participants can choose to remain within the scheme until they leave their employer. Shares are rebased when the employee leaves the scheme, at which point they can sell their shares with no CGT liability.

— The Annual Exempt Amount for CGT is £9,200 in 2007–08, rising to £9,600 in 2008–09.

— The vast majority of SAYE participants have gains within the AEA. (Average gain is estimated to be £2,300).

— Average gain under CSOP is also well within the AEA (estimated to be £3,300).

— Average gain on EMI shares is £48,000. However, EMI remains a generous tax scheme. It provides tax advantaged share options designed to help small, higher risk companies recruit and retain skilled employees. Under the scheme employees can hold tax advantaged options over shares with a market value of up to £120,000. The grant and exercise of the option is tax-free—there is no income tax and no NICs for the employee or employer. If the shares are sold at a gain, then the shares will be subject to capital gains tax. EMI therefore remains a generous tax scheme.
The table below shows estimated average grant values per employee using three tax-advantaged share schemes, together with the average tax-relieved gain per employee. The figures are based on information returns for 2005–06 and correspond to the latest published National Statistics.

<table>
<thead>
<tr>
<th>Share option scheme</th>
<th>Number of employees granted options in 2005–06 (’000)</th>
<th>Average grant per employee (£)</th>
<th>Number of employees exercising options in 2005–06 (’000)</th>
<th>Estimated average gain per employee on exercise (£)</th>
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</thead>
<tbody>
<tr>
<td>EMI</td>
<td>27</td>
<td>10,000</td>
<td>6</td>
<td>48,000</td>
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<tr>
<td>CSOP</td>
<td>120</td>
<td>6,300</td>
<td>130</td>
<td>3,300</td>
</tr>
<tr>
<td>SAYE</td>
<td>560</td>
<td>3,800</td>
<td>390</td>
<td>2,300</td>
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</table>

The average values set out above indicate that the great majority of gains at the time of acquiring shares fall well within the AEA. Although EMI gains are higher on acquisition, they are far fewer in number, and are below £10,000 in about 60% of cases.

Of those individuals in employee share schemes with gains above the AEA, many may be able to dispose of their shares in successive years. This allows them to take advantage of the AEA in each year as they make a disposal.

For those who sell their shares immediately and have a CGT liability, they will be better off under the new CGT regime, paying tax at 18% instead of 20% or 40%.

Statistics on the use of employee share schemes are only captured at the company level, rather than for each individual employee. This information also only covers shares provided through such schemes and does not include either the gain when the employee sells those shares nor whether employees hold other shares (such as in their employers).

March 2008