



House of Commons  
Treasury Committee

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# Government Response to the Committee's Third Report on The 2003 Pre-Budget Report (HC 136)

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Third Special Report  
of Session 2003–04

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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*)  
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The following Member was also a member of the Committee during this inquiry:  
Mr David Ruffley MP (*Conservative, Bury St Edmunds*)

### 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).

### Contacts

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# Third Special Report

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On 21 January 2004, we published our Third Report, *The 2003 Pre-Budget Report*, as House of Commons paper No. 136. We have now received a response from the Government (dated 17 March 2004) which is appended below.

## APPENDIX: MEMORANDUM FROM HM TREASURY

The Government notes the conclusions of the Treasury Committee's report on the 2003 Pre-Budget Report.

### The Pre-Budget Report

**1. We regret this omission [of a debate on the Pre-Budget Report], given that transparency and openness demand that government financial statements like the Pre-Budget Report should be subject to parliamentary scrutiny in the Chamber of the House of Commons. We reiterate our recommendation that every year the House should hold a half or full day's debate on the Pre-Budget Report. (Paragraph 3)**

As the Government set out in its response to the Treasury Select Committee's report on the 2002 Pre-Budget Report, the programming of business and allocation of parliamentary time is a matter for the business managers, acting in close consultation with other parties in the House through the usual channels. Parliamentary time is a scarce commodity and there are usually several competing demands for slots on the Floor of the House, especially either side of the Christmas recess. The Government will consider the need for a debate on future Pre-Budget Reports in the light of the circumstances prevailing at the time.

**2. We can only repeat our view that as much notice as possible for the Budget date is desirable and we therefore urge the Government to regard the 2002 practice — of at least 2 months' advance notice — to be at least a working target. Advance notice for the Pre-Budget Report is also helpful. The announcement of the date for this year's Pre-Budget report and statement was made during oral Question Time on Thursday 13 November, less than one month before the statement. We believe that the same arguments hold for advance notice for the Pre-Budget Report as for the Budget. (Paragraph 4)**

On 29 January the Chancellor announced on the floor of the House of Commons that Budget 2004 would be on 17 March, thereby providing seven weeks advance notice. As the Government set out in its response to the Treasury Select Committee's report on the 2003 Budget, it will announce the date of the Budget (and Pre-Budget Report) at the earliest convenient opportunity. However, it may not prove possible to give two months notice.

## The economy: the recent past

**3. We note the European Commission's comment that "the UK economy weathered the recent global slowdown well". This is particularly notable in the face of the continued weakness in activity in its major trading partners in the euro area. (Paragraph 5)**

In recent years, the domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well in a challenging global economic environment. Strong economic fundamentals and proactive monetary policy have supported private consumption, and fiscal policy has also supported demand, with sound public finances allowing counter-cyclical action through the operation of the automatic stabilisers.

**4. The Committee is concerned that the recent fall in the dollar may jeopardise global recovery prospects, although some of the evidence we received on this point was generally reassuring (Paragraph 6)**

Box A2 of the Pre-Budget Report highlights the danger posed by large global imbalances. It pointed out that a sharp fall in the value of the US dollar could have significant implications for growth in those economies that are dependent on US trade, and might also hit US domestic demand by pushing up long-term interest rates and reducing household purchasing power. Similarly, paragraph A16 notes that "sudden sharp movements" in major exchange rates pose a threat to the Pre-Budget Report forecasts for the world economy. Excess volatility and disorderly movements can dent confidence and hurt financial markets.

While the dollar has continued to decline steadily since the Pre-Budget Report was published, notably against the euro, so far this development has coincided with a general improvement in financial conditions – rising equity markets, narrowing corporate spreads and falling or steady long-term interest rates—and rising confidence across the world's major economies. As a result, global growth has continued to gather strength.

Nevertheless, global current account imbalances remain a threat to the medium term sustainability of this recovery. It is important that policy makers in all major economies continue to focus their attention on the underlying cause of these positions – imbalances in growth. This is why the Chancellor continues to press for policies that will foster more balanced medium term growth among the world's major economies, in particular structural reforms in Europe, which can raise potential growth rates and increase resilience to shocks. The 7 February 2004 Statement of G7 Finance Ministers and Central Bank Governors reiterated the importance of supply side structural policies that increase flexibility and raise productivity growth and employment. It noted that this Agenda for Growth initiative and sound medium term fiscal policies are key to addressing global imbalances.

**5. In spite of a rather disappointing trend in fixed investment and exports, current estimates of UK economic growth in 2003 are consistent with the reduced forecast of 2–2½% growth published by the Treasury at the time of the last Budget. (Paragraph 7)**

It is inevitable that as a highly open economy the UK is substantively affected by global developments; and international uncertainties in the first half of 2003 adversely affected

investment and underlying external demand. In the circumstances, UK GDP held up well, though it grew at below trend rates. The second estimate of GDP in 2003, published by the Office for National Statistics on 25 February 2004, showed growth of 2.3 per cent for 2003 as a whole, consistent with the 2003 Budget forecast and slightly above the 2003 Pre-Budget Report estimate.

**6. Throughout a volatile period in the world economy the Committee observes that the MPC has continued successfully to maintain UK inflation close to the target laid down by the Chancellor. Moreover, while maintaining inflation inside the target range, monetary policy has also been able to provide substantial support to growth by delivering historically low short-term interest rates to the economy. (Paragraph 8)**

The Government welcomes the Committee's positive remarks on the monetary policy framework and the performance of the Monetary Policy Committee of the Bank of England. The Government notes that the average rate of RPIX inflation has fallen since the introduction of the monetary policy framework in May 1997. Between May 1979 and May 1997, average RPIX inflation was 5.9 per cent while between May 1997 and the present, average RPIX inflation was 2.4 per cent. Inflation expectations have remained anchored close to the inflation target throughout.

The Government would, however, like to make clear that that the inflation target is a symmetric, point target; the trigger points for an open letter do not constitute a target range.

**7. The successful complementarity of monetary and fiscal policy has played a key role in delivering a UK economic performance over the past few years which the IMF describes as "enviable". Key tests for both monetary and fiscal policy nevertheless lie ahead as recovery emerges. (Paragraph 9)**

See response to conclusion 8 below.

**8. As the global economy recovers it is vital that UK economic policy adapts as anticipated to the upswing, to avoid potential problems flowing from the current imbalances in the economy. (Paragraph 9)**

The frameworks for monetary and fiscal policy provide a coherent strategy for maintaining high and stable levels of growth and employment. They are designed to help achieve macroeconomic stability throughout the economic cycle.

The monetary policy framework, through its symmetric inflation target, ensures that equal weight is given to under- and over-achieving the target. The Monetary Policy Committee has raised interest rates in November and in February in response to a strengthening global economy and pick up in UK economic growth.

Similarly, setting the fiscal rules over the economic cycle allows the automatic stabilisers to work in full at times when the economy is above trend as well as times when the economy is below trend, thereby helping to smooth the path of the economy. As can be seen from Chart 2.6 of the Pre-Budget Report, as the economy returns to trend so fiscal policy is forecast to return to a more neutral position.

There are already signs that a rebalancing of UK economic growth is underway. Private consumption growth for 2003 as a whole moderated compared with rates seen in recent years. Manufacturing output has risen since the end of 2002 and business surveys point to further strengthening going forward. There is also some evidence that exports have begun to pick up. The 2003 Pre-Budget Report forecast shows a continuing rebalancing of growth as the global recovery gathers pace.

## The outlook for the economy

**9. The Treasury's economic forecasts for 2004 and beyond continue to look more optimistic than most, although the gap between the Treasury's assessment and that of most other forecasters has narrowed, with most independent forecasters now a little more optimistic about growth in 2004 than they were in the spring. (Paragraph 10)**

The Treasury's forecasting record is good. Since 1997, Treasury Pre-Budget Report forecasts for economic growth in the year ahead have, on average, outperformed the independent consensus prevailing at the time.

For example, in April 2003, the Treasury's comparison of independent forecasts showed the independent average forecast for GDP growth in 2003 was 1.9 per cent, compared with the Budget 2003 range of 2 to 2½ per cent. Moreover, the average of *new* independent forecasts at that time – those made in the most recent month – was 1.8 per cent. By August 2003, the independent average for GDP growth was 1.7 per cent in 2003, with only 11 per cent of forecasters surveyed expecting GDP growth to be within or above the Budget forecast range.

By January 2004, the independent average had risen to 2.1 per cent – consistent with both the Budget 2000 and the 2003 Pre-Budget Report forecasts, and the preliminary outturn for 2003 published by the ONS on 23 January 2004—with 50 per cent of forecasters surveyed in line with or above the Pre-Budget Report projection.

Outside forecasters projections for GDP growth in 2004 have also risen in recent months. At the time of the Budget the average of *new* independent forecasts for GDP growth in 2004 was 2.3 per cent, compared with the Budget range of 3 to 3½ per cent. In August the average still stood at 2.3 per cent, with only 8 per cent of forecasters surveyed expecting GDP growth within the Budget range. By March 2004, the independent average had increased to 3.0 per cent with the average of new forecasts at 3.1 per cent – both consistent with the Pre-Budget Report range. Moreover, a number of prominent forecasters are now within the Budget and Pre-Budget 2003 range of 3 to 3½ per cent, including the IMF, Deutsche Bank, Goldman Sachs, the ITEM Club, J P Morgan, OEF.

Indeed, over ninety per cent of all forecasters included in the Independent comparison have revised up their 2004 GDP forecasts since September 2003.

The Bank of England has also recently revised up its projections. Indeed, chart 6.1 in the February Inflation Report suggests the MPC's latest GDP growth forecasts are fully consistent with Pre-Budget Report 2003 forecasts in every year of the projection period 2004 to 2006. As the Bank state in the Inflation Report 'the four-quarter growth rate is projected to increase sharply at the beginning of 2004. Recent survey data are consistent

with a pickup in quarterly growth. Revisions to 2003Q3 and a higher expected outturn for 2003Q4 also mean that the near-term profile for GDP growth.....is somewhat stronger' (Inflation Report: February 2004, p.44).

**10. While the probability of either a fall in house prices or a rise in interest rates on a scale that would create widespread problems for households should be viewed as very limited, we think it is nevertheless important for both the Treasury and the Bank of England to consider how policies could impact on individual households whose debt servicing ratios have become unsustainable. (Paragraph 13)**

The Government is alert to the risks that households with high levels of debt are more vulnerable to any significant future adverse shocks. However, for most households debt remains affordable, with interest rates close to their lowest since the 1950s, employment at a record high and total household net wealth up over 50 per cent since 1997. Despite global uncertainty, households remain confident in their own finances.

The Government aims to provide a framework of macroeconomic stability and awareness of financial issues within which people can make informed, responsible decisions about how much debt it is prudent to incur. But the Government is also working to address the issue of over-indebtedness.

The Consumer Credit White Paper, published in December 2003, set out policy on tackling over-indebtedness, unfair lending practices and loan sharks, and the quality and quantity of information available to consumers looking for credit. There are Government initiatives to help consumers once they get into problems, such as National Debtline, which gives all consumers free, easy access to debt advice by telephone and access to debt repayment plans. The Government is also taking steps to empower consumers by improving their financial literacy. The FSA has published a preliminary paper entitled "Towards a national strategy for financial capability". A Steering Group, on which the Government is represented by the Financial Secretary to the Treasury, is informing FSA thinking on this work. This Strategy will present a co-ordinated approach for the provision of education, information and generic advice for financial services.

**11. The Committee attaches the highest importance to securing the best possible value for money in public spending. It is disappointing to note that, despite the welcome improvements to the control of public expenditure that have enhanced flexibility, many departments are still failing to manage their capital spending programmes as efficiently as they should. We recommend that the Treasury takes action to improve the planning and monitoring of public sector capital spending programmes within the financial year. We would welcome a report on any such action in the 2004 Spending Review. (Paragraph 15)**

The Government has instituted a number of reforms to improve the delivery of public sector capital programmes in recent years, including reforms to the public expenditure framework and a number of departmental-specific initiatives, and these are supporting significant improvements in public services. Building on these reforms, the Government will be examining the management of departmental investment programmes in the context of the 2004 Spending Review. As part of this process, it will consider the scope for further improvements in the framework for delivering public investment.

**12. The Committee is disappointed at the lack of progress on improving official pension fund statistics. The health of UK company pension schemes appears to be a major gap in the information flow into the Treasury's assessment of the economic outlook. Given its crucial impact on British households, we recommend that the Government show much greater urgency in ensuring the provision of regular and reliable official information on pension fund deficits. We further recommend that the Chancellor report on this issue expressly in the 2004 Budget. (Paragraph 17)**

The Treasury thanks the Committee for its interest in the complex area of pension statistics. The Government considers improving pension statistics an important issue, and established the Pension Statistics Review Committee, comprising academics, industry experts and officials. It published an action plan in October 2002, and a recent update on progress in December 2003. All work planned for 2003 has been completed.

One of the action points was to consider whether a statistical digest or fact sheet could be produced, bringing together all available pension statistics. The action points are being taken forward by the ONS, the Treasury, DWP and others. The format, content and layout of an initial pension contributions guide have been agreed by DWP and the ONS. The guide is currently being developed for publication in early 2004, and will be developed further as the quality and range of pension statistics improves.

Information has not been collected on defined benefit pension fund deficits to date. The Government is establishing a new Pensions Regulator for work-based pensions. The new body will need to collect data on a wide range of issues to support its own risk based work and the work of the Pensions Protection Fund. This will include information about the levels of funding of defined benefit occupational pension schemes. The exact form this data is collected in will depend on the nature of the funding regime for DB schemes that is introduced in the Bill, but the Pensions Regulator is likely to collect pension deficit data from April 2005.

The Treasury welcomes your suggestion for an update in the Budget. We plan to include details on the progress of the pensions statistics review.

**13. The Committee welcomes the improved transparency in recent years provided by the Treasury's explicit discussion of issues such as the output gap and the cyclical position of the UK economy. It encourages the Treasury to explore ways of further improving transparency, which may include closer involvement of outside bodies or experts in the judgements made. (Paragraph 20)**

The Treasury seeks to be transparent in its approach and positively welcomes external scrutiny. The Government is keen to take advantage of external analysis where appropriate, although in practice it is far from clear that external expertise is ahead of the Treasury. Indeed, in their 1997 Report ('Market Testing of the Treasury Forecast', 1997) KPMG Management Consulting stated that:

“[the Treasury's] detailed evaluations and discussions provide a richness of consideration that one would expect a Ministry of Economics and of Finance to conduct. It does not have

a parallel outside the Treasury....(and) this depth of analysis appears to give the Treasury an edge in forecasting accuracy.”<sup>1</sup>

**14. Although the Governor of the Bank of England has indicated that he does not think the switchover will be of major significance for monetary policy, given the focus on inflation two years ahead, we note his comments regarding the need for care in the short term in explaining the switch in the inflation target from RPIX to CPI inflation and will scrutinise the progress made in enhancing public understanding of the change. (Paragraph 25)**

The Government agrees with the Committee that care will be needed in explaining the switch in the inflation target and welcomes its intention to scrutinise the progress made in enhancing public understanding of the change. Details of the new inflation target, including the reasons for the switch in the target were set out in Chapter 2 of the 2003 Pre-Budget Report and in the letter from the Chancellor to the Governor of the Bank of England of 10 December 2003 setting out the new monetary policy remit. The paper by the Office for National Statistics, *The New Inflation target: the Statistical Perspective*, 10 December 2003, will also assist in providing detail on the measure of inflation that is now used.

## The fiscal balance

**15. The Committee accepts that the substance of the golden rule has not changed, but differences in phrasing in recent Treasury documents may have been a source of some confusion. We recommend that the presentation of the Government's progress towards meeting the golden rule should be standardised and be based on the average annual surplus of the current budget as a percentage of GDP. (Paragraph 27)**

The golden rule has been consistently defined. It is measured by the average annual surplus on the current budget as a ratio to GDP over the economic cycle. Page 10 of Budget 1997, *Equipping Britain for our long-term future*, [HC85], sets out figures for the current budget as a ratio of GDP from 1985-86 to 1996-97. Page 47 of the Economic and Fiscal Strategy Report 1998, *Stability and investment for the long term*, [Cm 3978] outlines progress against the golden rule from 1997-98 to 2003-04. Since then, the Government has continued to present performance against the golden rule on the basis of ratios to GDP.

Improving knowledge of the fiscal framework is important to building a credible fiscal policy, and while being methodologically sound, the concept of an average annual ratio expressed as a ratio to GDP can be difficult to grasp. Presenting figures in terms of billions of pounds is designed to help people understand the scale of the margin against unexpected events. That does not detract from the position that compliance with the golden rule is measured using ratios to GDP and this has been consistently the case since the rule was first introduced.

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<sup>1</sup> KPMG Management Consulting, 'Market testing the Treasury's Macroeconomic Forecasting Function' 9 May 1997, p29 and p42.

**16. The Treasury should make the role of the cautious case in the fiscal planning process through the cycle clearer in the Budget and Pre-Budget Report documentation. (Paragraph 28)**

The cautious case provides a stress test for the public finances, and therefore helps to build a margin against unexpected events into the public finances. This is supported by the use of independently audited, cautious assumptions, including the assumption for the trend rate of economic growth, which is assumed to be  $\frac{1}{4}$  of a percentage point below the neutral view. This cautious approach to projecting the public finances is central to the Government's fiscal framework. Excessive caution could, however, lead to an unnecessarily restrictive fiscal policy. When setting fiscal policy, the Government must therefore reach a judgment about the appropriate level of margin against unexpected events.

In the case of the 2003 Pre-Budget Report, the Government was able to draw on the margin it had created to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full, while remaining on track to meet the fiscal rules. The Government will continue report the reasons for its fiscal policy settings, including the appropriate degree of caution, in future Budgets and Pre-Budget Reports.

**17. We were surprised that there was no table contained in the 2003 Pre-Budget Report breaking down the changes in public sector borrowing since the previous forecast between those attributable to the automatic stabilisers, non-discretionary factors and policy decisions. We ask the Treasury to re-introduce such a table in the Budget (and future Budgets and Pre-Budget Report). (Paragraph 31)**

The Government is committed to transparency and openness and aims to provide full and complete information on the public finances. Tables 2.4 and 2.5 of the 2003 Pre-Budget Report explained the reasons for the change in projection for public sector net borrowing. Table 2.4 explained the impact of changes in the NAO audited assumptions, GDP components and other forecasting effects; Table 2.5 explained the changes by individual receipt and spending item. These tables were chosen as they were best able to explain the reasons for the change in public sector net borrowing projections. The Government will continue to show analyses on the public finances using the most informative presentation including, where appropriate, information on the automatic stabilisers.

The Treasury's 2003 Pre-Budget Report judgement on the current and future cyclical position of the economy, as measured by the path of the output gap, had changed only marginally compared with the Budget. This means that only a negligible fraction of the change in public sector net borrowing between Budget 2003 and the 2003 Pre-Budget report would have been ascribed to the automatic stabilisers. Including a table separating out the effects of the automatic stabilisers would not, therefore, have been particularly informative.

**18. While the extra borrowing envisaged since the time of the last Budget means that there is now less slack, the Government remains on track but will meet the golden rule only if its central forecasts for economic growth, tax revenues, spending, and the likely end of the current cycle are met. The Government will have to remain mindful of the**

**consequences of any further unplanned increases in borrowing arising from any shortfall in planned tax revenues. (Paragraph 35)**

The Government remains vigilant to the risks to the public finances and continues to base projections of the public finances on cautious, independently audited assumptions, including using a trend rate of economic growth  $\frac{1}{4}$  of a percentage point below the Government's neutral view. The use of a lower rate of trend growth means that the public finances are projected using the lower end rather than the centre of the range for GDP growth. On the basis of these cautious assumptions, the 2003 Pre-Budget Report projections show the Government is projected to remain on track to meet the golden rule over the economic cycle with an average surplus on the current budget of 0.2 per cent of GDP.

**19. The Committee notes that the UK's fiscal position remains comparatively strong internationally and should remain so if it strengthens as planned through economic recovery. (Paragraph 37)**

The Government welcomes the Committee's recognition of the relative performance of the UK's public finances. The latest OECD projections show that the UK had the lowest level of net debt among G7 countries in 2003, and is forecast to have net borrowing and net debt below the average for the OECD as a whole for this year and next. In addition, the analysis contained in the 2003 *Long-term public finance report* concludes that the UK is in a strong position compared to many other developed countries to meet the challenges of an ageing population.

**20. The *End of year fiscal report* should analyse the Treasury's performance in the preceding two years against its forecasting record separately for receipts, and different portions of expenditure. It should also analyse the forecasting records of previous Pre-Budget Reports. (Paragraph 38)**

The *End of year fiscal report* is designed to provide additional, retrospective information on the public finances. Chapters 3 and 4 of the Report provide analyses of the differences between forecast and outturn for individual taxes, other receipts and public expenditure components. The Government is willing to consider carefully any detailed suggestions for further analysis, but does value continuity of analysis as this facilitates comparisons over time.

The projections published in the Pre-Budget Report have a different status from those presented in the Budget. The Pre-Budget Report projections are an interim forecast update and not necessarily the outcome the Government is seeking. Given this difference in status, the Government does not believe that a full and detailed analysis of Pre-Budget Report forecasts would add significantly to the information available in the *End of year fiscal report*, which has brought the UK into line with international best practice.

## **Tax receipts**

**21. Receipts have come in weaker than expected despite growth being on target for the Treasury's forecast. The factors behind this decline in tax receipts may be structural or may be cyclical. The Treasury's projections for tax revenues up to 2008-09 suggest that**

it does not see the problem as predominantly a structural one. This is contrary to the view of some of our expert witnesses. A shortfall in expected receipts for a given level of GDP is a phenomenon that has also occurred in other countries including the USA, although compared to countries in continental Europe the UK's public finances remain in good shape. In the USA research has been undertaken into why revenues as a percentage of GDP have declined. We recommend strongly that the Treasury undertake similar research in the United Kingdom and publish it as soon as possible. (Paragraph 40)

The Government already investigates the reasons for any significant shortfalls in receipts, and publishes the results of this analysis in the *End of year fiscal report*. Chapter 3 of the Report provides a tax by tax analysis of receipts, detailing the differences between forecast and outturn and ascribing these differences to one of four categories. As in the USA much of the recent shortfall can be ascribed to changes in asset prices and the effect of distributional and other technical factors on effective tax rates.

**22. We note that the Treasury continues to project a rise in the ratio of tax receipts to GDP over the forecast horizon from 35.9% in 2003-04 to 38.2% in 2008-09. We recommend that the Treasury includes in future Budgets a discussion of the risks underlying this tax forecast. This assessment should be informed by the research we recommend the Treasury carry out at paragraph 40 above. This will be an opportunity for the Treasury to explain in more detail the assumptions on which it makes its tax forecasts. (Paragraph 42)**

A detailed commentary on all the main tax forecasts is already provided in Annex B of the Pre-Budget Report. This includes descriptions of the main reasons for and assumptions underlying the projected rise in the tax-GDP ratio. Annex B also includes a section on economic risks that could impact on the public finance projections. As suggested by the committee, the assumptions underlying the fiscal projections are largely informed by the conclusions of the *End of year fiscal report*.

**23. Since the projection forward of an improved relationship between income tax receipts and GDP in 2001, receipts have consistently come in under the Treasury's forecast. We note that the Treasury's projections of income tax receipts, which rise as a share of GDP, imply increasing numbers of people paying income tax at the higher rate. We would welcome more information on the proportion of salaries paid in annual bonuses and how the Treasury is forecasting them going forward. To improve our understanding of the 2004-05 forecasts we ask the Treasury to publish the components of the forecast in greater detail differentiating between PAYE, self-assessment, bonus payments and income at standard and higher rates. (Paragraph 46)**

There are no direct data available on the proportion of salaries paid in annual bonuses, although inferences can be made from the pattern of monthly income tax receipts data, which are available from the ONS.

Inland Revenue data on receipts from large employers suggest that most of the recent variability in the end year surges in income tax receipts associated with bonus payments stems from the financial sector. The fiscal projections assume that the strong relationship

between employee remuneration (including bonuses) and profits in the financial sector will continue in the projection period.

The Inland Revenue publishes a large amount of information on the liabilities of income tax payers and on income tax receipts, which is available on the Inland Revenue website: [http://www.inlandrevenue.gov.uk/stats/income\\_tax/index.htm](http://www.inlandrevenue.gov.uk/stats/income_tax/index.htm). The Treasury will consider publishing the components of the income tax forecast in greater detail.

**24. To improve transparency and aid the Committee and other outside observers to understand the forecasts for tax revenue, we recommend that the Treasury should publish details of how the receipts from the major taxes are forecast, including wherever possible the model used and all the economic determinants that feed into the model. (Paragraph 47)**

There are a number of examples of where the Government has published details on the methodology and models used to forecast particular taxes:

- Forecasting the public finances in the Treasury (IFS volume 19, Feb 1998);
- Eason, R. (2000) 'Modelling Corporation Tax in the United Kingdom', in: *Microsimulation in Government Policy and Forecasting, 2000*, Gupta, A. and Kapur, V (editors);
- 'Consumers' Demand and Excise Duty Receipts Equations for Alcohol, Tobacco, Petrol and Derv' Marcus J Chambers, University of Essex, November 1998, Revised August 1999. GES Working Paper No 138.

Transparency is also enhanced by the independent auditing and reporting of the key assumptions underlying the fiscal projections, including trend growth, equity prices, and oil prices. In addition, the *End of year fiscal report* provides additional information on the key drivers of projections for individual taxes, and explains how differences between forecast and outturn for the economic determinants contributes to differences between forecast and outturn for receipts.

Even if the Government made all its forecasting models available, it is unlikely that they would be of much use to other forecasters as they rely on detailed confidential information contained in tax returns. The Government will continue to include in every Budget and Pre-Budget Report an explanation of the main factors affecting changes in receipts of the major taxes.

The Government will continue to include in every Budget and Pre-Budget Report an explanation of the main factors affecting changes in receipts of the major taxes.

At the Pre-Budget Report hearing with Treasury officials on 16<sup>th</sup> December 2003 the Committee asked for a note explaining the reasons underlying the nominal increase in forecast public sector receipts between 2003–04 and 2004–05, as contained in Table B9 of the 2003 Pre-Budget Report. This is provided in the note which accompanies this response.

## Public expenditure

**25. We note that it is unusual to provide no margin at all for annual managed expenditure in future years. An explanation should be given as to why it is envisaged that, in contrast to previous practice, no AME margin is provided for the next two financial years. (Paragraph 49)**

The forecasts published in the Pre-Budget Report have a different status from those presented in the Budget. Budget 2003 contained forward projections based on the Government's definitive fiscal policy settings, and reflected the decision to reset the AME margin through to 2005/06; the Pre-Budget Report provides an interim update against those projections. In line with previous practice, the Government will re-assess the level of the AME margin in the context of Budget 2004.

**26. We note the Regulator's concern at officials' late intervention [in the access charges review]. It is essential that the allocation of public spending between capital and current expenditure is carried out in a way that reflects the substance of the spending. Government funded increases in capital expenditure on the railways must be correctly treated. We request that the Treasury provides further information and transparency in regard to the classification of current and capital spending. (Paragraph 51)**

The Government sees it as important that public support for the railways is appropriately structured and correctly classified.

The classification of public expenditure in Total Managed Expenditure as current or capital follows national accounts principles laid down in international agreements that are operated by the independent Office for National Statistics. Public expenditure that supports capital expenditure by the private sector may be current or capital depending on the mechanism used for the public sector's payments:

- grants to support investment are capital; and
- subsidies and payments for services are current, even though some of the money may fund capital expenditure.

The Rail Regulator sets the level of Network Rail's financial requirement that is funded by Network Grants from the Strategic Rail Authority (SRA) to support investment and by track access charges paid by train operating companies, who may receive subsidies from the SRA. The Rail Regulator also determines the split between these two sources of Network Rail's funds. The Rail Regulator has a duty to have regard to a number of factors including the promotion of efficiency and economy and the financial position of the SRA. Departments' resource and capital expenditure budgets are set separately in the biennial Spending Reviews.

The Government agrees that it is important for all parties to have early and open discussions.

**27. This Committee attaches the highest possible emphasis to ensuring that any increases in public expenditure are delivered efficiently and result in improved outcomes, rather than in cost inflation. The current measure of government output**

**does not adequately reflect improvements in quality and is therefore a bad measure of public sector productivity. It is absurd that a reduction in class sizes, for example, should count merely as an increase in cost and a reduction in productivity, with no account taken of any improvements in the quality of education. We welcome the Atkinson review of measures of government output, productivity and associated price indices. We note that the preliminary findings of the review are to be published by July 2004, in time to inform the 2004 Spending Review. (Paragraph 54)**

Box A4, on page 184 of the 2003 Pre-Budget Report, discussed issues surrounding the measurement of real government output in some detail.

At the Pre-Budget Report hearing with Treasury officials on 16<sup>th</sup> December 2003 the Committee asked for a Treasury response to a Goldman Sachs article on public sector cost growth. This is provided in the note which accompanies this response.

**28. In the light of the review of the measurement of government output, the Treasury should assess the extent to which any under-estimation of the real rate of growth of public sector output could affect estimates of GDP growth and the output gap. (Paragraph 55)**

The Treasury attaches a great deal of importance to the Atkinson review of the measurement of government output, and it is looking forward to the completion of the review, its conclusions and recommendations. The final report is expected in January 2005. The Treasury will then assess the findings of the review and their implications for estimates of public sector output growth and consequently GDP growth overall. For under-estimation of public sector output growth to affect estimates of the output gap, it would have to have a differential impact on estimates of actual and trend output growth.

## **The housing market**

**29. The Committee believes that improving the functioning of the UK housing market has a key role, not only in terms of stability and growth in the UK economy, but also in tackling social inequalities by improving the access of families and others to decent housing at an affordable price. We also note the important role of the housing market in promoting labour mobility and regenerating deprived areas. We welcome the interim reports of the Miles review of fixed-rate mortgages and the Barker review of housing supply. Alongside any policy recommendations their final reports should also estimate how long it would take for any shift to fixed-rate mortgage finance in the UK, and improvements in housing supply, to produce a detectable difference in terms of smoothing the operation of the macro economy. We may examine the detail of any recommendations made as part of our regular scrutiny of the Budget. (Paragraph 57)**

The Government has recognised that reforms are needed to help increase the supply of housing, particularly affordable housing, and reduce volatility and promote stability. The Communities Plan, announced in February 2003 by the Deputy Prime Minister, places key housing, planning and regeneration policies in the context of wider requirements for sustainable communities, including jobs, quality public services, transport, a safe and healthy local environment and sound local government.

Building on these reforms, the Chancellor commissioned Kate Barker to lead a review of the factors affecting housing supply in the UK and David Miles to lead a review of the UK mortgage market. The Government welcomed their interim reports, produced at the time of the Pre-Budget Report, and looks forward to their final reports due by Budget 2004. These are independent reviews and the Government will wait to see what their final reports conclude and recommend. The outcome of the Barker and Miles reviews will be central to taking reforms forward.

**30. The Treasury should assess the extent to which allowing self-administered pension funds to invest in residential property by buying individual houses, rather than via any new type of Real Estate Investment Trust, will increase the sensitivity of the economy to the housing market and create opportunities for abuse. If the proposals are implemented the Inland Revenue should ensure that a robust regime is in place to prevent tax avoidance. (Paragraph 59)**

Large pension funds can currently invest in a range of assets including residential property. Small and self directed pensions, known as SSAs (small self-administered schemes) and SIPPs (self-invested personal pensions), cannot currently invest in residential property. This prohibition is designed to prevent pension scheme assets being used for the private use of the member or his or her family, where the rent foregone reduces the growth of the pension fund.

With the proposal to simplify the pensions regime, so that a single regime applies to all schemes, the Government has decided to extend the ability to invest in residential property to all pension schemes. This change is subject to the overall decision on pension regime simplification that will be made at the time of the Budget.

The Inland Revenue is putting in place legislation to ensure that any non-commercial or personal use of the property would lead to a benefit-in kind-charge on the individual. Individual property investment is not likely to be attractive in all cases, as all income generated must go into the pension pot. All transactions would need to take place within the pension fund envelope.

An appropriate compliance regime will also be put in place to identify and audit those schemes that do invest in residential property.

## **Taxation of small incorporated businesses**

**31. We would welcome further details (in advance of the Budget) of the nature of the Government's proposals for changes to the way tax is paid by owner managers of small incorporated businesses on the profits extracted from their company. (Paragraph 61)**

The Pre-Budget Report announced the Government's intention to bring forward proposals in the Budget to reform the tax treatment of profits extracted from small businesses; to ensure that differences between earned income and dividend income do not distort business strategies, or enable reductions through tax planning of individuals' tax liability. Further work is continuing to develop and assess detailed policy options, and it would be inappropriate to announce specific measures outside the normal Budget process.

## Child poverty and the Child Tax Credit

**32. We welcome the Government's action to reduce child poverty and note the substantial progress made so far. The approach needs to establish an effective balance between providing income to the parents through the tax credit system with expenditure on services aimed at increasing opportunity for both the parent and the child. (Paragraph 62)**

As set out in *Tackling child poverty: giving every child the best possible start in life*, published in December 2001, the Government's strategy for tackling child poverty involves ensuring decent family incomes, with work for those who can and support for those who cannot, and providing support for parents. It also involves delivering high quality public services and harnessing the power and expertise of the voluntary and community sectors.

Budget 2003 announced a Child Poverty Review to examine the welfare reform and public services changes needed to advance towards its long-term goals to halve and then eradicate child poverty. The review is underway, with a series of seminars having been held during autumn 2003 covering issues such as ethnic minority groups, educational outcomes, parenting, early years services, health outcomes, supporting families with disabled children and deprived areas. In taking forward this work the Treasury will continue to work closely with outside organisations. The Review will feed into the 2004 Spending Review.

## Savings

**33. We, therefore, request an explanation for [the] apparent contradiction in policy and recommend that the proposed ISA reductions should be reconsidered. (Paragraph 63)**

The Government introduced the ISA scheme in 1999 principally to give people—particularly those who have little or nothing put away—the chance to save flexibly and tax-free in a range of different savings and investments including cash, stocks and shares and life insurance. The Government wants to ensure that the ISA tax relief is distributed as fairly as possible. The subscription limits have therefore been set with the objectives of the scheme in mind.

Originally the overall annual subscription limit of £7,000 (£3,000 for the cash component) was due to be decreased to £5,000 (£1,000 for the cash component) in April 2000, after ISAs' first year of existence. But this decrease has been deferred until April 2006. This announcement was made in the 2000 Pre-Budget Report—it is not a new policy. The Government regularly keeps under review incentives for saving, including ISAs.

The Inland Revenue Press Release dated 17 March 1998 announced the introduction of the individual savings account (ISA) from 6 April 1999. This stated that:

*"it will have an annual subscription limit of £5,000, of which no more than £1,000 can go into cash and £1,000 into life insurance; however, in the first year of the scheme only (1999–2000), the annual limit will be £7,000 of which no more than £3,000 can go into cash and £1,000 into life insurance."*

The Pre-Budget Report of 8 November 2000 (p107) extended the £7,000 overall limit and £3,000 cash limit until April 2006:

*"To build on the success of ISAs, the Government will retain the £7,000 contribution limit for a further five years until April 2006. Keeping a higher £3,000 limit for cash will particularly help those low-income and younger savers who have saved in mini cash ISAs."*

### Additional information:

At the 2003 Pre-Budget Report hearings on 16 December 2003 and 18 December 2003 the Treasury Committee asked the Treasury to provide three pieces of follow-up information. These are provided in the note which accompanies this response.<sup>2</sup>

HM Treasury  
17 March 2004

## FOLLOW-UP INFORMATION REQUESTED FROM TREASURY IN DECEMBER 2003

### 1) Explaining changes in forecast nominal receipts (See QQ 124–156)

The Committee asked for a note explaining the reasons underlying the nominal increase in forecast public sector receipts between 2003–04 and 2004–05, as contained in Table B9 of the 2003 Pre-Budget Report, and detailed in Table 1 below.

**Table 1: Changes in tax receipts between 2003–04 and 2004–05**

	2003–04	2004–05	Change	
	£ bn	£ bn	£ bn	Per cent
Income tax (gross of tax credits)	118.8	128.3	9.5	8.0
Social security contributions	72.6	78.4	5.8	8.0
Corporation tax	29.4	34.6	5.2	17.5
Stamp duties	7.5	9.3	1.8	23.9
Value added tax	69.0	72.2	3.1	4.5
Fuel duties	22.9	24.8	2.0	8.6
Council tax	18.4	19.9	1.4	7.7
Other	84.2	88.7	4.5	5.4
<b>Total current receipts</b>	<b>422.8</b>	<b>456.2</b>	<b>33.4</b>	<b>7.9</b>

Around two-thirds of the projected increase in income tax receipts is a result of growth in wages and salaries, growing broadly in line with money GDP. The remaining increase is explained by:

<sup>2</sup> See below

- higher projected interest rates, which increase income tax receipts from interest income;
- fiscal drag. As is standard practice, income tax allowances and bands are assumed to grow in line with prices. As earnings tend to grow in real terms due to productivity growth, this adds to income tax receipts in 2004–05; and
- changes in the distribution of income. The slowdown in the world economy and weakness in equity markets over the past few years has had a particularly adverse impact on the profitability of the financial sector. This has also had a negative impact on the average marginal tax rate on wages and salaries as it has depressed the level of bonuses which are generally subject to the higher rate of income tax. The public finance projections assume that financial sector profitability will recover from its current depressed levels and move back towards its historical trend with GDP. As a result, financial sector bonuses are expected to increase and have a positive impact on income tax receipts.

The projected increase in national insurance contributions (NICs) in 2004–05 is also largely explained by general rises in the level of wages and salaries. In addition, there is a lagged effect of the increase in NICs rates that came into effect from April 2003, which boosts receipts. In particular, the new rates will not feed into NICs from the self employed until January 2005.

The return of financial sector profits towards historical trend rate described above, together with the rise in industrial company profits and the impact of the significant rise in equity prices observed in 2003, explains much of the expected increase in corporation tax in 2004–05. In addition, the overpayment of corporation tax by large companies observed since the introduction of quarterly instalments is expected to decline. There is also a positive contribution from previous Budget measures.

Stamp duty receipts are expected to rise by £1.8 billion in 2004–05, mainly as a result of expected significant year-on-year growth in property prices and equity prices. It also reflects the impact of Stamp Duty Land Tax, introduced in December 2003, on yield from commercial transactions, as 2004–05 is the first full year it will apply.

VAT receipts are projected using audited assumptions regarding the ratio of underlying VAT receipts to consumers' expenditure and the impact of the VAT strategy announced in the 2002 Pre-Budget Report and extended in the 2003 Pre-Budget Report. These cautious assumptions result in projected growth in VAT receipts in 2004–05 of 4.5 per cent, despite expected growth in 2003–04 of nearly 9 per cent.

The £2.0 billion increase in fuel duty receipts in 2004–05 largely reflects the normal forecasting assumption that duty rates will be increased in line with inflation at the time of the Budget, rather than in October as in 2003.

The growth in fuel duties in 2004–05 also reflects general economic growth, and the declining oil prices, which boost receipts by reducing fuel prices, thereby increasing demand.

The growth in council tax receipts reflects the conventional assumption that council tax rates will grow at similar rates to those observed over previous years. However, council tax receipts have no overall impact of the fiscal aggregates as the projections assume they are fully spent by local authorities.

The remaining growth in total receipts is broadly in line with economic activity. It also includes the impact of:

- indexation of duty rates and VED rates;
- higher CGT and IHT receipts, reflecting significant year-on-year growth in house prices and equity prices; and
- higher VAT receipts from government expenditure. Although these have no impact on the fiscal aggregates as they are also included in the spending forecasts.

## 2) Goldman Sachs article on public sector inflation (See QQ 198–201)

***Goldman Sachs European Weekly Analyst 12/12/03: “UK Public Spending – Where’s the Money Gone?”***

This article discusses the increases in public sector inflation – as measured by the government consumption deflator – over the past few years, but gives little consideration to probable mis-measurement. Indeed, Goldman Sachs’ analysis suggesting significant increases in both labour and non-labour cost inflation in the public sector relies heavily upon real government output being measured correctly.

Goldman Sachs look at the increase in public sector inflation, divide this between labour and non-labour components, and compare their rates of growth to the private-sector. This approach, however, ignores the underlying issue as to how much of the growth in measured public sector inflation has resulted from the mis-measurement of real public sector output. Hence, without taking into account such mis-measurement issues, attributing the increase in measured public sector inflation to either a slowdown in productivity growth or an increase in non-labour cost inflation has significant caveats.

Indeed, as set out in Box A4 on page 184 of the Pre-Budget Report, there are reasons to believe that real public sector output (and hence public sector labour productivity growth) is being significantly under-recorded, and inflation correspondingly over-estimated. While the article alludes to the Pre-Budget Report text, it does not address these measurement problems.

An ONS article published in July 2003 stated that: “*some government spending may have been on things which improve outcomes but do not contribute to output as measured for the National Accounts; ONS’ measures may not have monitored all outputs being produced; and ONS’ output measures may have failed to reflect all of the quality improvements made in outputs.*” This again suggests that real public sector output growth is being significantly under-recorded, and hence that both labour and non-labour cost growth are being over-estimated.

The Goldman Sachs article further argues that “*for the acceleration in costs to be explained entirely by measurement error, biases in the measurement of public sector output must have increased significantly in recent years, not just in absolute terms but also relative to the private sector*”. There are strong grounds for believing that measurement bias has indeed increased in recent years. The pick-up in growth in the government consumption deflator has coincided with the substantial increases in growth in nominal government consumption over the past few years, probably serving to highlight the deficiencies of the real output indicators and leading to marked overstatement of public sector inflation (as measured by the government consumption deflator).

### 3) Local Housing Allowance rates in Blackpool and Lewisham (See QQ194–197)

#### Blackpool LHA rates for November 2003

Number of Rooms	LHA
1 room	£ 47.50
2 room	£ 75.00
3 room	£ 97.00
4 room	£101.00
5 room	£120.00
6 room	£133.00

#### Lewisham LHA rates for December 2003

Number of Rooms	Lewisham Central	Lewisham Inner
1 room	£ 77.50	£ 92.50
2 room	£147.50	£200.00
3 room	£190.50	£252.00
4 room	£231.00	£284.00
5 room	£265.50	£363.50
6 room	£381.00	£437.50

## List of Reports from the Treasury Committee since 2001

### Session 2003–04

		Report	Govt Response*
First Report	The Transparency of Credit Card Charges	HC 125	<i>HC 431</i>
Second Report	Child Trust Funds	HC 86	<i>HC 387</i>
Third Report	The 2003 Pre-Budget Report	HC 136	<i>HC 478</i>
Fourth Report	Annual Report for 2003	HC 386	
Fifth Report	Restoring confidence in long-term savings: Endowment mortgages	HC 394	

### Session 2002–03

First Report	National Statistics: The Classification of Network Rail	HC 154	<i>HC 550</i>
Second Report	The 2002 Pre-Budget Report	HC 159	<i>HC 528</i>
Third Report	Split Capital Investment Trusts	HC 418	<i>HC 651</i>
Fourth Report	The Handling of the Joint Inland Revenue/ Customs and Excise PFI Project	HC 184	<i>HC 706</i>
Fifth Report	Annual Report for 2002	HC 491	
Sixth Report	The UK and the Euro	HC 187	<i>HC 1004</i>
Seventh Report	The 2003 Budget	HC 652	<i>HC 1028</i>
Eighth Report	Appointment to the Monetary Policy Committee of the Bank of England of Mr Richard Lambert	HC 811	
Ninth Report	Appointment of Ms Rachel Lomax as a Deputy Governor of the Bank of England and member of the Monetary Policy Committee	HC 1011	
Tenth Report	Inland Revenue Matters	HC 834	<i>HC 1181</i>

### Session 2001–02

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

\* Government Responses are usually received in the same session as the Report was published. Accordingly, the HC number refers to that session unless otherwise indicated.