



House of Commons  
Treasury Committee

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# The 2003 Budget

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**Seventh Report of  
Session 2002–03**

*Volume I*





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Treasury Committee

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Session 2002–03**

*Volume I:  
Report, together with formal minutes*

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## The Treasury Committee

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

### Current membership

Mr John McFall MP (*Labour, Dumbarton*) (Chairman)  
Mr Nigel Beard MP (*Labour, Bexleyheath and Crayford*)  
Mr Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)  
Angela Eagle MP (*Labour, Wallasey*)  
Mr Michael Fallon MP (*Conservative, Sevenoaks*)  
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Mr George Mudie MP (*Labour, Leeds East*)  
Dr Nick Palmer MP (*Labour, Broxtowe*)  
Mr James Plaskitt MP (*Labour, Warwick and Leamington*)  
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Mr Andrew Tyrie MP (*Conservative, Chichester*)

### Powers

The Committee is one of the departmental select committees, the powers of which are set out in the House of Commons Standing Orders, principally in SO No. 152. These are available on the Internet via [www.parliament.uk](http://www.parliament.uk) The Committee has power to appoint a Sub-Committee, which has similar powers to the main Committee, except that it reports to the main Committee, which then reports to the House. All members of the Committee are members of the Sub-Committee, and its Chairman is Mr Michael Fallon.

### Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) from Session 1997-98 onwards are available on the Internet at: [www.parliament.uk/parliamentary\\_committees/treasury\\_committee/treasury\\_committee\\_reports.cfm](http://www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_reports.cfm). A list of Reports of the Committee published in the present parliament is at the back of this volume.

### Committee staff

The current staff of the Committee is Crispin Poyser (Clerk), Alex Kidner (Second Clerk), Lis Partridge (Committee Assistant), Amanda Waller (Secretary), Mike Cruickshank (Senior Office Clerk), Dominic Lindley (Committee Specialist) and George Hodgson (Committee Specialist).

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# Contents

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|   |             |
|---|-------------|
| <b>Report</b>   | <i>Page</i> |
| <b>Summary</b>  | <b>3</b>    |
| <b>1 Introduction</b>   | <b>5</b>    |
| This inquiry  | 5           |
| Summary of policy measures                                    | 5           |
| Timing of the Budget statement                                | 6           |
| <b>2 The Economy</b>  | <b>7</b>    |
| The recent past   | 7           |
| <i>The MPC's inflation target</i>                             | 8           |
| The outlook for the UK economy                                | 9           |
| <i>Consumption</i>  | 10          |
| <i>Business investment and pension funding</i>                | 10          |
| <i>Assessment of the forecast</i>                             | 11          |
| <i>The forecasting process</i>                                | 13          |
| <b>3 Public Sector Finances</b>                               | <b>14</b>   |
| Growth assumptions underlying the public finances             | 14          |
| Tax receipts  | 15          |
| <i>Forecasting tax receipts</i>                               | 18          |
| Expenditure   | 18          |
| The fiscal balance  | 20          |
| <b>4 Individual Budget measures</b>                           | <b>23</b>   |
| Protecting tax receipts                                       | 23          |
| Stamp duty  | 23          |
| Child Trust Funds   | 24          |
| Regional and local variations in pay                          | 25          |
| Tax credits   | 27          |
| <b>Conclusions and recommendations</b>                        | <b>31</b>   |
| <b>Formal minutes</b>   | <b>36</b>   |
| <b>Witnesses</b>  | <b>39</b>   |
| <b>List of written evidence</b>                               | <b>40</b>   |
| <b>List of appendices</b>                                     | <b>40</b>   |
| <b>List of Reports from the Treasury Committee since 2001</b> | <b>41</b>   |



## Summary

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### *Budget 2003*

The date of the Budget was announced on 5 March 2003, just over one month before the Budget itself on 9 April. We have previously requested that the Chancellor should announce the date as far in advance as possible, but give at least two months notice. While we recognise the complications introduced this year by the Iraq war, we reiterate our request and hope that the amount of notice given this year will not set a precedent for the future.

### *Economic forecasts*

Growth of 1.8% in 2002 was weaker than forecast in the Budget 2002, but the UK performed better than any other major European economy. The Treasury growth forecast for 2003 of 2% to 2½% is similar to most other forecasts, but we note that the Treasury forecasts for 2004 are more optimistic than those of a wide range of other forecasting bodies. There are concerns that pension fund deficits may pose a threat to the recovery, particularly through their impact on business investment; the Treasury should co-ordinate the publication of aggregate data to facilitate assessment of this issue. We recommend that the Treasury should consider commissioning a technical review of its forecasting procedures to reinforce its reputation in the area of economic forecasting, as has usefully been done by the Bank of England.

### *Public finances*

Treasury projections assume that tax receipts as a share of GDP by 2007-08 will climb back to the highest level since the mid-1980s. To be fulfilled, this forecast requires not just a sharp rebound in overall economic activity but also a rapid recovery in the prosperity of the City. There is a risk that tax revenues will not recover as rapidly as the Treasury suggests.

Public sector spending in 2002-03 came in close to the original forecast, after adjusting for the costs of the Iraqi conflict. Even so, current spending was above and capital spending below planned totals. We recommend an investigation of the reasons for the inability to adhere to investment programmes. Dramatic fluctuations in public sector investment militate against the efficient delivery of a sound public sector infrastructure. It may help deliver a smoother, more efficient flow of public sector investment if the Treasury were to adopt an explicit target range for public sector net investment as a percentage of GDP over the cycle.

The Government is on course to meet the golden rule during the current cycle, thanks to the large surplus built up in the early years of the current cycle. As we move into the latter half of the current cycle, we await with interest the Treasury's views on the public finances over the next cycle.

### *Individual budget measures*

The Report contains brief discussions on protecting tax receipts, stamp duty, Child Trust Funds, regional and local variations in pay, and tax credits.



# 1 Introduction

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## This inquiry

1. The Chancellor of the Exchequer, Rt. Hon Gordon Brown MP, made his Budget Statement on Wednesday 9 April.<sup>1</sup> In accordance with our practice, we have conducted a short inquiry into the main points of the Budget, with a view to informing the House's debates.<sup>2</sup>

2. Three oral evidence sessions were held, with:

- economic experts<sup>3</sup> on a range of macro- and micro-economic issues (on the morning of Monday 14 April);
- officials from HM Treasury,<sup>4</sup> led by Mr Gus O'Donnell the Permanent Secretary (on the afternoon of Monday 14 April), and
- the Chancellor of the Exchequer, supported by Treasury officials (on Wednesday 30 April).

3. The oral evidence is printed with this Report, together with a number of the written submissions which were received. We are very grateful to all those who helped with the inquiry.

## Summary of policy measures

4. The 2003 Budget contained few significant tax changes. The most significant measures announced in the Budget (in terms of effect on the Exchequer) included the introduction of the Child Trust Fund and an additional winter fuel payment of £100 for every pensioner over 80. On the business side, the main measures included the introduction of a capital allowance for ICT investment and a package of measures aimed at protecting tax revenues and tackling avoidance. HSBC concluded that "individually these items are small and overall they are still small. In total the new Budget policy changes amount to an additional £0.5 billion of net spending in 2003 or 0.1% of GDP".<sup>5</sup> These changes must be put into the context of the more substantial tax changes announced previously and taking effect from April 2003, including the increase in National Insurance Contributions for employers, employees and the self-employed, and the changes to the tax credit system. Mr John Whiting, of PricewaterhouseCoopers, pointed out that while there were no "headline-

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<sup>1</sup> HC Deb, 9 April 2003, cols 271-288

<sup>2</sup> The Committee has not been able on this occasion to prepare and publish its report in time for the Second Reading of the Finance Bill.

<sup>3</sup> Mr Ciarán Barr (Deutsche Bank), Mr Robert Chote (Institute for Fiscal Studies), Professor Peter Spencer (University of York), Mr David Walton (Goldman Sachs) and Mr Martin Weale (National Institute of Economic and Social Research) on macro issues; Mr Robert Chote (Institute for Fiscal Studies), Mr Martin Weale and Ms Mary O'Mahoney (National Institute of Economic and Social Research), and Mr John Whiting (PricewaterhouseCoopers) on micro-economic issues.

<sup>4</sup> Mr Gus O'Donnell (Permanent Secretary), Mr Jon Cunliffe (Managing Director, Macroeconomic Policy & International Finance), Mr Nicholas Holgate (Director, Welfare Reform), Mr Adam Sharples (Director, Public Spending), Mr John Kingman (Director, Enterprise and Growth Unit), and Mr Andrew Lewis (Head, Tax Policy Team)

<sup>5</sup> HSBC, *UK Budget 2003 Review*, 9 April 2003, p 3

grabbing tax changes”, it was clear that “there are quite a lot of minor tweaks and twiddles” to the tax system.<sup>6</sup>

## Timing of the Budget statement

5. Traditionally, the date of the Budget has been subject to considerable speculation and interest, as there is no fixed date for the Chancellor to make his budget statement. The date of the 2003 Budget was announced in a written ministerial statement on 5 March, giving just over one month’s notice of the Budget on 9 April. This contrasts unfavourably with the 2002 Budget, where a notice period of approximately three months was given, although shorter periods of notice were given in 1999 and 2001 (see table below). During this Parliament, steps have been taken to enhance the transparency of parliamentary procedure by pre-announcing the dates of future recesses. In our report on the 2002 Pre-Budget Report, we concluded that “It would be helpful for the Chancellor to announce the date of the Budget as far in advance as possible (at least two months)”.<sup>7</sup> In its reply, the Treasury stated that the “Government will announce the date of the Budget at the earliest suitable opportunity. However, it may not prove possible to give two months’ notice of Budget Day.”<sup>8</sup> **We reiterate our view that, in the interests of openness, it is important for the Chancellor to announce the Budget statement as far in advance as possible (at least two months). While we recognise that the Iraq war may have made the process difficult this year, the amount of notice given should not be allowed to set a precedent for future years.**

Table 1

| Announcement of Budget dates |                |                      |                |                     |
|------------------------------|----------------|----------------------|----------------|---------------------|
| Year                         | Date of Budget | Date of announcement | Notice (Weeks) | Announcement method |
| 1998                         | 17 March       | 20 January           | 8              | Written Question    |
| 1999                         | 9 March        | 8 February           | 4              | Written Question    |
| 2000                         | 21 March       | 3 February           | 7              | Oral Question       |
| 2001                         | 7 March        | 14 February          | 3              | Written Question    |
| 2002                         | 17 April       | 28 January           | 11             | Written Question    |
| 2003                         | 9 April        | 5 March              | 5              | Written Statement   |

Source: *HC Debates*<sup>9</sup>

<sup>6</sup> Q 50

<sup>7</sup> Treasury Committee, Second Report of Session 2002–03, *The 2002 Pre-Budget Report* HC 159 para 8

<sup>8</sup> Treasury Committee, Second Special Report of Session 2002–03, *Government Response to the Committee’s Second Report: The 2002 Pre-Budget Report* HC 528, p 3

<sup>9</sup> 20 January 1998 col 469w, 8 February 1999 col 31w, 3 February 2000 col 1187, 14 February 2001 col 181w, 28 January 2002 col 8w, 5 March 2003 col 84ws

## 2 The Economy

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### The recent past

6. The global economy in 2002 staged a weak recovery from the trough experienced in 2001. The rise in Middle Eastern tension, the associated pick-up in oil prices and the continued weakness in world stock markets all played a role in constraining the recovery. In its latest assessment the OECD suggests that world economy saw growth accelerate from 0.8% in 2001 to 1.8% in 2002.<sup>10</sup> In contrast, last year saw growth in the UK economy moderate slightly, slipping back from 2.1% in 2001 to 1.8% in 2002. The domestic economy thereby failed to match the 2 to 2½% growth the Treasury predicted in its 2002 Budget forecasts<sup>11</sup> and moved from being the strongest performing major economy in 2001 to a position near the OECD average for 2002. **Even so, as the OECD recently highlighted, “the UK economy has so far shown greater resilience in weathering the downturn than any other major European economy”.**<sup>12</sup> **In spite of undershooting the Treasury’s growth forecast in the Budget 2002, in achieving growth of 1.8% in 2002 the UK economy performed better than most of its eurozone counterparts.**

7. Investment was the weakest area of the UK’s economic performance through 2002, both in absolute terms and relative to the Treasury’s initial expectations. Gross fixed capital formation fell by 3.2%, compared with Treasury expectations of a rise of 1½ to 2% at the time of the 2002 Budget,<sup>13</sup> although this was actually a little better than the Treasury’s forecast fall of 4¼% presented in the November Pre-Budget Report.<sup>14</sup> This fits into a wider picture suggesting that, in spite of the rising tension surrounding Iraq through Q4 2002, both the global and the UK economies generally performed through the winter in line with the Treasury’s expectations in last November’s Pre-Budget Report. Business investment nevertheless suffered particularly badly through 2002, falling 8% compared with the Treasury’s Budget 2002 forecast of a fall of ½% to 1%. **The fall in business investment in 2002–03, if it was sustained, would be of particular concern given its potential impact on UK productivity.**

8. The Committee notes with concern that, despite the many measures that have been introduced in recent years, the productivity of the UK economy lags substantially behind that of the USA, France and Germany. The further steps included in this Budget are noted, like improvements to R&D tax credits and additional measures to improve skills in the UK. **The Committee considers that an assessment of the success of these individual measures in contributing to improved productivity would be valuable.**

9. While investment was the major area of disappointment in the domestic economy last year, exports were also weak, falling by 1% in volume terms. In part, this reflected weak growth in the UK’s major trading partners, although the National Institute of Economic

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<sup>10</sup> OECD Economic Outlook No. 73, Preliminary Edition, April 2003

<sup>11</sup> HM Treasury, Budget 2002, HC (2001–02) 592, Table B2, p147

<sup>12</sup> OECD Economic Outlook No. 73, Preliminary Edition, April 2003

<sup>13</sup> HM Treasury, Budget 2002, Table B6, p199

<sup>14</sup> HM Treasury, Pre-Budget Report 2002, Cm. 5664, Table A6, p 174

and Social Research (NIESR) has also highlighted a loss of UK market share through the latter half of 2002.<sup>15</sup> Household consumption and general government consumption were, in contrast, notable areas of strength in the economy. Both grew by 3.8%, a little above original Treasury expectations last spring, with household consumption growth supported by strong real income growth and a buoyant housing market. The strong performance of domestic consumption alongside the weak performance from investment and exports deepened many of the imbalances in the UK economy. It is the Treasury's own view that household consumption has now enjoyed "seven years of unsustainable growth".<sup>16</sup> In our Report on the 2002 Pre-Budget Report, the Committee noted that the continuation of recent imbalances "could pose increasing dangers to the future stability and growth of the economy".<sup>17</sup> **We note that the imbalances between domestic consumption and other parts of the economy in the UK continued, although since the end of the first quarter of 2002 there is some evidence of a slowdown in domestic consumption.**

10. The past year or so also saw some significant exchange rate moves after a period of relative stability. As the NIESR has noted,<sup>18</sup> the effect of recent currency moves will be to redistribute global demand, to the benefit of the US economy and the detriment of the eurozone. The dollar weakened against most currencies, with a fall of 12.8% against sterling between January 2002 and January 2003. The euro strengthened over the same period, with a 6.2% rise relative to sterling. The rally in the euro has gathered pace since the start of 2003, however, and this is now starting to have a significant impact on the sterling effective exchange rate. After slipping a modest 2.7% between January 2002 and January 2003, the sterling exchange rate index had slipped a further 4.6% by the end of April.

11. Looking at the world economy, as the IMF noted in April 2003, "there has been a notable increase recently in concerns about global deflation".<sup>19</sup> In the UK, inflation has remained very low by historic standards, in spite of recently moving above the mid-point of the Monetary Policy Committee's target range. The recent rise in inflation partly reflects the impact of higher oil prices, although the buoyancy of the housing market has also played a role. Much of the impact of the recent weakness in sterling will not yet have appeared in the reported inflation numbers. Even so, the MPC felt sufficiently confident about the outlook for inflation to cut interest rates by 25 basis points to 3.75% in February, the first reduction since November 2001. **The MPC has so far been successful in maintaining inflation within its stated target range, avoiding both the traditional UK problem of excessive inflation and the current problem in some other economies of deflationary conditions, of which Japan is the most severe example.**

### ***The MPC's inflation target***

12. In the Budget, the Chancellor reaffirmed the MPC's symmetrical inflation target of "2.5% for the 12 month increase in the Retail Price Index excluding mortgage payments (RPIX)".<sup>20</sup> An alternative measure of inflation, used for comparisons within the European

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<sup>15</sup> NIESR, National Institute Economic Review No 184, April 2003, p 36

<sup>16</sup> HM Treasury, Budget 2003, HC (2002–03) 500, paragraph B42, p 227

<sup>17</sup> Treasury Committee, Second Report of Session 2002–03, *The 2002 Pre-Budget Report*, HC 159, para 22

<sup>18</sup> NIESR, National Institute Economic Review No 184, April 2003, p 13

<sup>19</sup> IMF, World Economic Outlook, April 2003, p11

<sup>20</sup> HM Treasury, Budget 2003, p 21

Union, is the Harmonised Index of Consumer Prices (HICP). The Chancellor noted that “there is a case in principle for adopting for Britain this index of consumer prices and the Treasury will continue to examine the detailed implications of such a change”.<sup>21</sup> Inflation measured on the HICP is currently around 1 percentage point lower than an equivalent measurement on RPIX, caused in part by major differences in coverage (HICP excludes housing costs and council tax) and in part by technical measurement issues. Adopting the HICP would have the benefit of bringing us into line with other European countries. **We note the Treasury’s intention to continue to examine the detailed implications of a change to using the Harmonised Index of Consumer Prices (HICP) as the measure of domestic inflation targeted by the Bank of England. We note that this would bring the UK into line with the European Central Bank, which targets eurozone inflation based on the HICP. We further note that such a change could have implications for wage settlements and the uprating of benefits linked to inflation. It would also require a translation of the inflation target. We recommend that the Treasury publish a formal review of the implications of a change to the HICP by the time of the Pre-Budget Report 2003.**

## The outlook for the UK economy

Table 2

| Comparison of latest UK GDP growth forecasts, % change |         |         |
|--|---------|---------|
|  | 2003    | 2004    |
| HM Treasury*   | 2 to 2½ | 3 to 3½ |
| Bank of England**                                      | 2.5     | 2.3     |
| IMF†   | 2       | 2.5     |
| European Commission††                                  | 2.2     | 2.6     |
| OECD‡  | 2.1     | 2.6     |
| NIESR‡‡  | 2.2     | 2.8     |
| Av of Ind Forecasts***                                 | 1.9     | 2.4     |

\*Budget 2003; \*\*February Inflation Report; †IMF World Economic Outlook, April 2003; ††EU Commission Spring 2003 Economic F/csts; ‡OECD Economic Outlook No. 73, Preliminary Edition, April 2003; ‡‡NIESR Review No 84, April 2003; \*\*\*Forecasts for the UK economy, HM Treasury, April 2003

13. Economic forecasters generally agree about the outlook for the UK economy in 2003. Most expect a very modest acceleration in growth relative to 2002. Most also expect the recovery to gather pace somewhat in 2004, although the Treasury’s forecasts stand out in terms of their optimism regarding the scale of the acceleration in UK growth anticipated next year. This is illustrated by Table 2.

14. In spite of not being as optimistic as the Chancellor about growth in 2004, most economic forecasters concur with the Treasury’s view that the forecast period should see some rebalancing away from consumption led growth in the UK economy. The Treasury’s assessment is that “strengthening world conditions are expected to boost growth in manufacturing output and business investment, while consumption growth gradually reverts to more sustainable rates in response to weaker real income growth and falls in

<sup>21</sup> Budget Statement, HC Deb 9 April 2003, col 273

equity prices”.<sup>22</sup> This is closely mirrored, for example, in the OECD’s assessment that “an expansionary fiscal stance and a reduced drag from net exports should ensure a slight pick-up in growth this year, despite a slowdown in consumption. As business investment and exports revive, the output gap should close in 2004 with inflation falling back to the official target”.<sup>23</sup> We note that the steep rise in house prices which has previously caused concern is moderating.

### **Consumption**

15. The scale of the slowdown likely in consumer spending nevertheless remains a subject of keen debate. The Treasury expects household consumption to slow “to sustainable rates....consumers are expected to adjust their expenditure with a lag to weaker real disposable income gains and reductions in financial wealth following falls in equity prices over recent years. With the ratio of their debt to income at a historically high level, the current economic climate is likely to deter households from wanting to take on further debt”.<sup>24</sup> At the same time, however, the Treasury expects the consumer to do little to rebuild savings, with the saving ratio projected to remain relatively steady at around 5% throughout the forecast period.<sup>25</sup> This is sufficient to leave the consumer as still one of the main motors to UK growth this year and next. Other forecasters are less sanguine about the consumer outlook, with fears compounded by initial evidence that the housing market is now softening. In the minutes of its April meeting, the MPC noted that “it now seemed likely that consumption growth in 2003 Q1 has been considerably lower than envisaged in the February *Inflation Report*”.<sup>26</sup> The IMF also signalled concern, highlighting “significant downside risk to the (UK) outlook, arising not only from the uncertain external outlook, but also from the vulnerability of private consumption to unemployment and house price shocks”.<sup>27</sup>

### **Business investment and pension funding**

16. Another area of controversy within the economic outlook is the outlook for investment. As we noted earlier,<sup>28</sup> this was an area of significant disappointment through 2002 but the Treasury’s forecasts predict a decisive rebound. In part, this reflects the ongoing surge in general government gross fixed capital formation, but business investment is also expected to recover. The Treasury’s optimism is based on the view that “postponed investment projects are expected to come back on stream as the outlook for demand improves. With firms having largely adjusted to the overhang from the investment boom of the late 1990s, a step-up in new ICT expenditure is expected to emerge over the course of the forecast horizon as a stronger world economy gives firms more confidence to upgrade and expand productive potential. Business investment is therefore forecast to grow by 4¾ to 5¼% next year and 5¼ to 6% in 2005, accounting for a marked increase in

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<sup>22</sup> HM Treasury, Budget 2003, p 211

<sup>23</sup> OECD Economic Outlook No. 73, Preliminary Edition, April 2003

<sup>24</sup> HM Treasury, Budget 2003, paragraph B45 p 227

<sup>25</sup> HM Treasury, Budget 2003, Table B6, p 235

<sup>26</sup> Minutes of the Monetary Policy Committee Meeting, 9 and 10 April 2003, paragraph 14, p 7

<sup>27</sup> IMF, Staff Report for the 2002 Article IV Consultation, February 2003, paragraph 7, p 7

<sup>28</sup> Paragraph 7 above

its ratio to GDP”.<sup>29</sup> Most forecasters agree that investment should recover to some extent but many feel that a recovery on the scale projected by the Treasury is unlikely. The IMF, for example, noted that while it agreed that many of the factors listed by the Treasury “would support investment, staff felt that the recovery would be gradual, given uncertain global growth prospects, low corporate profitability, and the fact that investment was still at historically high levels”.<sup>30</sup> Several of our expert witnesses expressed similar views. Professor Peter Spencer, of the University of York, for example, noted that when looking at “the underlying profitability of the company sector, which is ultimately what drives the demand for investment, we have not seen any significant increase in gross trading profits of the non-financial sector”.<sup>31</sup>

17. Expert witnesses also indicated concern over the potential impact on investment, among other things, of the corporate sector’s pension fund liabilities. Credit Suisse First Boston has estimated that the deficit on defined benefit pension fund schemes for FTSE 100 companies could be of the order of £79 billion.<sup>32</sup> In evidence to the Committee Mr Ciarán Barr, of Deutsche Bank, noted that this issue could be very important. “We are hearing from our equity contacts that this is another...drain on capital that might have been able to fund investment.”<sup>33</sup> The MPC has also expressed concern, noting that: “Eventually, stronger balance sheets might encourage investment, but in the near future firms might want to increase their net saving further, for example to offset the widespread increase in deficits in company defined-benefit pension funds, and that might mean further cuts in planned investment, dividends and employment. Companies in declining sectors of the economy had particularly tough challenges in financing defined-benefit pension funds.”<sup>34</sup> **The potential impact on the broader economy of the current weak state of many pension funds is a serious issue that does not yet seem to have received the attention it deserves, even if the stock market recovery were to continue to the point that the current problem with deficits was resolved. We recommend that the Treasury should co-ordinate with relevant bodies the publication of aggregate data to enable the issue to be more readily quantified and assessed.**

### **Assessment of the forecast**

18. The Treasury has now scaled back its GDP growth forecasts for 2003 to a more modest 2 to 2½%<sup>35</sup> from the 2½ to 3% projected at the time of last November’s Pre-Budget Report.<sup>36</sup> As Table 2 confirms, this is close to most other forecasts. Table 2 nevertheless also confirms that the Treasury’s latest forecasts of 3 to 3½% growth in 2004 are notably more upbeat than the equivalent predictions of most other forecasters. In their evidence to the Committee, independent economic experts were unanimous in their view that the Treasury’s 2004 forecasts appeared to be optimistic.<sup>37</sup> Mr Robert Chote of the Institute for

<sup>29</sup> HM Treasury, Budget 2003, paragraph B76 p 238

<sup>30</sup> IMF, Staff Report for the 2002 Article IV Consultation, February 2003, paragraph 6, p 7

<sup>31</sup> Q 21

<sup>32</sup> Credit Suisse First Boston, UK Strategy Focus, “FRS 17: market implications”, 28 February 2003

<sup>33</sup> Q 21

<sup>34</sup> Minutes of the Monetary Policy Committee Meeting, 9 and 10 April 2003, paragraph 8, p5

<sup>35</sup> HM Treasury, Budget 2003, paragraph B2, p 219

<sup>36</sup> HM Treasury, Pre-Budget Report 2002, Table A2, p 158

<sup>37</sup> Qq 2–6

Fiscal Studies also observed that the Chancellor's "forecast for growth for the year ahead is further away ... from prevailing perceived wisdom than it has been on any previous occasion".<sup>38</sup>

19. It is not the role of this Committee to adjudicate between rival views of the UK economic outlook. The assessment of the economic outlook underpinning the Chancellor's Budget strategy looks optimistic relative to the assessment of most other reputable forecasting bodies. Mr O'Donnell pointed out that the Treasury has "a very good forecasting record and if you look back on the forecasts we have done ... over the past ten years the average error on GDP forecasts in the year is plus or minus three-quarters of per cent".<sup>39</sup> Expert witnesses generally agreed that the Treasury's forecasting track record was relatively good. Mr David Walton, of Goldman Sachs, argued that "the Treasury's forecasting record is not that bad when you look one year ahead"<sup>40</sup> and Professor Spencer went further, noting that "there is no doubt that the Treasury does have a good forecasting record".<sup>41</sup>

20. The Chancellor also argued that, since the end of the fighting in Iraq, "if you look at the changing nature of people's views of the world economy, I think they are moving towards what we have suggested for 2004 and 2005"<sup>42</sup>... "forecasts, even among people who made forecasts before the Budget, are moving upwards. The OECD and the National Institute are already moving their forecasts upwards".<sup>43</sup> Certainly late April saw the NIESR, for example, raise its growth forecast for 2004 from 2.4% to 2.8%.<sup>44</sup> It nevertheless remains true that even the lower, "cautious case" end of the Treasury's projected "opportunity range"<sup>45</sup> for growth in 2004 is higher than any of the central forecasts from the other major forecasting bodies. This inevitably leaves UK economic policy open to questions about the extent to which it passes the Treasury's own assessment that it uses "cautious assumptions and the 'stress test' against the cautious case to help ensure that the public finances are sound and sustainable".<sup>46</sup>

**21. The Committee recognises that the international circumstances in which the Budget forecasts were constructed were unusually uncertain as a result of the Iraqi conflict, but observes that the Treasury's forecasts for 2004 are notably more optimistic than those of a wide range of other forecasting bodies. It is important to maintain the credibility of the economic assessment underpinning Treasury forecasts for the public finances. The Committee recommends that in these circumstances it would be helpful for the Treasury to publish supporting technical studies to explain the basis of its forecasts, as the Bank of England does with its Quarterly Bulletin.**

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<sup>38</sup> Q 5

<sup>39</sup> Q 104

<sup>40</sup> Q 3

<sup>41</sup> Q 4

<sup>42</sup> Q 297

<sup>43</sup> Q 299

<sup>44</sup> NIESR, National Institute Economic Review No 184, April 2003, p 3

<sup>45</sup> The Treasury's projections for GDP growth are presented as opportunity ranges which represent alternative views about the supply side performance of the UK economy. Projections at the lower end of the opportunity range are intended to be deliberately cautious, making no allowance for improvement in the supply side performance of the UK economy over recent years. The Treasury's central forecast of economic growth is represented by the mid-point of the opportunity range. (HC, 2002-03, 159, page 72)

<sup>46</sup> HM Treasury, Budget 2003, p 243

### *The forecasting process*

22. The Committee notes that the Bank of England recently submitted its forecasting procedures to independent review by an eminent outside expert, Professor Andrew Pagan. The Bank has reported that it found his report useful, providing “important observations about economic modelling and forecasting in general, as well as a number of recommendations as to how the process at the Bank of England might be improved”.<sup>47</sup>

23. The Treasury has already moved to improve the transparency of its forecasting process by publishing many of the key assumptions underpinning its forecasts and asking the National Audit Office (NAO) to verify them as reasonable. Expert witnesses generally agreed with Mr Walton that “while the NAO’s role in this is a little bit limited .... it is useful to have the assumptions set out. To the extent that we have that, that at least increases the transparency”.<sup>48</sup> However, it was the view of several of our expert witnesses that the Treasury should now go further and submit its technical modelling to outside review to ensure that its forecasting procedures conform to current best practice. Mr Weale, for example, noted, “on the question of an outside report on the Treasury’s forecasting process such as Professor Pagan did for the Bank of England, I should have thought that it is bound to be useful...to provide the econometric skills that someone like Professor Pagan would be able to bring to bear”.<sup>49</sup>

24. In spite of the Treasury’s good long-term forecasting record, the debates surrounding both the 2002 and the 2003 Budgets have to an extent been dominated by widespread discussion of the Treasury’s economic forecasts, diverting attention away from the substance of the Government’s economic strategy. **To reinforce the Treasury’s reputation in the area of economic forecasting, the Committee recommends that the Treasury should consider commissioning a technical review of its forecasting procedures, as has usefully been done by the Bank of England.**

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<sup>47</sup> Bank of England, Bank of England Quarterly Bulletin, Spring 2003, p 89

<sup>48</sup> Q 13

<sup>49</sup> Qq 7, 10

## 3 Public Sector Finances

### Growth assumptions underlying the public finances

25. The Treasury has stated in a document examining lessons from previous policy experience that, in the past, “a failure to guard against optimism and build in a margin for prudence for unexpected events led to undesirable outcomes for spending plans”.<sup>50</sup> However, HSBC noted that “in the past the Chancellor has based his public finance projections on whichever is lower – his estimate for trend growth or the lower bound of his economic forecasts. In the latest Budget he is basing public finances on whichever is the higher of the two”.<sup>51</sup> We raised this issue in our report on the 2002 Pre-Budget Report.<sup>52</sup> In response, the Treasury told us that the public finance projections “are based on the bottom of the forecast range for growth in each year of the projection period, which is anchored around a deliberately prudent and cautious assumption for trend output growth”.<sup>53</sup>

26. Table 3 below shows the assumptions for GDP growth that underpin projections of the public finances. These now appear to be closer to the mid-point, rather than the bottom, of the forecast range for GDP growth. Mr Barr told us that the assumption of 3.25% growth which feeds into the 2004–05 fiscal projections is the “highest of any independent forecast”.<sup>54</sup> The Treasury’s growth forecasts were for growth of 3 to 3.5% in both 2004 and 2005. **We note that the growth assumption underlying the public finances is 3.25% in 2004–05, which is the mid-point, rather than the bottom end, of the Treasury’s forecast ranges for growth in 2004 and 2005. We ask the Treasury to clarify whether this is a departure from their previously stated policy of using the bottom end of the forecast range for growth, in projections of the public finances, and to give in more detail the basis of their calculation.**

Table 3

| Growth assumptions used for the public finance projections (financial years) |         |         |         |         |         |         |         |
|--|---------|---------|---------|---------|---------|---------|---------|
|  | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 |
| Budget 2003  |         | 1¾*     | 2*      | 2¼      | 3¼      | 3       | 2½      |
| PBR 2002   |         | 1½*     | 2       | 2¾      | 3       | 2¾      | 2½      |
| Budget 2002  | 3*      | 1¾*     | 2½      | 2¾      | 2½      | 2½      | 2½      |
| PBR 2001   | 2¾*     | 2       | 2¼      | 2½      | 2¼      | 2¼      | 2¼      |
| Budget 2001  | 3*      | 2¼      | 2¼      | 2¼      | 2¼      | 2¼      | **      |

\* outturn

Sources: Budget 2001 Table C3, Pre-Budget Report 2001 Table B3, Budget 2002 Table C3, Pre-Budget Report 2002 Table B3, Budget 2003 Table C3

<sup>50</sup> HM Treasury, Planning sustainable public spending (2000) p5

<sup>51</sup> HSBC, *UK Budget 2003 Review*, 9 April 2003, p4

<sup>52</sup> Treasury Committee, Second Report of Session 2002–03, *The 2002 Pre-Budget Report*, HC 159, para 31

<sup>53</sup> Treasury Committee, Second Special Report of Session 2002–03, *Government Response to the Committee’s Second Report: the 2002 Pre-Budget Report*, HC 528, p 6

<sup>54</sup> Q 6

27. Underlying the Treasury's GDP growth forecasts is a "deliberately prudent and cautious assumption of trend output growth of 2.5% a year up to 2006-07 a quarter percentage point lower than the Government's neutral view [of 2.75%]".<sup>55</sup> This assumption was audited by the Comptroller and Auditor General in April 2002 who concluded that it was "reasonable and cautious".<sup>56</sup> The Treasury uses an estimate of the output gap (the gap between actual and trend output) in calculating the cyclical adjustment of the public finances.<sup>57</sup> Mr Walton told us that "the Treasury believe that the economy is operating below trend" and that "in the next two years the economy will get back to trend", referring to the Treasury's estimates showing the output gap being eliminated over the next two years. PricewaterhouseCoopers told us that the Treasury's estimates of the output gap, "seem to be assuming" trend growth of 2.75% in 2001-02 and 2002-03, before reverting to 2.5% for the projections to 2006-07. They also point out that had the Treasury assumed a trend growth rate of 2.5% in each year then the output gap would be lower than the Treasury's estimate. PwC believed that "given its importance in assessing whether the Golden Rule is met...the Treasury should be asked to clarify its methodological approach to cyclical adjustment of the public finances and to explain the justification for the assumptions adopted on trend growth in these calculations".<sup>58</sup> A further margin of error is built into the system since, as Treasury officials and the Chancellor pointed out, the public finance projections are stress-tested against a cautious case in which the level of trend output is assumed to be 1% lower than the Government's central view.<sup>59</sup> Even so, in the interests of transparency it is important that the assumptions underlying the Treasury's central view are clearly set out. **We ask the Treasury to clarify the trend growth rate used to estimate the path of the output gap in each year from 2000-01 to 2007-08 and to provide justification for their approach.**

## Tax receipts

28. Tax receipts in 2002-03 are now expected to be £397.1 billion, £10.1 billion lower than projected in the 2002 Budget and £2.7 billion lower than the projection in the 2002 Pre-Budget Report. The Treasury attributes much of the shortfall since the 2002 Budget to "falls in equity prices and weaker financial company profits".<sup>60</sup> The falls since the 2002 Pre-Budget report are largely attributed "to lower than expected receipts from income tax and national insurance contributions".<sup>61</sup>

29. Tax receipts fell short of expectations partly because growth in 2002 was lower than the Treasury anticipated in the 2002 Budget.<sup>62</sup> More important, however, is the fact that tax as a share of GDP also fell below expectations. Last spring net taxes and social contributions were expected to account for 36.7% of GDP in 2002-03. That figure is now put at 35.5%.<sup>63</sup>

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<sup>55</sup> HM Treasury, Budget 2003, p 249

<sup>56</sup> NAO Audit of Assumptions for the 2002 Budget, HC 760, para 30

<sup>57</sup> See HM Treasury, Budget 2003, Chart B4 p 226

<sup>58</sup> PricewaterhouseCoopers Ev 23

<sup>59</sup> Q 77; see HM Treasury, Budget 2003, p 248

<sup>60</sup> HM Treasury, Budget 2003, paragraph 2.37, p 29

<sup>61</sup> HM Treasury, Budget 2003, paragraph 2.37, p 29

<sup>62</sup> See paragraph 18 above

<sup>63</sup> HM Treasury, Budget 2003, Table C10, p 260

30. Our expert witnesses generally concluded<sup>64</sup> that this decline in tax as a per cent of GDP suggests that the Treasury's revenue problems are structural rather than cyclical. They also suggested that this had strong implications for the public finances in the future. The Treasury, in contrast, views recent problems as mainly cyclical. The Budget 2003 forecasts assume that net taxes and social security contributions as a share of GDP will rise to 38.2% by 2007–08.<sup>65</sup> This would be the highest level since the mid-1980s.<sup>66</sup> As Mr Chote pointed out in evidence to us, “the Chancellor is essentially assuming that the economy bounces back and the public finances bounce back with it and beyond it”.<sup>67</sup>

31. As Table 4 illustrates, the main areas driving the projected rebound in overall tax receipts as a share of GDP are income tax and corporation tax. Income tax as a share of GDP is projected to rise over the forecast period from 10.7% to 11.7%. Non-North Sea corporation tax as a share of GDP rises from 2.5% to 3.4%. In evidence to the Committee, Mr O'Donnell suggested that much of the anticipated rebound in income tax revenues reflected hopes of a rebound in financial companies' bonuses, particularly since “those bonuses are paid disproportionately to higher rate tax payers, so (we) get more tax back”.<sup>68</sup> Similarly, a recovery in the financial sector seems to be at the heart of the Treasury's optimism on corporation tax revenues. In evidence to the Committee the Chancellor chose to highlight that “if you look at the share of financial companies profits as a percentage of GDP...it has risen quite significantly over a period of time...I think it is rising by 0.2% per year and although there has been a dip in recent years, because of what has been happening in the City, there is no reason to expect that financial company profitability will not return”.<sup>69</sup>

**Table 4**  
**Current receipts as per cent of GDP**

|  | 2002-2003   | 2003-2004   | 2004-2005   | 2005-2006   | 2006-2007   | 2007-2008   |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| Income Tax   | 10.7        | 11.0        | 11.2        | 11.4        | 11.6        | 11.7        |
| Non-North Sea corporation tax                        | 2.5         | 2.5         | 2.9         | 3.2         | 3.3         | 3.4         |
| Tax Credits  | -0.3        | -0.4        | -0.4        | -0.4        | -0.4        | -0.3        |
| North Sea Revenues                                   | 0.5         | 0.4         | 0.4         | 0.4         | 0.4         | 0.4         |
| VAT  | 6.0         | 6.0         | 6.0         | 6.0         | 5.9         | 5.9         |
| Excise Duties  | 3.5         | 3.5         | 3.4         | 3.3         | 3.2         | 3.2         |
| Social Security Taxes                                | 6.1         | 6.7         | 6.9         | 6.8         | 6.9         | 6.9         |
| Other  | 6.6         | 6.6         | 6.7         | 6.8         | 6.9         | 6.9         |
| <b>Net Taxes &amp; Social Security Contributions</b> | <b>35.6</b> | <b>36.3</b> | <b>37.1</b> | <b>37.6</b> | <b>37.9</b> | <b>38.2</b> |

Source: HM Treasury, Budget 2003, Table C9, p 260

32. Expert witnesses generally felt that the Treasury was being too optimistic. Mr Weale observed that “to expect a revival in the revenue based on a revival of the financial sector I fear may be rather mistaken ...the expansion of the business services and financial industry that we have seen, particularly between 1995 and 2000...was largely associated with the stock market boom. It may happen, but there is no reason to assume that we are going to

<sup>64</sup> Qq 22–24

<sup>65</sup> HM Treasury, Budget 2003, Table C10, p 260

<sup>66</sup> HM Treasury, Budget 2003, Chart C3, p 261

<sup>67</sup> Q 24

<sup>68</sup> Q 159

<sup>69</sup> Q 328

have a stock market boom”.<sup>70</sup> Similarly Mr Chote thought that “the Chancellor has corporation tax revenues returning to something like 3.4% of GDP at the end of this forecasting period, a level which... (on)... the current tax rates and rules would only have been achieved in the past 15 years on about three occasions, either when the economy was operating far above trend or when the performance of the financial sector was being boosted by the stock market boom”.<sup>71</sup>

33. In evidence to the Committee, the Chancellor pointed out that “I think you will find, if you look in the tables, that corporation tax as a share of GDP has in the last 15 or so years, if I just give you the figures, has been in the late 1980s—3.6%, 4.0%, 3.7%, 3.0%; in the mid-1990s—3.1%, 3.5%, 3.5% 3.3%, 3.6% and, while corporation tax revenues have come down in the last few years, I think it is not an unrealistic set of figures to say that corporation tax will be 2.5% last year, 2.5% this year, [and then] 2.9%, 3.2%, 3.3% 3.4%. That is not out of line with what have been historical positions for corporation tax”.<sup>72</sup> The IFS has, however, noted, “over the past 15 years, corporation tax revenues averaged 3.2% of national income. While this seems very close to the [Treasury’s] forecast, it ignores that fact that tax rates have been cut. Revenues also received a temporary boost in the four years from 1999-2000 to 2002-03 from the introduction of a payment system in quarterly instalments”.<sup>73</sup>

34. One of the Chancellor’s key underlying assumptions, audited by the National Audit Office, is that the “FTSE All Share index rises from 1778 (close 28 March) in line with money GDP”.<sup>74</sup> Using the Treasury’s projections for money GDP growth,<sup>75</sup> this would still leave share prices by March 2008 around 25% below their peak in December 1999 (3146 for the FTSE All Share index). **Even though the Treasury is adhering to cautious underlying assumptions about the equity market over the next few years, it nevertheless forecasts a strong recovery in corporation tax revenues. This implies a far sharper recovery in corporate profitability than is currently envisaged by independent forecasters.**

35. The general view of the Committee’s expert witnesses was summarised by Professor Spencer, who observed “essentially what the Chancellor is doing is saying that the very high tax ratios, the ratios of tax revenue to GDP that we saw in the run up to the last election, are the norm to which we will return. I think most of us here, on the basis of the analysis that we have done, both of the boom in tax and the subsequent fall-back, would indicate that that is the exception rather than the norm, and so the bottom-line is that even if growth does come in in-line with forecast, the tax revenues will not”.<sup>76</sup>

**36. The Committee concludes that the spread of risks around the Treasury’s revenue assumptions, particularly in 2004-2005 and beyond, is skewed downwards. To be fulfilled, the Treasury’s forecasts require not just a sharp rebound in overall economic activity but also a rapid recovery in the prosperity of the City of London. At a time of**

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<sup>70</sup> Q 22

<sup>71</sup> Q 24

<sup>72</sup> Q 327

<sup>73</sup> The Institute for Fiscal Studies, The IFS Green Budget, January 2003, p 24

<sup>74</sup> HM Treasury, Budget 2003, Box C1, p 252

<sup>75</sup> HM Treasury, Budget 2003, Table C3, p 250

<sup>76</sup> Q 26

**significant structural change in financial markets and the financial services industry, there is a risk that profitability and tax revenues will not recover as rapidly as the Treasury suggests.**

### **Forecasting tax receipts**

37. The Chancellor indicated to the Committee that his approach to forecasting tax revenues is radically different from other forecasters. He argued that “the difference...between ourselves and the Institute for Fiscal Studies or the National Institute is that, ...theirs is a top down approach where they make assumptions about what has happened to the economy. Ours is a bottom-up approach where we look at what is happening to tax.”<sup>77</sup> He added that the Treasury’s approach to revenue “is bound to be different because it is a ground-up approach. It is based on what is happening in individual tax returns and individual parts of the sector”, noting also that “the way we draw up our corporation tax forecasts is based on information that is available only to the Inland Revenue”.<sup>78</sup>

**38. While recognising the need to preserve confidentiality in tax matters, the Committee feels that it would boost transparency and better inform the policy debate if the Treasury published its revenue projections in greater detail. We ask the Treasury to consider if it is possible to publish revenue projections and past data for broad areas of the economy, such as for the financial sector, the manufacturing sector and the services sector, without threatening confidentiality. This would greatly aid transparency and permit a much clearer assessment of official revenue projections.**

### **Expenditure**

39. The Treasury’s spending plans continue to call for totally managed expenditure to rise more rapidly than the broad economy. After rising by 8.1% in 2002–03,<sup>79</sup> relative to a rise in money GDP of 4¾–5¼%,<sup>80</sup> current plans call for a rise in expenditure of 8.2% in 2003–04 relative to the projected rise in money GDP of 5¾–6¼%. In subsequent years current plans call for expenditure to rise by approximately 6.5%, still slightly ahead of Treasury forecasts of money GDP growth of 5¾–6¼%. The NIESR has warned that expenditure may nevertheless “amount to less in volume terms than the Government predicts...[since]...strong levels of public expenditure are likely to result in inflation in the price of public goods and services ahead of inflation in the aggregate price level”.<sup>81</sup>

40. Total managed expenditure in 2002–03 is now estimated to have been £421 billion.<sup>82</sup> This compares with a projected figure in spring 2002 of £418.4 billion. The pattern of spending has nevertheless been very different from that projected at the start of the last financial year. Current spending in 2002–03 was £5.1 billion higher than expected, representing a rise of 7.5 % compared with a budgeted rise of 6.1%. At the same time public

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<sup>77</sup> Q 327

<sup>78</sup> Q 390

<sup>79</sup> HM Treasury, Budget 2003, Table C11, p262

<sup>80</sup> HM Treasury, Budget 2003, Table B9, p241

<sup>81</sup> NIESR, National Institute Economic Review No 184, April 2003, p 40

<sup>82</sup> HM Treasury, Budget 2003, Table C11, p 262

sector net investment in 2002–03 fell short of target, but the Treasury has also substantially revised downward its estimate of public sector net investment in 2001–2002 since the 2002 Budget (from £12.0 billion<sup>83</sup> to £9.6 billion<sup>84</sup>). The overall result is that public sector net investment over the two years 2001–02 and 2002–03 is now put at £21.8 billion, relative to a projected equivalent in last year’s Budget of £26.4 billion, a shortfall of 17.4%. Mr Sharples explained that “central government numbers (for investment) ...are actually pretty much in line with budgets...where there has been a shortfall, interestingly, it has been rather more on the local government side and the public corporation side”.<sup>85</sup> **The full amount of the £3 billion contingency provision relating to the cost of Iraqi operations has been allocated to 2002–03. Adjusting for this unanticipated item, overall spending has come in very close to plan. We note, however, the over-run in current spending in 2002–03 and would welcome an explanation as to how this occurred.**

41. The Government is currently engaged in, as Mr Sharples put it, “an entirely deliberate attempt to try and get a step change in the level of investment in public infrastructure”,<sup>86</sup> with a rise of 54.9% in public sector net investment projected for 2003–04, followed by a rise in 2004–05 of 21.7% and a further 10.4% rise in 2005–06.<sup>87</sup> The recent record of significant shortfalls relative to plans nevertheless tends to confirm the Institute of Fiscal Studies judgement that “the delivery of investment spending remains problematic”.<sup>88</sup> **The Committee recommends closer monitoring of the planned expansion in public investment, particularly in the case of local authorities and public corporations. In the light of substantial underspending by government departments, local authorities and public corporations of money budgeted for investment in recent years, the Committee recommends an investigation of the reasons for this inability to adhere to investment programmes with a view to correcting either investment planning or means of delivery this year and in future years.**

42. Whilst the IMF has observed “the sheer speed at which spending was being increased risked inefficiencies that a more gradual approach might have avoided”,<sup>89</sup> it nevertheless acknowledged that “some spending increases were likely needed in area such as health and transport, where spending was low relative to historical and EU averages”.<sup>90</sup> A similar point was made by Mr Weale, who observed public sector net investment in the UK had fallen to around 0.5% of GDP in 1999–2000 and 2000–01 while “at the same time the United States, which has a narrower view than many of us here of what the public sector should be doing, had [public sector net investment] of 1.3% of GDP”.<sup>91</sup> He suggested that since 1996–97 the UK figures “had been very low, not only by historical experience, but also by the experience of economies that are generally thought of as having a rather restrictive role for the public sector”.<sup>92</sup> **We note that by historic standards and by comparison to competitors the UK**

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<sup>83</sup> HM Treasury, Budget 2002, Table C11, p 223

<sup>84</sup> HM Treasury, Budget 2003, Table C11, p 262

<sup>85</sup> Q 131

<sup>86</sup> Q 132

<sup>87</sup> HM Treasury, Budget 2003, Table C11, p 262

<sup>88</sup> The Institute for Fiscal Studies, The IFS Green Budget, January 2003, pp 26–27

<sup>89</sup> IMF, Staff Report for the 2002 Article IV Consultation, February 2003, paragraph 16, p25

<sup>90</sup> IMF, Staff Report for the 2002 Article IV Consultation, February 2003, paragraph 16, p25

<sup>91</sup> Q 41

<sup>92</sup> Q 41

**public sector has a record of low capital expenditure, but we also note that any future increases in capital spending must be efficiently and effectively managed.**

43. Public sector net investment in the UK as a percentage of GDP fell sharply and to historically low levels through the latter half of the 1990s,<sup>93</sup> but when asked<sup>94</sup> none of our expert witnesses knew of any studies that had tried to establish the economic costs of relatively low levels of public sector net investment in the economy. **The lack of any publicly available detailed assessment of the overall economic and welfare impact of public sector net investment is striking. Without such information, it is very difficult to take an informed view of what the appropriate level of public investment is.**

44. The Government currently frames its fiscal policy against a set of fiscal rules, with the sustainable investment rule being designed to maintain “public sector debt at a low and sustainable level – other things being equal, net debt should be held below 40% of GDP”.<sup>95</sup> This does little to address the issue of the very sharp fluctuations seen in public sector net investment in recent years. Public sector net investment fell from 2.0% of GDP in 1992–3 to 0.8% of GDP in 1999–2000.<sup>96</sup> It is now projected to rise from 1.0% of GDP in 2001–02 to 2.1% of GDP in 2005–06.<sup>97</sup> **These dramatic fluctuations in public sector net investment militate against the efficient delivery of a sound public sector infrastructure. We believe that it might help to deliver a smoother, more efficient flow of public sector investment spending if the Treasury adopted an explicit target range for public sector net investment as a per cent of GDP over the economic cycle.**

45. From our discussions with the Chancellor regarding Foundation Hospitals,<sup>98</sup> important issues relating to the existing control of public expenditure arose to which we may return.

## The fiscal balance

46. The “golden rule” states: “over the economic cycle, the Government borrow only to invest and not to fund current spending”.<sup>99</sup> This implies that there should be at least a balance for tax receipts relative to current spending. Over the recent past, however, tax receipts have fallen short of the Treasury’s forecasts<sup>100</sup> and current spending has exceeded planned totals.<sup>101</sup> The net result is that the Treasury now expects to see a deficit of £11.7 billion<sup>102</sup> on the current budget in 2002–03. This is equivalent to 1.1% of GDP.<sup>103</sup> Moreover, the current budget does not swing back into surplus on the Treasury’s projections until 2005–06.<sup>104</sup> Even so, thanks to the large cumulative surplus built up in the early years of the current cycle, on the Treasury’s current projections the Chancellor states

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<sup>93</sup> HM Treasury, Budget 2003, Table C26, p281

<sup>94</sup> Q 42 ff

<sup>95</sup> HM Treasury, Pre-Budget Report 2002, para 2.52, p 29

<sup>96</sup> HM Treasury, Budget Report 2003, Table C26, p 281

<sup>97</sup> HM Treasury, Budget Report 2003, Table C5, p 254

<sup>98</sup> Q 366 ff

<sup>99</sup> HM Treasury, Pre-Budget Report 2002, paragraph 2.52, p 29

<sup>100</sup> See paragraph 28 above

<sup>101</sup> See paragraph 40 above

<sup>102</sup> HM Treasury, Budget Report 2003, Table C2, p 246

<sup>103</sup> HM Treasury, Budget Report 2003, Table C1, p 244

<sup>104</sup> HM Treasury, Budget Report 2003, Table C4, p 266

that he will meet the “golden rule over the cycle...we will not only achieve a balance, but achieve an estimated surplus at £32 billion”.<sup>105</sup> This compares with an estimated surplus of £46 billion forecast at the time of the Pre-Budget Report.<sup>106</sup>

47. The Treasury also monitors the cyclically-adjusted surplus on the current budget, which it considers “a useful indicator of the structural state of the public finances...In conjunction with medium-term projections for the average surplus on the current budget since the start of the economic cycle, these estimates provide an indication of within-cycle progress towards meeting the golden rule”.<sup>107</sup> The cyclically-adjusted surplus on current budget has also slipped into a deficit equivalent to 0.5% of GDP in 2002–03, but on the Treasury’s central case swings back into surplus from 2003–04. The Budget documentation also shows estimates of the cyclically-adjusted surplus on current budget on a “cautious case” assumption,<sup>108</sup> in which “the level of trend output is assumed to be one percentage point lower than the Government’s central view”.<sup>109</sup> On this basis, the cyclically-adjusted surplus on current budget remains in deficit continuously through to 2006–07. The surplus accumulated through the first four years of the cycle enables the Treasury to state that “the average cyclically-adjusted current budget is in surplus in the cautious case over the economic cycle”.<sup>110</sup>

48. Mr O’Donnell made it plain to the Committee that the Treasury felt that the cautious case was a “quite strenuous stress test”<sup>111</sup> for the public finances and that the fiscal rules “did not relate to the cautious case”.<sup>112</sup> Several of our witnesses, like Mr Weale, nevertheless expressed concern “that perhaps the cautious case is the more realistic”<sup>113</sup> of the various Treasury options. Mr Chote also suggested “the fact that there is not a number [for the margin by which the cyclically-adjusted current budget meets the golden rule on the cautious case] suggests that it may be very small”.<sup>114</sup> Professor Spencer expressed similar sentiments, observing “that it was very clear [from the chart of the cyclically adjusted surplus on current budget] that the Chancellor is sailing very close to the wind”.<sup>115</sup> However, it is also noted in the submission to the Committee from Mr Walton of Goldman Sachs that “it is unnecessary for the Government always to meet its rules with a safety margin. Otherwise the fiscal stance will be unnecessarily tight”.<sup>116</sup>

**49. The Chancellor is on course to meet the golden rule during the current cycle. However, on the central case the estimated surplus has fallen from £46 billion to £32 billion since November 2002. The margin for error around the Government’s fiscal**

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<sup>105</sup> Budget Statement, HC Deb, 9 April 2003, col 284

<sup>106</sup> Pre-Budget Report Statement, HC Deb, 27 November 2002, col 320

<sup>107</sup> Second Special Report: *Government response to the Committee’s Second Report: The 2002 Pre-Budget Report 2002*, HC 528, p 8

<sup>108</sup> HM Treasury, Budget Report 2003, Chart C2, p 248

<sup>109</sup> HM Treasury, Budget Report 2003, para C23, p 248

<sup>110</sup> HM Treasury, Budget Report 2003, para C23, p 248

<sup>111</sup> Q 177

<sup>112</sup> Q 177

<sup>113</sup> Q 48

<sup>114</sup> Q 48

<sup>115</sup> Q 48

<sup>116</sup> Ev 3

**position in the current cycle has narrowed from the forecasts in Budget 2002 and the Pre-Budget Report 2002.**

50. The greatest concerns expressed to the Committee related to the longer-term outlook for the fiscal arithmetic. Mr Chote raised the point of “how long the Treasury can go on talking about whether it is meeting the fiscal rules or not by focussing on what is happening over the current cycle...eventually the Treasury is going to have to...[give us]...its view of the next cycle”. The CBI has pointed out “it still seems more likely than not that the golden rule will be achieved over the present economic cycle, thanks to the significant current budget surpluses of 2000–01 and 2001–02. However, some form of fiscal policy tightening may well be needed if the rule is to be achieved over the next cycle”.<sup>117</sup>

51. The Treasury currently assumes that the current cycle extends from 1999–2000 to 2005–06.<sup>118</sup> On the basis that the current cycle ends in 2005–06, the public sector current budget surplus of 0.4% of GDP projected for 2006–07, the first year of the next cycle, compares starkly with the surplus of 2.2% of GDP with which fiscal policy entered the current cycle. **The golden rule has survived recent global shocks relatively well, thanks to the large surplus built up in the early years of the current cycle. As we move into the latter half of the current cycle, we await with interest the Treasury’s views on the public finances over the next cycle.**

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<sup>117</sup> Appendix 4, para 30

<sup>118</sup> HM Treasury, Budget Report 2003, para C5, p 244

## 4 Individual Budget measures

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### Protecting tax receipts

52. The Budget saw the announcement of a new compliance and enforcement package for direct tax and National Insurance Contributions. “An additional £66 million is being provided to the Inland Revenue over the next three years to support implementation of the package. The package is expected to produce at least £1.6 billion in revenue over the next three years, but in line with the Government’s cautious approach to the public finances a lower figure of under £1.4 billion over three years ... has been included in the forecast.”<sup>119</sup>

53. The Centre for Economic and Business Research has expressed concern that “the Chancellor will have difficulty in achieving the revenue he hopes to achieve from reduced tax avoidance and tax evasion without making the burden of tax collection excessively onerous on legitimate business activity”.<sup>120</sup> Mr Whiting similarly observed that the target for incremental revenues of £1.6 billion “sounds too much, partly because if there is that much relatively easy money there, why have we not done it already...one of my great concerns is that there is going to be increased effort at policing those who are already trying to comply and get it right and it will get in the way of ordinary business”.<sup>121</sup> Mr O’Donnell nevertheless defended the assumed rise in receipts from the additional package of measures, pointing out that in the past the Treasury had asked “the NAO to audit what we are doing in terms of anti-smuggling strategy. They looked at it and they said that what we were assuming was cautious....thanks to the excellent work of Customs & Excise, we have done better than we expected”.<sup>122</sup>

54. The Committee nevertheless notes that the Comptroller and Auditor General, in assessing the likely impact of the new package of revenue protection measures, concludes that “given the inevitable uncertainties, it is important that information emerging from the Inland Revenue’s planned work to monitor the impact of the measures is taken into account on a timely basis, to ensure that the projections of additional yield are revised if they appear not to be cautious in practice”.<sup>123</sup> **The Committee welcomes the C and AG’s recommendation and suggests that a clear assessment should be published each year of the actual impact on receipts of any revenue protection measures announced in the previous year’s Budget. This assessment should be audited by the NAO. It would provide a clearer framework for assessing both the impact of recent revenue protection moves and the likely gains from any further revenue protection moves in the future.**

### Stamp duty

55. In his Budget Statement the Chancellor indicated that “as a result of tax avoidance only half of all large commercial property transactions—worth £10 billion a year—are paying

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<sup>119</sup> HM Treasury, Budget Report 2003, para 5.79, p 120

<sup>120</sup> Appendix 2, para 5

<sup>121</sup> Q 7

<sup>122</sup> Q 216

<sup>123</sup> Report by the Comptroller and Auditor General, Audit of Assumptions for Budget 2003, HC627, Session 2002-03, para 56

the stamp duty owed”.<sup>124</sup> As part of his agenda to tackle tax avoidance, the Budget confirmed the details of the proposed modernisation of the regime for stamp duty announced in Budget 2002.<sup>125</sup> Amongst these proposed reforms were changes to stamp duty charged on the grant of new leases (known as lease duty). At present the charge is calculated according to lease length and the annual average rent. The Government proposes replacing this charge with a “single 1% charge of the total Net Present Value (NPV) of rental payments”<sup>126</sup> over the length of the lease. In conjunction with this measure, the stamp duty zero rate band threshold will be increased from £60,000 to £150,000. The lease duty reforms were aimed at “addressing tax distortions between purchasing and leasing and in the structure of leasehold contracts”.<sup>127</sup>

56. The Committee has received representations from both the CBI<sup>128</sup> and the British Property Federation, with the latter expressing “concern that the Chancellor regards leases as a means of avoiding stamp duty on outright property purchase”.<sup>129</sup> In evidence to the Committee Mr Whiting expressed similar views, stating that he found it “strange that the Chancellor seems to think that property leasing is an avoidance device whereas to me leasing of property is a perfectly normal transaction”.<sup>130</sup> He pointed out that there were far more significant tax avoidance techniques in use, such as buying property “when you can very often be offered a company which owns that property. The company carries stamp duty at half per cent, the property at four per cent”.<sup>131</sup>

57. The Chancellor confirmed that ahead of introducing the proposed changes in the stamp duty treatment of leases, he intended to enter into further consultation with business and commerce. He would introduce the proposed lease duty reforms only if, “after consultation with industry, there is no effective alternative for tackling avoidance”.<sup>132</sup> **The Committee notes that tax avoidance in the property market is an important issue for the authorities to address. We recommend that the proposed consultation process focusing on the reform of the stamp duty treatment of commercial leases should be allied to a wider ranging review of the taxation of commercial property transactions. In this context we note the current consultation on stamp duty and await its outcome with interest.**

## Child Trust Funds

58. One of the more prominent individual measures in the Budget was the proposal for Child Trust Funds. These are to be individual endowments, for each child born from September 2002. The Budget documentation indicates four key elements of the proposal:

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<sup>124</sup> HC Deb, 9 April 2003, col 279

<sup>125</sup> HM Treasury, Budget Report 2002, p 161

<sup>126</sup> HM Treasury, Budget Report 2003, para 5.90, p 122

<sup>127</sup> HM Treasury, Budget Report 2003, para 5.90, p 122

<sup>128</sup> Appendices 3 and 4

<sup>129</sup> Appendix 1

<sup>130</sup> Q 96

<sup>131</sup> Q 97

<sup>132</sup> HC Deb, 9 April 2003, col 278

- the endowment is to be £250 per child, rising to £500 for children in families qualifying for full Child Tax Credit (about one-third of all families)
- additions to the Trust Fund will be permitted by family members or others up to an annual limit of £1,000
- access to the Fund will be at age 18, with no restriction on use of the Fund
- provision of the actual accounts will be by open market competition with any authorised provider able to enter the market.<sup>133</sup>

The total cost of the proposal in the present and next financial years is budgeted at £350m (2003-04), £230m (2004-05), £235m (2005-06); however, a range of other details remain to be specified in full proposals to be published in the coming months, including the “extent of any incentives for contributions into the CTF”.<sup>134</sup> The actual accounts for individual children will not be in place until 2005.<sup>135</sup>

59. The announcement has aroused expectations and questions from the public which cannot yet be resolved. How are the funds already being set aside going to be managed before the actual accounts come on stream? Will they attract some form of interest? Can sums be added to the Funds before the accounts come on stream? One of our expert witnesses suggested that it might in practice have been helpful “to have seen a little more of the detail before [the initiative] was actually formally launched”.<sup>136</sup> The proposal is not a new one, and has been under consideration by the Treasury since early in 2001. The Government indicated in the Budget documentation that the announcements followed “extensive consultation”,<sup>137</sup> and had indicated in the Pre-Budget Report 2002 that it would “consult further with key stakeholders on the detailed implementation of the Child Trust Fund”. **We may wish to examine these proposals further when particulars of the Child Trust Funds are more clearly defined.**

## Regional and local variations in pay

60. In his Budget statement, the Chancellor announced:

“...the British economy is now better placed to recognise local and regional conditions in pay... In future, therefore, we plan regional price indexes showing differences in regional inflation rates; remits for pay review bodies and for public sector workers, including the civil service, will include a stronger local and regional dimension.”<sup>138</sup>

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<sup>133</sup> HM Treasury, Budget Report 2003, paras 5.61–5.63; Budget Press Notice 03

<sup>134</sup> HM Treasury, Budget Report 2003, Table A.1; the higher sum for 2003–04 compared to later years reflects the provision for the liability for children born between September 2002 and March 2003, so that FY 2003–04 is bearing the cost for 19 months.

<sup>135</sup> Q 224

<sup>136</sup> Q 75

<sup>137</sup> *Savings and assets for all* HM Treasury April 2001; *Delivering Savings and Assets* HM Treasury November 2001; see *Pre-Budget Report 2002* (Cm 5664, para 5.59).

<sup>138</sup> HC Deb, 9 April 2003, col 283

This followed comments on regional pay issues in the Spending Review 2002,<sup>139</sup> with the subsequent publication of a Treasury study on the public sector labour market,<sup>140</sup> and in the Pre-Budget Report 2002.<sup>141</sup> The initial work on the preparation of regional price indices is to be done by Mr Christopher Allsop later this year, on completion of his term of office on the Monetary Policy Committee.<sup>142</sup> At present, most public service pay is based on national pay rates, though Treasury officials indicated that there were some exceptions, for example in the Prison Service and in the way local government pay is determined,<sup>143</sup> and there are a number of additional payments related to the extra costs of living in London or the south-east.<sup>144</sup> Mr Weale thought that in principle the move towards greater regional variation made sense, noting that “if you want to have public sector workers in London then you have to be prepared to pay what they cost and if you do not do that you keep hearing about shortages and so on”.<sup>145</sup>

61. The concern is that if pay rates in some areas—typically, the existing low pay areas—were effectively reduced then this could lead to an increase rather than a decrease in the economic disparities between better and worse off areas.<sup>146</sup> This could occur both directly because of the lower pay rates and indirectly if the relative unattractiveness of rates in the lower paid areas encouraged an exodus of the better qualified public sector workers to other areas. The Chancellor emphasised that the proposal was directed at the need to address the problems of recruitment and retention in London and the south-east, not to lower rates in other areas. He added that other government initiatives—in particular the new tax credits—provided security against problems of low pay,<sup>147</sup> and that there was no intention to bring to an end national pay bargaining.<sup>148</sup> Both Mr Weale and Treasury officials observed that, if a regional or local pay rate in one area correctly reflected the difference in the cost of living over another area, then by definition the standards of living of the people receiving those rates in the different areas would be the same.<sup>149</sup>

62. A further issue is that of the relationship between differing pay rates and the way in which the funding received by the relevant public sector employer is determined. It was suggested for example that if hospitals were to have different labour costs then this would have implications for whether it would be right to have nationally-set tariffs for payments to hospital trusts for specific kinds of services. For the Treasury, Mr Sharples accepted that these were “issues that will need to be worked through and considered...”.<sup>150</sup>

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<sup>139</sup> Cm 5570 (see para 27.4)

<sup>140</sup> *Cross-Cutting Review of the Public Sector Labour Market*, HM Treasury, November 2002 (Chapter 6 deals with regional variations in pay)

<sup>141</sup> Cm 5664, HM Treasury, November 2002, Box 6.2

<sup>142</sup> Qq 250–252, 418–419

<sup>143</sup> Q 270

<sup>144</sup> Differing rates can occur also in the devolved jurisdictions where the service concerned is a devolved matter Qq 271–276; further information is given in chapter 6 of the Treasury’s *Cross-Cutting Review of the Public Sector Labour Market*, November 2002

<sup>145</sup> Q 60; see also Q 59 [Mr Whiting]

<sup>146</sup> The Treasury shares with the Office of the Deputy Prime Minister and the Department of Trade and Industry a joint Public Service Agreement to “make sustainable improvements in the economic performance of all English regions and over the long term reduce the persistent gap in growth rates between the regions...” (Cm. 5571 p 35).

<sup>147</sup> Q 418

<sup>148</sup> Q 422

<sup>149</sup> Q 62; Q 280 [Mr O’Donnell]

<sup>150</sup> Q 262

63. Treasury officials indicated that the intention was to alter the remit of the relevant negotiators and pay review bodies for the discussions in the coming autumn, in time for the next round of pay awards.<sup>151</sup> We suggest that **the inclusion of a stronger local and regional dimension into the remit for public sector pay negotiations should proceed with the consideration of the associated issues such as the formulation of the price indices required to underpin the exercise, the risk of reducing demand in low pay areas, the danger of limiting the switch of public sector jobs from London and the South-East, and the consequences of the devolution of responsibility for some public sector pay to devolved administrations.**

## Tax credits

64. As part of the Government's reforms of the tax and benefit system to guarantee decent family incomes and tackle child poverty, the 2002 Budget introduced two new tax credits for families and those on low incomes to be paid from April 2003:

- Child Tax Credit, available to nine out of ten families with children, which replaces the child elements of the Working Families' Tax Credit, the Disabled Person's Tax Credit, Income Support or Jobseeker's Allowance, and the Children's Tax Credit; and
- Working Tax Credit, which replaces the adult elements of the Working Families' Tax Credit, the Disabled Person's Tax Credit and New Deal 50+ Employment Credit.<sup>152</sup>

65. Around 5.75 million families with children are expected to benefit from the Child Tax Credit. The Budget documentation notes that the Inland Revenue had received over 3.9 million claims for Child Tax Credit and that "for those who have not yet claimed, claims can be backdated for up to three months, so families will receive their full entitlement provided they claim before 6 July 2003. People can call the tax credits freephone response line ...to request a claim pack, or can log on to the tax credits website...which enables families to calculate their entitlement and make a claim online."<sup>153</sup>

66. The Budget documentation also notes that "to ensure that families understand the changes and claim what they are entitled to the Government has:

- issued claim forms to all recipients of existing tax credits;
- launched a £12 million nationwide awareness campaign, involving national television advertising, supported by radio, press and online publicity ...;
- worked with intermediary organisations, such as Citizens Advice, the Child Poverty Action Group and the National Council for One Parent Families, to provide information, training and support to help them communicate with their client groups;

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<sup>151</sup> Qq 267-269

<sup>152</sup> HM Treasury, Budget Report 2003, page 90, para 4.36, and page 106, para 5.18

<sup>153</sup> HM Treasury, Budget Report 2003, page 106, para 5.18

- held a series of tax credit road-shows throughout the country and hosted seminars aimed at particular groups, such as employers and those who work with students or people with disabilities; and
- initiated two four month pilot projects to communicate information on the new tax credits to those with whom the Government currently has little or no contact....”<sup>154</sup>

67. We asked the Treasury about reported delays in the payment of the new tax credits and problems with the helpline. The Treasury told us that about two-thirds of the applicants for tax credits had chosen to be paid four-weekly and would receive their first payment by 2 May 2003. Those who were to be paid weekly should all have received their first payment by 14 April 2003, unless there was some problem with the individual application, and about one million people had received their new tax credit payments.<sup>155</sup>

68. The Treasury could not tell us how many people who were due to be paid tax credits weekly had not been paid, but believed that the great majority had received their payment. However, the Treasury admitted that “we have slightly added to people’s sense of unease in this because we were hopeful that significant numbers of the weekly recipients would get their money last week, we were trying to stagger the first pay-out in order that if problems cropped up we would be able to roll with it, and that is exactly what happened. Some people therefore had an award notice saying they would be paid on 8 or 9 April and they will not have got it until 10 or 11 or today [14 April]. That is what has fed the impression that something was wrong.”<sup>156</sup>

69. In a statement to the House on 28 April 2003 the Paymaster General said that the Inland Revenue had received more than 4 million applications for the new tax credits and that an additional 1.3 million families on income support and jobseeker’s allowance, who were already benefiting from the increased level of support, would be transferred automatically from April 2004 to the child tax credit. More than 1 million families had chosen to be paid weekly and most of those were then in their fourth week of payment. However, two thirds of families had asked to be paid monthly, and one of the facts that the helpline had consistently had to confirm was that the earliest date for the first monthly payment was 28 April 2003.<sup>157</sup> The Paymaster General stated that:

“The Inland Revenue informed families that they should claim their tax credits by 31 January, so that their awards could be set up in good time for the payment of tax credits to start in April. I have to tell the House that nearly 1 million claims have been received in March. Those claims are being processed as fast as possible by the Inland Revenue, which is prioritising people who have asked to be paid weekly and those families who claimed working families tax credit.

Some Members have also raised with me instances of families who did not receive their money when they expected it, particularly those who had claimed credits before

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<sup>154</sup> HM Treasury, Budget Report 2003, page 106, para 5.19

<sup>155</sup> Qq 245, 246

<sup>156</sup> Q 247

<sup>157</sup> HC Deb, 28 April 2003, cols 53 and 54

31 January but had not received their award notice or payment. I apologise for the difficulties experienced by individual families, and I can assure the House that the Revenue is doing all that it can to put things right. The Revenue has now contacted almost all those families, and the vast majority of them are already receiving payment. It is our intention that anyone who has made a complete application and has yet to receive money will do so by the end of this week, and arrangements are in place to make interim payments to people where necessary. ...”<sup>158</sup>

70. The Paymaster General also said “with regard to compensation ... if there are circumstances in which people did not receive the service that they were entitled to expect I shall certainly look very closely at that”.<sup>159</sup>

**71. We recognise the scale and importance of the reforms of the tax and benefit system that the new tax credits represent. Child Tax Credit is available to nine out of ten families with children. The Working Tax Credit provides support to low paid workers without children. However, we note with concern the difficulties, acknowledged by the Paymaster General, being experienced by applicants for the new tax credits. It is simply unacceptable that some families that had submitted their claim for tax credits by 31 January, as requested by the Inland Revenue, had not received their award notice or payment by the start of the scheme in April.**

**72. It appears that some families did not receive their money when they expected to and this may have been due to confusion about the date of the first monthly payments. However, we note the Treasury’s evidence that some weekly recipients had received an award notice saying that they would be paid on 8 or 9 April, when the money would not be received until 10, 11 or 14 April. We are concerned that in these cases inaccurate and confusing information has been issued to the public about the payment of tax credits.**

**73. We welcome the Paymaster General’s assurance that arrangements are in place to make interim payments to people where necessary and to look very closely at the question of compensation for people who did not receive the service that they were entitled to expect. We plan to follow up these matters when the Treasury Subcommittee takes evidence from the Inland Revenue on its expenditure plans.**

74. A telephone helpline to handle inquiries about the two new tax credits was set up in August 2002. The helpline received some 1.2 million calls in February 2003 and over 2.4 million calls in March 2003, the latest months for which figures were available.<sup>160</sup> The Paymaster General noted that “one of the biggest issues about the helpline has been the huge volume of calls, which has frustrated some claimants and prevented them from making contact”.<sup>161</sup> In response, Inland Revenue increased the number of staff to provide advice on the helpline from 2,000 to 2,700. The Treasury told us that “there is here ... a peak loading problem, you cannot just take on and train up people for a very brief period when the tax credits are launched, we do some sculpting so that you are ready to react. You will not get it exactly right. If there had been no problem at all we would have been open to

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<sup>158</sup> HC Deb, 28 April 2003, col 54

<sup>159</sup> HC Deb, 28 April 2003, col 57

<sup>160</sup> HC Deb, 28 April 2003, col 171w

<sup>161</sup> HC Deb, 28 April 2003, col 64

criticism that we over-padded or over-engineered the system. I do not pretend we were expecting to be in such difficulty as we have been over the past week. The Revenue have put in 700 more people for the helpline today [14 April]”.<sup>162</sup>

**75. The Inland Revenue appears to have seriously underestimated the volume of calls to the tax credits helpline as the April implementation date approached, and the service suffered accordingly. We note the similarities of this case to that of the 2001 Census helpline on which we reported in March 2002.<sup>163</sup> As in that case, we consider that the number of calls received by the Revenue on their helpline suggests a need for the Revenue to review their communications campaign and the nature and volume of calls received on the helpline to determine what can be done to reduce the level of help sought by the public in similar situations in the future.**

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<sup>162</sup> Q 248

<sup>163</sup> Treasury Committee, First Report of Session 2001–02, *The 2001 Census in England and Wales*, HC 310

## Conclusions and recommendations

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### ***Announcement of Budget date***

1. We reiterate our view that, in the interests of openness, it is important for the Chancellor to announce the Budget statement as far in advance as possible (at least two months). While we recognise that the Iraq war may have made the process difficult this year, the amount of notice given should not be allowed to set a precedent for future years. (Paragraph 5)

### ***The economy: the recent past***

2. As the OECD recently highlighted, “the UK economy has so far shown greater resilience in weathering the downturn than any other major European economy”. In spite of undershooting the Treasury’s growth forecast in the Budget 2002, in achieving growth of 1.8% in 2002 the UK economy performed better than most of its eurozone counterparts. (Paragraph 6)
3. The fall in business investment in 2002–03, if it was sustained, would be of particular concern given its potential impact on UK productivity. (Paragraph 7)
4. The Committee considers that an assessment of the success of [the] individual measures [in this and earlier Budgets] in contributing to improved productivity would be valuable. (Paragraph 8)
5. We note that the imbalances between domestic consumption and other parts of the economy in the UK continued [since the time of the 2002 Pre-Budget Report], although since the end of the first quarter of 2002 there is some evidence of a slowdown in domestic consumption. (Paragraph 9)
6. The MPC has so far been successful in maintaining inflation within its stated target range, avoiding both the traditional UK problem of excessive inflation and the current problem in some other economies of deflationary conditions, of which Japan is the most severe example. (Paragraph 11)

### ***The inflation target: RPI and HICP***

7. We note the Treasury’s intention to continue to examine the detailed implications of a change to using the Harmonised Index of Consumer Prices (HICP) as the measure of domestic inflation targeted by the Bank of England. We note that this would bring the UK into line with the European Central Bank, which targets eurozone inflation based on the HICP. We further note that such a change could have implications for wage settlements and the uprating of benefits linked to inflation. It would also require a translation of the inflation target. We recommend that the Treasury publish a formal review of the implications of a change to the HICP by the time of the Pre-Budget Report 2003. (Paragraph 12)

### ***Outlook for the economy and forecasts***

8. The potential impact on the broader economy of the current weak state of many pension funds is a serious issue that does not yet seem to have received the attention it deserves, even if the stock market recovery were to continue to the point that the current problem with deficits was resolved. We recommend that the Treasury should co-ordinate with relevant bodies the publication of aggregate data to enable the issue to be more readily quantified and assessed. (Paragraph 17)
9. The Committee recognises that the international circumstances in which the Budget forecasts were constructed were unusually uncertain as a result of the Iraqi conflict, but observes that the Treasury's forecasts for 2004 are notably more optimistic than those of a wide range of other forecasting bodies. It is important to maintain the credibility of the economic assessment underpinning Treasury forecasts for the public finances. The Committee recommends that in these circumstances it would be helpful for the Treasury to publish supporting technical studies to explain the basis of its forecasts, as the Bank of England does with its Quarterly Bulletin. (Paragraph 21)
10. To reinforce the Treasury's reputation in the area of economic forecasting, the Committee recommends that the Treasury should consider commissioning a technical review of its forecasting procedures, as has usefully been done by the Bank of England. (Paragraph 24)

### ***Public finances: growth assumptions***

11. We note that the growth assumption underlying the public finances is 3.25% in 2004–05, which is the mid-point, rather than the bottom end, of the Treasury's forecast ranges for growth in 2004 and 2005. We ask the Treasury to clarify whether this is a departure from their previously stated policy of using the bottom end of the forecast range for growth, in projections of the public finances, and to give in more detail the basis of their calculation. (Paragraph 26)
12. We ask the Treasury to clarify the trend growth rate used to estimate the path of the output gap in each year from 2000–01 to 2007–08 and to provide justification for their approach. (Paragraph 27)

### ***Tax receipts***

13. Even though the Treasury is adhering to cautious underlying assumptions about the equity market over the next few years, it nevertheless forecasts a strong recovery in corporation tax revenues. This implies a far sharper recovery in corporate profitability than is currently envisaged by independent forecasters. (Paragraph 34)
14. The Committee concludes that the spread of risks around the Treasury's revenue assumptions, particularly in 2004–2005 and beyond, is skewed downwards. To be fulfilled, the Treasury's forecasts require not just a sharp rebound in overall economic activity but also a rapid recovery in the prosperity of the City of London. At a time of significant structural change in financial markets and the financial

services industry, there is a risk that profitability and tax revenues will not recover as rapidly as the Treasury suggests. (Paragraph 36)

15. While recognising the need to preserve confidentiality in tax matters, the Committee feels that it would boost transparency and better inform the policy debate if the Treasury published its revenue projections in greater detail. We ask the Treasury to consider if it is possible to publish revenue projections and past data for broad areas of the economy, such as for the financial sector, the manufacturing sector and the services sector, without threatening confidentiality. This would greatly aid transparency and permit a much clearer assessment of official revenue projections. (Paragraph 38)

### ***Public expenditure***

16. The full amount of the £3 billion contingency provision relating to the cost of Iraqi operations has been allocated to 2002–03. Adjusting for this unanticipated item, overall spending has come in very close to plan. We note, however, the over-run in current spending in 2002–03 and would welcome an explanation as to how this occurred. (Paragraph 40)
17. The Committee recommends closer monitoring of the planned expansion in public investment, particularly in the case of local authorities and public corporations. In the light of substantial underspending by government departments, local authorities and public corporations of money budgeted for investment in recent years, the Committee recommends an investigation of the reasons for this inability to adhere to investment programmes with a view to correcting either investment planning or means of delivery this year and in future years. (Paragraph 41)
18. We note that by historic standards and by comparison to competitors the UK public sector has a record of low capital expenditure, but we also note that future increases in capital spending must be efficiently and effectively managed. (Paragraph 42)
19. The lack of any publicly available detailed assessment of the overall economic and welfare impact of public sector net investment is striking. Without such information, it is very difficult to take an informed view of what the appropriate level of public investment is. (Paragraph 43)
20. [The recent] dramatic fluctuations in public sector net investment militate against the efficient delivery of a sound public sector infrastructure. We believe that it might help to deliver a smoother, more efficient flow of public sector investment spending if the Treasury adopted an explicit target range for public sector net investment as a per cent of GDP over the economic cycle. (Paragraph 44)

### ***Borrowing and the 'golden rule'***

21. The Chancellor is on course to meet the golden rule during the current cycle. However, on the central case the estimated surplus has fallen from £46 billion to £32 billion since November 2002. The margin for error around the Government's fiscal

position in the current cycle has narrowed from the forecasts in Budget 2002 and the Pre-Budget Report 2002. (Paragraph 49)

22. The golden rule has survived recent global shocks relatively well, thanks to the large surplus built up in the early years of the current cycle. As we move into the latter half of the current cycle, we await with interest the Treasury's views on the public finances over the next cycle. (Paragraph 51)

### ***Protecting tax receipts***

23. The Committee welcomes the C and AG's recommendation and suggests that a clear assessment should be published each year of the actual impact on receipts of any revenue protection measures announced in the previous year's Budget. This assessment should be audited by the NAO. It would provide a clearer framework for assessing both the impact of recent revenue protection moves and the likely gains from any further revenue protection moves in the future. (Paragraph 54)

### ***Stamp duty on commercial leases***

24. The Committee notes that tax avoidance in the property market is an important issue for the authorities to address. We recommend that the proposed consultation process focusing on the reform of the stamp duty treatment of commercial leases should be allied to a wider ranging review of the taxation of commercial property transactions. In this context we note the current consultation on stamp duty and await its outcome with interest. (Paragraph 57)

### ***Child Trust Funds***

25. We may wish to examine these proposals further when particulars of the Child Trust Funds are more clearly defined. (Paragraph 59)

### ***Regional and local variations in pay***

26. The inclusion of a stronger local and regional dimension into the remit for public sector pay negotiations should proceed with the consideration of the associated issues such as the formulation of the price indices required to underpin the exercise, the risk of reducing demand in low pay areas, the danger of limiting the switch of public sector jobs from London and the South-East, and the consequences of the devolution of responsibility for some public sector pay to devolved administrations. (Paragraph 63)

### ***Tax credits***

27. We recognise the scale and importance of the reforms of the tax and benefit system that the new tax credits represent. Child Tax Credit is available to nine out of ten families with children. The Working Tax Credit provides support to low paid workers without children. However, we note with concern the difficulties, acknowledged by the Paymaster General, being experienced by applicants for the

new tax credits. It is simply unacceptable that some families that had submitted their claim for tax credits by 31 January, as requested by the Inland Revenue, had not received their award notice or payment by the start of the scheme in April. (Paragraph 71)

28. It appears that some families did not receive their money when they expected to and this may have been due to confusion about the date of the first monthly payments. However, we note the Treasury's evidence that some weekly recipients had received an award notice saying that they would be paid on 8 or 9 April, when the money would not be received until 10, 11 or 14 April. We are concerned that in these cases inaccurate and confusing information has been issued to the public about the payment of tax credits. (Paragraph 72)
29. We welcome the Paymaster General's assurance that arrangements are in place to make interim payments to people where necessary and to look very closely at the question of compensation for people who did not receive the service that they were entitled to expect. We plan to follow up these matters when the Treasury Subcommittee takes evidence from the Inland Revenue on its expenditure plans. (Paragraph 73)
30. The Inland Revenue appears to have seriously underestimated the volume of calls to the tax credits helpline as the April implementation date approached, and the service suffered accordingly. We note the similarities of this case to that of the 2001 Census helpline on which we reported in March 2002. As in that case, we consider that the number of calls received by the Revenue on their helpline suggests a need for the Revenue to review their communications campaign and the nature and volume of calls received on the helpline to determine what can be done to reduce the level of help sought by the public in similar situations in the future. (Paragraph 75)

## Formal minutes

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**Tuesday 13 May 2003**

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard

Mr Jim Cousins

Angela Eagle

Mr Michael Fallon

Norman Lamb

Mr George Mudie

Dr Nick Palmer

Mr James Plaskitt

Mr Andrew Tyrie

The Committee deliberated.

Mr Michael Fallon, Dr Nick Palmer and Mr Andrew Tyrie declared pecuniary interests in relation to the consideration of stamp duty on property and would accordingly withdraw from consideration of the relevant section of the draft report on The 2003 Budget.

Draft Report [The 2003 Budget] proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 5 read and agreed to.

Paragraphs 6 and 7 read, amended and agreed to.

A paragraph—(*Mr Nigel Beard*)—brought up, read the first and second time, and inserted (now paragraph 8).

Paragraphs 8 to 11 read, amended and agreed to (now paragraphs 9 to 12).

Paragraph 12 read and agreed to (now paragraph 13).

Paragraph 13 read, amended and agreed to (now paragraph 14).

Paragraph 14 read and agreed to (now paragraph 15).

Paragraphs 15 and 16 read, amended and agreed to (now paragraphs 16 and 17).

Paragraphs 17 to 19 read and agreed to (now paragraphs 18 to 20).

Paragraph 20 read, amended and agreed to (now paragraph 21).

Paragraph 21 read and disagreed to.

Paragraphs 22 and 23 read and agreed to.

Paragraph 24 read, amended and agreed to.

Paragraphs 25 to 29 read and agreed to.

Paragraph 30 read, amended and agreed to.

Paragraphs 31 to 33 read and agreed to.

Paragraph 34 read, amended and agreed to.

Paragraph 35 read and agreed to.

Paragraph 36 read, amended and agreed to.

Paragraph 37 read and agreed to.

Paragraph 38 read, amended and agreed to.

Paragraph 39 read as follows:

**“In view of the sharp shortfall in tax revenues relative to initial Treasury expectations in 2002-03, the Treasury should undertake and publish an assessment of the comparative predictive power of the two approaches, top-down and bottom-up, to predicting tax revenues. It may well be that one approach is superior in the near term but that the other offers more reliable forecasts of likely tax receipts in the medium term.”**

Paragraph disagreed to.

Paragraph 40 read and agreed to (now paragraph 39).

Paragraphs 41 to 44 read, amended and agreed to (now paragraphs 40 to 43).

Paragraph 45 read and agreed to (now paragraph 44).

A paragraph—(*Mr George Mudie*)—brought up, read the first and second time, and inserted (now paragraph 45).

Paragraphs 46 to 49 read, amended and agreed to.

Paragraph 50 read and agreed to.

Paragraph 51 read, amended and agreed to.

Paragraphs 52 to 55 read and agreed to.

Paragraph 57 read, amended and agreed to.

Paragraph 58 read and agreed to.

Paragraph 59 read, amended and agreed to.

Paragraph 60 read as follows:

“The purpose of the CTF is to contribute towards the Government’s commitment to “strengthening the saving habit of future generations and ensuring that all children have a stake in the wealth of the nation”. Clearly, one of the major factors in determining whether

the Funds will be effective in encouraging saving overall is the extent to which there will be tax or other incentives for adding to the Funds, although even then there is the possibility that the money invested could just displace money which would have been placed in some other savings vehicle. Arguably, even if there is encouragement for others to add to a Fund, this will not in itself necessarily encourage the child or young person concerned to save. The lack of restriction on what the fundholder may do with the money on his or her 18th birthday may be realistic (since, as one witness pointed out, it would be very difficult to police how the money is spent) but provides no guarantee as to whether it will promote a savings habit. We note speculation that it might be possible to limit any tax advantages enjoyed by additions to a Fund to a requirement to use the funds for a public interest purpose such as education. **It would be premature to judge whether the proposals for Child Trust Funds are likely to reach the objectives set—in particular how far the scheme will promote a savings habit—before the more detailed proposals are available. We may wish to return to the proposals in a subsequent Pre-Budget or Budget report.”**

Paragraph disagreed to.

Paragraphs 61 to 63 read and agreed to (now paragraphs 60 to 62).

Paragraph 64 read, amended and agreed to (now paragraph 63).

Paragraphs 65 to 71 read and agreed to (now paragraphs 64 to 70).

Paragraph 72 read, amended and agreed to (now paragraph 71).

Paragraphs 73 to 76 read and agreed to (now paragraphs 72 to 75).

Summary read, amended and agreed to.

*Resolved*, That the Report be the Seventh Report of the Committee to the House.

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

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

*Ordered*, That the Appendices to the Minutes of Evidence be reported to the House—(*The Chairman*)

[Adjourned till Monday 16 June at 4.15 pm

## Witnesses

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(See Volume II)

### Monday 14 April 2003

[Morning sitting]

Page

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

Ev 1

**Mr Robert Chote**, Institute for Fiscal Studies, **Ms Mary O'Mahoney**, National Institute of Economic and Social Research, **Mr Martin Weale**, National Institute of Economic and Social Research, and **Mr John Whiting**, PricewaterhouseCoopers

Ev 24

[Afternoon sitting]

HM TREASURY

**Mr Gus O'Donnell**, Permanent Secretary, **Mr Jon Cunliffe**, Managing Director, Macroeconomic Policy & International Finance, **Mr Nicholas Holgate**, Director of Welfare Reform, **Mr Adam Sharples**, Director, Public Spending, **Mr John Kingman**, Director, Enterprise and Growth Unit, and **Mr Andrew Lewis**, Head of Tax Policy Team

Ev 32

### Wednesday 30 April

HM TREASURY

**Rt Hon Gordon Brown MP**, Chancellor of the Exchequer, **Mr Gus O'Donnell**, Permanent Secretary, **Mr Ed Balls**, Chief Economic Adviser, and **Mr Adam Sharples**, Director of Public Spending

Ev 50

## List of written evidence

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(See Volume II)

|   |   |       |
|---|---|-------|
| 1 | Professor Peter Spencer, University of York                         | Ev 1  |
| 2 | Mr David Walton, Goldman Sachs                                      | Ev 3  |
| 3 | Mr Martin Weale, National Institute of Economic and Social Research | Ev 7  |
| 4 | Mr John Whiting, PricewaterhouseCoopers                             | Ev 19 |

## List of appendices

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(See Volume II)

|   |  |       |
|---|--|-------|
| 1 | The British Property Federation                | Ev 71 |
| 2 | The Centre for Economics and Business Research | Ev 72 |
| 3 | The CBI  | Ev 75 |
| 4 | Further memorandum from the CBI                | Ev 81 |
| 5 | Professor David Heald, University of Aberdeen  | Ev 89 |
| 6 | The Institute of Directors                     | Ev 91 |
| 7 | HM Treasury                                    | Ev 92 |

## List of Reports from the Treasury Committee since 2001

---

### Session 2002–03

|               |   |  |
|---------------|---|--|
| First Report  | National Statistics: The Classification of Network Rail<br><i>Response: Second Special Report</i> | HC (2002–03) 154<br>HC (2002–03) 550   |
| Second Report | The 2002 Pre-Budget Report<br><i>Response: Third Special Report</i>                               | HC (2002–03) 159<br>HC (2002–03) 528   |
| Third Report  | Split Capital Investment Trusts<br><i>Response: Fourth Special Report</i>                         | HC (2002–03) 418–I<br>HC (2002–03) 651 |
| Fourth Report | The Handling of the Joint Inland Revenue/Customs<br>and Excise PFI Project                        | HC (2002–03) 184                       |
| Fifth Report  | Annual Report for 2002  | HC (2002–03) 491                       |
| Sixth Report  | The UK and the Euro   | HC (2002–03) 187–I                     |

### Session 2001–02

|                |   |                                       |
|----------------|---|---------------------------------------|
| First Report   | The 2001 Census in England and Wales<br><i>Response: Ninth Special Report</i>   | HC (2001–02) 310<br>HC (2001–02) 852  |
| Second Report  | Budget 2002<br><i>Response: Tenth Special Report</i>  | HC (2001–02) 780<br>HC (2001–02) 1075 |
| Third Report   | The Office of Government Commerce<br><i>Response: Eleventh Special Report</i>   | HC (2001–02) 851<br>HC (2001–02) 1217 |
| Fourth Report  | Appointment to the Monetary Policy Committee<br>of the Bank of England of Mr Paul Tucker and<br>Ms Marian Bell                | HC (2001–02) 880                      |
| Fifth Report   | Banking, the Consumer and Small Businesses<br><i>Response: Twelfth Special Report</i>   | HC (2001–02) 818<br>HC (2001–02) 1218 |
| Sixth Report   | The Financial Regulation of Public Limited<br>Companies<br><i>Response: Thirteenth Special Report</i>                         | HC (2001–02) 758<br>HC (2001–02) 1219 |
| Seventh Report | Parliamentary Accountability of Departments<br><i>Response: First Special Report [Session 2002–03]</i>                        | HC (2001–02) 340<br>HC (2002–03) 149  |
| Eighth Report  | Inland Revenue: Self Assessment Systems<br><i>Response: Fourteenth Special Report</i>   | HC (2001–02) 681<br>HC (2001–02) 1220 |
| Ninth Report   | Appointment of Sir Andrew Large as a Deputy<br>Governor of the Bank of England and Member<br>of the Monetary Policy Committee | HC (2001–02) 1189                     |