House of Commons

Treasury Committee

GOVERNMENT RESPONSE TO THE COMMITTEE'S SECOND REPORT: BUDGET 2002

Tenth Special Report of Session 2001–02

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

TENTH SPECIAL REPORT

The Treasury Committee has agreed to the following Report:

GOVERNMENT RESPONSE TO THE COMMITTEE'S SECOND REPORT: BUDGET 2002

APPENDIX

Government Response to the Committee's Second Report

On 30th April 2002, we published our Second Report, *Budget 2002*, as House of Commons Paper No. 780. We have now received a response from the Government (dated 2 July) which is appended below.

The economy

(a) The Committee expressed concern that the Budget may be based on over-optimistic growth projections given the considerable uncertainties facing the global economy at the present time. In this context it noted that growth in 2001 was at the bottom of the opportunity range forecast at the time of Budget 2001 (paragraph 10).

As stated in Budget 2002, UK GDP growth is expected to gather pace through the year, supported by a strengthening world economy. The upside and downside risks to the world economic forecast were set out in Chapter B of the Financial Statement and Budget Report (paragraphs B9 and B10). However, it is notable that consensus growth forecasts for many of the UK's major trading partners have increased—some quite markedly so—over the past few months.

(b) The Committee noted that the imbalances between net trade and domestic demand may present a challenge to the stability of the UK economy and urged policy-makers to remain alert to the risks (paragraph 13).

The Government has consistently given a clear account of the main risks surrounding its forecasts, including those associated with imbalances, and this year's Budget forecast was no exception. In particular, paragraphs B42, B43, B55 and B56 in Chapter B of the Financial Statement and Budget Report discuss risks to the outlook for external demand and household consumption.

(c) The Committee commented that it was unsure of the reason behind the forecast slowdown in consumption and that it was not clear that the Budget would make any significant contribution to correcting the imbalances in the economy (paragraph 15).

The Government's macroeconomic policy framework is designed to ensure lasting economic stability to allow businesses, individuals and the Government to plan effectively for the long term. Consistent with the fiscal rules, Budget 2002 locked in economic stability for the future, while introducing further reforms to promote work and enterprise, and deliver the sustained investment needed to modernise Britain's public services.

(f) The committee recommended that details of important technical changes (such as revision of the neutral trend growth assumption) should be published in advance of Budgets and Pre-Budget Reports to aid transparency and scrutiny. The committee also recommended that the timing of future changes to the trend growth rate and other key assumptions underpinning the economy and public finance forecasts should allow a common basis to be used for both the Pre-Budget Report and the Budget (paragraph 22).

The Budget paper, *Trend Growth: Recent developments and prospects*, provides a transparent exposition of the Treasury's revised neutral assumption for trend growth of 2¾ per cent. The paper sets out both the framework for estimation and the detailed methodology used to derive the trend growth assumption, together with comparisons between the Treasury estimate and estimates made by external organisations.

The Treasury reviews its estimate of the economy's trend rate of growth prior to every Pre-Budget Report and Budget. The estimate is an integral element of the economic forecast and public finance projections and it would therefore be inappropriate to publish it in advance of the Pre-Budget Report or the Budget.

Fiscal policy and the public finances

(g) The committee recommended that, if the assumptions adopted in Budget 2002 were maintained, it may be advisable for the Treasury to maintain a budget strategy which allowed for a continued projection of surpluses on the current budget balance, in order to ensure that the fiscal rules were still met in the event of GDP growth being significantly weaker than expected (paragraph 24).

The Government's fiscal rules are set over the economic cycle so that the fiscal balances can vary between years in line with the cyclical position of the economy. Following usual practice, the trend growth assumption used in projecting the public finances in Budget 2002 was ¼ percentage point lower than the Government's neutral view.

In addition, the robustness of the public finance projections was, as usual, tested against an alternative scenario in which the level of trend output was assumed to be 1 percentage point lower than in the central case. This is set out in Chart 2.6 of the Economic and Fiscal Strategy Report. Meeting this 'cautious case' and maintaining the cautious trend growth assumption increases the probability of meeting the fiscal rules and also maintains a buffer against fiscal risks.

(h) The Committee recommended that the Red Book should include an annual estimate of contingent liabilities stemming from accumulated future PFI and PPP commitments (paragraph 27).

Information about contingent liabilities is already published:

- in audited resource accounts for each department and laid before Parliament ; and
- all Departmental contingent liabilities (including guarantees) above £100,000 or outside the course of normal business are set out annually in the Supplementary Statements to the Consolidated Fund and National Loan Funds accounts.

In addition to this information, the Financial Statement and Budget Report provides:

- information on estimated capital spending by the private sector on PFI and PPP forecast commitments ; and
- forecasts of the estimated payments by the public sector flowing from private investment in signed projects over the next 25 years (actual expenditure will depend on the details of the payment mechanism for each contract).

The UK is one of the few countries in the world with statutory requirement to report government liabilities, assets and all other financial information in the same way as companies are required to report.

(i) The Committee recommended that the Treasury's published medium-term fiscal projections should cover the complete period over which specific spending figures are committed. Given the significance of the additional NHS spending, it suggested that the borrowing requirement for 2007–08 should have been published at the time of the Budget (paragraph 28).

Table C2 of the Financial Statement and Budget Report sets out projections for the public finances for the five years up to and including 2006–07.

Prior to firm plans being set in the 2004 Spending Review, paragraph C22 sets out the assumptions for spending after 2005–06, which allow for the five year spending plans for health. The illustrative long-term fiscal projections in Annex A of the Economic and Fiscal Strategy Report are based on these assumptions for spending up to and including 2007–08. These long-term projections are consistent with the health spending plans and are underpinned by particularly cautious trend growth assumptions. They show that the fiscal position is sustainable over a thirty year horizon.

Following usual practice, the next Pre-Budget Report will contain projections for the main fiscal aggregates up to and including 2007–08.

(k) The Committee shared the Government's view that the Stability and Growth Pact should take account of issues such as the economic cycle, debt sustainability and the accounting for investment expenditure. It urged the Government to work with other Member States to find agreement on the definition and interpretation of the Stability and Growth Pact as soon as possible (paragraph 33).

The Government welcomes the Committee's support for its prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). The Budget projections are consistent with this interpretation. The Government continues to discuss this issue with EU colleagues.

Public expenditure

(l) The Committee expressed concern that some departments seemed to be experiencing difficulties in delivering on the Government's agenda of increasing public sector investment, and that under-spending had been significant in some departments. It recommended that the comparison of departmental spending with planned intentions should be reviewed quarterly (paragraph 38).

Public sector net investment more than doubled from 2000–01 to 2001–02. The Government's plan for total spending in Departmental Expenditure Limits last year was £212.5 billion. Budget 2002 estimated outturn in 2001–02 at £211.8bn (Table C14). Departments will expand their budgets in-year by drawing on stocks of End-Year Flexibility and by being granted access to central unallocated funds. Their individual limits need to be underspent in order to meet the Government's aggregate plan.

The Government will continue to report estimated six-monthly outturn against departments' Requests for Resources alongside the Winter Supplementary Estimates.

(m) On the issue of underspending, and of the matching of money to reforms for SR2002, the Committee suggested it remained unclear what sanctions were proposed and how they might be implemented (paragraph 39).

PSX, the Cabinet Committee on public services and public spending, meets regularly to assess progress against departmental Public Service Agreement targets with the accountable Secretary of State. Performance against those targets and spending plans will be taken fully into account in setting budgets in the 2002 Spending Review.

National insurance contributions

(n) The Committee concluded that the Treasury had failed to make the case for choosing a method of revenue raising (higher employer and employee national insurance contributions) which excluded well-off pensioners and people living comfortably off unearned income from making a contribution to higher NHS spending (paragraph 54).

The reasons why the Government decided to raise the additional revenue by increasing national insurance contributions are set out in paragraph 6.45 of the Economic and Fiscal Strategy Report.

(o) The Committee concluded that it was "sophistry" to maintain that the Upper Earnings Limit (UEL) remained in place (paragraph 55).

The UEL determines the level of earnings at which the main rate of NICs (11 per cent in 2003–04) ceases to be payable. It also sets the upper limit for earnings on which contracted out rebates are due to both employers and employees, and the earnings which are taken into account for SERPS and state second pension. It remains a fundamental part of the system of National Insurance Contributions.

(p) The Committee recommended that legislation to implement the new NIC arrangements should be framed in such a way that further primary legislation will be required before the rate of charge above the upper earnings limit can be increased (paragraph 56).

The published Bill does not extend existing powers to change rates and thresholds by regulation. Changes to the additional rate would require primary legislation.

(t) The Committee expressed concern that the changes to employer National Insurance Contributions were inconsistent with promoting employment (paragraph 68).

Since 1997, reforms to the structure of employer NICs have removed labour market distortions and eased the burdens on employers, and employer NICs for the lowest paid will still be lower in 2003 than in 1997. The Government has also introduced a number of measures to help make work pay and stimulate labour supply. These include the 10 pence starting rate of income tax, the Working Families' Tax Credit and, from April 2003, the new Working and Child Tax Credits, the rates of which were set in this Budget.

Taxes and tax credits

(q) The Committee recommended that full details of the take-up of the new tax credits be published when the information is available (paragraph 60).

The Inland Revenue will publish statistics on the numbers receiving one or both of the new tax credits as it currently does for both the Working Families' Tax Credit (WFTC) and the Disabled Person's Tax Credit (DPTC).

(r) The Committee welcomed measures that make work pay and encouraged the Government to keep the issue of high marginal rates under close review in the light of projected substantial increase in the projections for 2003–04 (paragraph 63).

The Government will keep under close review the issue of marginal deduction rates. As noted in the evidence provided by Treasury officials, the numbers of households facing the highest marginal deduction rates of over 70 per cent has fallen by around half a million compared with the 1997–98 tax and benefit system.

(u) The Committee expressed concern about the lack of consultation with foreign banks in London on 24 April 2002 (paragraph 72).

The principles underlying the changes to the taxation of foreign banks have been clearly established through an international consultative process led by the Organisation for Economic Cooperation and Development (OECD). Trade organisations representing foreign banks have played a part in this work, both through written submissions and participation in a recent public consultation in Paris. This process has demonstrated that the UK has become far out of line with other countries such as the US, France and Germany, who already recognise the principle that capital should be attributed to branches for tax purposes.

Productivity

(e) The Committee expressed concern about UK productivity performance and agreed with the Budget's aim to increase the rate of growth of productivity. It recommended that the effectiveness of the various measures included in the Budget for this purpose should be closely monitored and reported on in future Pre-Budget Reports and Budget Statements (paragraph 21).

Budget 2002 sets out a range of measures designed to support the drivers of UK productivity growth, including major reforms to corporation tax, simplification of VAT, introduction of a volume based research and development tax credit and details of pilots to test new measures to improve access to training and enable employees to attain basic and level 2 skills. The Government is committed to monitoring the effectiveness of its policy approach and will continue to report on progress towards meeting its productivity objective in future Pre-Budget Reports and Budgets.

HM Treasury
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